Volume 31, No. 2, July 28, 2017

Quarterly Update

CWS Capital Partners LLC

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CWS

CALENDAR OF EVENTS

September 4, 2017
Labor Day
CWS Offices Closed

September 15, 2017
3rd Quarter 2017
Est. Tax Payments Due

October 16, 2017
2016 Personal Income Tax Return
Extensions Due

October 27, 2017
3rd Quarter 2017
Quarterly Packages Mailed

November 2017
CWS Capital Partners
Semi-Annual Conference Call

November 23, 2017
Thanksgiving Day Holiday
CWS Offices Closed

November 24, 2017
Day-after Thanksgiving Holiday
CWS Offices Closed

December 25, 2017
Christmas Holiday
CWS Offices Closed

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Stay To Play

By Gary Carmell

I just celebrated my 30th year with CWS and I have been so fortunate to have worked in one place with such great people for all of these years. It has also been an incredible laboratory for studying human behavior, psychology, economics, sociology, demographics, and politics, just to name some of the most important disciplines that have helped me become a better investor. I must say, however, that the most important lesson learned for me has been to buy well-located real estate with good long-term demand fundamentals while possessing the financial and emotional staying power to manage through downturns. Staying power is not very important if the assets you are trying to support do not recover their value. It is enormously important if they do. Thus, it is imperative that one purchase or invest in properties that have long-term durability.

So what makes me think that well-located properties with solid long-term demand fundamentals will recover to reach new highs in value after each downturn? Real estate is an

Continued on Page 2

Continued from Page 1

asset class that has traditionally done well during economic expansions and their prices tend to go higher as the increasing pool of global savings from pension funds, insurance companies, REITs, wealthy families, individuals, and firms like CWS allocate these funds to real estate possessing these characteristics.

The following chart from Green Street Advisors shows how its U.S. Commercial Property Price Index has more than fully recovered since the sharp downturn in values that occurred during the Great Recession. Those that could not or would not hold onto their properties would have obviously missed out on the recovery in asset values and the income produced during the recovery phase. One can see that the long-term trend has been higher, which is necessary to continue to believe that will be the case, if one wants to invest in real estate. While the index appears to be leveling off, we still think that the demand fundamentals of apartments are strong enough, combined with a more difficult construction lending environment, to warrant continued capital deployment in the industry. This is particularly the case with borrowing rates being less than the capitalization rates we are purchasing properties at. This enables these investments to generate competitive dividend yields and appreciation potential while also benefiting from the favorable tax treatment of owning real estate.

One of the reasons I believe that quality real estate should hold its own over the long-term is due to the continued income stratification occurring in our society and around the world. Quite frankly, wealthy people tend to prefer owning high-quality real estate because it is a great place to store wealth due to the payment of dividends, the tangibility of the investment, the scarcity value, inflation hedge, favorable tax treatment and benefits, and long-term performance.

Continued on Page 3

Continued from Page 2

The following chart shows how the share of income is increasingly going to a very small subset of the United States population. While the growth is not a straight line up, the trend is clearly towards greater concentration of income, as well as wealth within the top 1%.

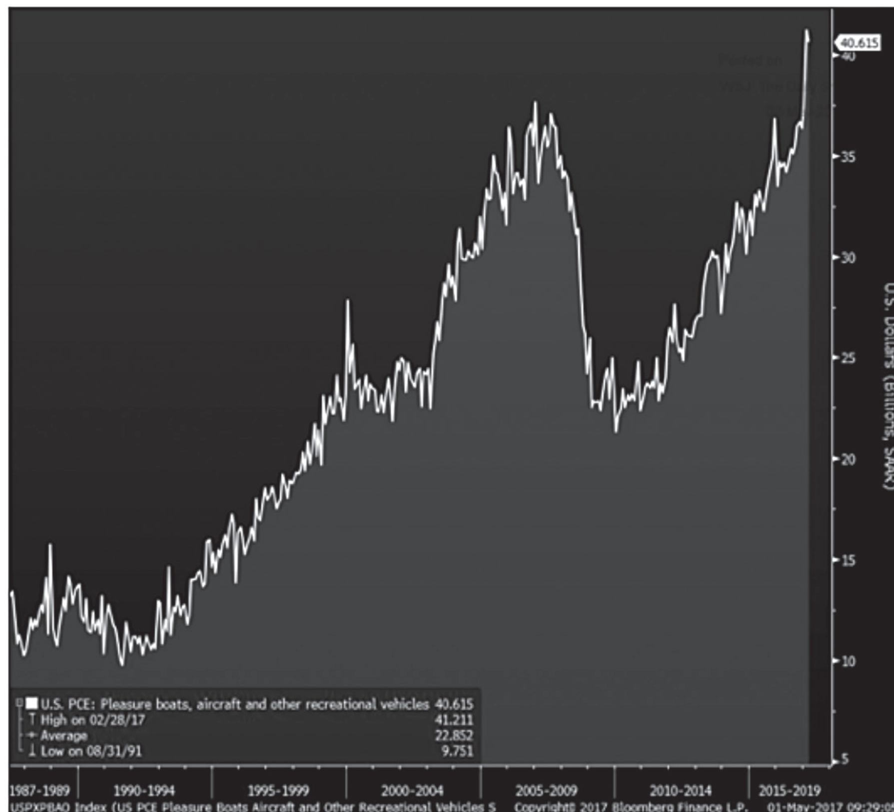
This trend speaks to the importance of owning high-quality assets that will be in long-term demand and having the staying power to manage through downturns since they should recover all of their value given the high elasticity of income and wealth among the global elite who will want to store their wealth in these types of assets. My premise is that there will be more global multi-millionaires and billionaires created as China continues to become wealthier, India remains on the path of reform, and the United States remains a very "financialized" type of economy which can create tremendous wealth for owners of capital and entrepreneurs. I also think the United States will be a highly desirable place to invest for the world's wealthiest individuals, families, and institutions.

It's important to be cognizant of the premises one is basing his or her investments on, therefore I will have to be on guard for changes in the political and economic environment that may counter these trends. Populism, a more redistribution oriented set of policies, and social unrest are trends to be paying attention to. Even if these do materialize more than they have there is a strong argument that these could buttress the demand for high-quality real estate even more because these types of investments are better places to store one's wealth than the stock market.

Continued on Page 4

Continued from Page 3

The following graph, while not depicting apartments, is one that I think is very representative of the importance of staying power. It shows annual expenditures on pleasure boats, aircrafts, and other recreational vehicles. Clearly these are discretionary expenditures as most people don't need these to live their daily lives. They are highly correlated to the economy and financial market returns since people will spend money on these items when they are earning higher incomes and will cut back on these expenditures during recessions and bear markets. I think it is an accurate depiction of what typically happens to real estate values in growing areas during various economic cycles.



Despite the sharp contractions, especially during the Great Recession, spending does recover and comes to exceed previous highs. This is not the case for all types of assets. For example, we sold our manufactured housing portfolio between 1998 and 2000 and some of these properties are worth less than what we sold them for or have barely appreciated during this long period of time. This is because the industry's buying power collapsed due to the poor lending standards that were present and led to large losses for lenders who never returned to provide capital to the industry.

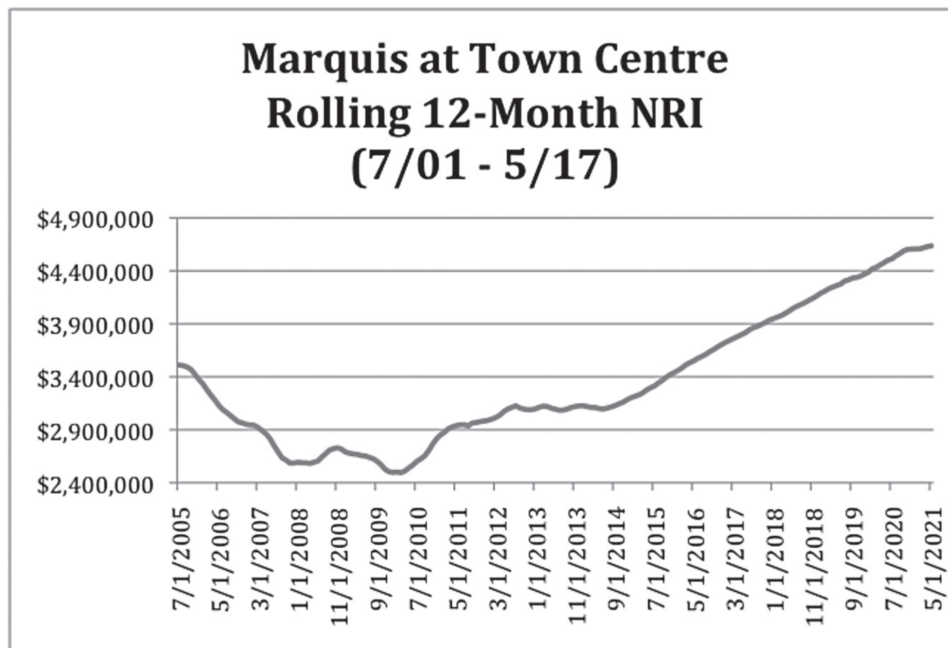
The Marquis at Town Centre in Colorado is a good example of the importance of staying power. We have owned this property since 2000 and our timing was rather poor when we bought it. If we were being brutally honest then we would say our timing couldn't have

Continued on Page 5

Continued from Page 4

been worse. We basically bought the property at the top of the market. Within a year we were in the midst of a terrible downturn in the technology sector which impacted Denver very negatively. And soon after September 11th happened. The results were not pretty as it experienced one of the most severe revenue contractions in the history of CWS' apartment ownership when between July 2001 and November 2003, as measured by the change in our rolling 12 months of net rental income, the cumulative drop was approximately 26%. Given we bought the property with debt of approximately 75% of the purchase price, we could not weather this storm without the need for additional capital.

This is where my disdain for fixed-rate loans with onerous pre-payment penalties came to burn through every cell in my body, into my psyche, and my soul. Our interest rate was 8% and the loan didn't come due until 2010. With so much time left until maturity and such a high interest rate in a declining interest rate environment we couldn't refinance without a huge penalty. We had no choice but to manage through by convincing our investors to infuse new capital into the investment to support it until the market improved and our debt came due and we could replace it with lower cost debt. The following graph shows that we ended up making the right decision in supporting the investment.



As the graph shows, our decision to seek new capital turned out to be the right one as we were able to refinance the property in 2010 with a 5% loan, repay the capital that was infused, and set the property up to capitalize on the powerful recovery that has taken place since then. Today the property is worth far more than we paid for it.

I have found it important to study our performance during the downturns that took place in

Continued on Page 6

Continued from Page 5

2001-3 and 2008-9 to see how the type of apartments we invested in performed when times got tough. The results are interesting. The 2001-3 downturn was much worse for us than the Great Recession. During the downturn of 2001-3, 15 properties had double digit cumulative drops in their net rental income. On a same store portfolio basis the cumulative revenue drop was approximately 9.5% over the 22 month downturn. That was a very painful time for us. Like Town Centre, a number of these investments required additional capital to get through the tough times and, also like Town Centre, they all recovered nicely to repay the capital and earn favorable returns for our investors. The value of staying power was proven many times over during that recession.

Despite much greater economic carnage, the downturn during the Great Recession was much more benign for our apartments. Our worst performing property had a cumulative 10% drop in net rental income while the portfolio only dropped about 3% over 19 months. Our challenge was more related to having loans maturing in a very difficult lending market. This necessitated having to extend or modify some of our loans as lending criteria had tightened up significantly, making it much more difficult to refinance maturing loans. I considered this more of a balance sheet recession than a cash flow recession. Our property performance held up reasonably well and relatively few of our properties required capital infusions to sustain themselves. The challenge was when the loans came due. Fortunately, we worked all of them out and they too have more than recovered and generally produced competitive rates of return for our investors despite the roller coaster ride that all investors were on during the 2008-9 near global meltdown.

These results lead to the natural question of, "What does this mean for Houston?" While I would expect it to fall somewhere in between the two downturns, we are weathering the storm in much stronger financial shape than the previous two downturns and I can't overemphasize how important this is. Right now the revenue downturn on a rolling 12 months basis is one year in duration and shows a cumulative drop of approximately 3%. All 16 same store properties are down and I would expect this downturn to last at least another year bringing the duration to 24 months, which would make it longer than the 2001-3 contraction. I don't expect the trough to be as severe and should bottom with a cumulative 6% to 8% reduction in net rental income. While it's not something we're happy about, all in all it is not catastrophic and pretty manageable. Fortunately, supply is dropping quite significantly in the suburbs and should peak in the next six months or so in the Inner Loop, which is the more urbanized part of Houston.

The lessons of the past have helped inform our decision making for the future. We were hampered in the early 2000s with high cost, heavy pre-payment, fixed-rate loans, negative

Continued on Page 7

cash flow, and the need for additional capital. The 2008-9 downturn still had some fixed rate loan challenges but better cash flow. The issue we faced then was maturing loans that needed to be refinanced or extended into a very inhospitable financing market.

Today, we are in much better shape. In general our working capital position at the properties is healthy, we only have a couple of Houston loans maturing in the next couple of years, one of which we don't expect any issues refinancing and the other may need a capital infusion but manageable relative to the overall capitalization of the investment. Our loans have very low interest rates because most of them are variable rates with current interest rates less than 3.25%, they can be prepaid with minimal cost, and the properties are generally all producing healthy cash flows.

I have come to learn that winning the game comes from being able to continue to play the game for a long period of time. In some areas of life one has to "pay to play." In real estate one has to "stay to play." This has been such a valuable lesson for CWS and me over not only the 30 years I have been here, but in our nearly 50 year history. It is why we are still on the field playing and at a very high level. It has been an honor and a privilege to have been part of such a special family these past three decades.