Volume 34, No. 2, July 31, 2020

Quarterly Update
CWS Capital Partners LLC

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CWS

CALENDAR OF EVENTS

September 7, 2020
Labor Day Holiday
CWS Offices Closed

September 15, 2020
3rd Quarter 2020
Est. Tax Payments Due

October 15, 2020
2019 Tax Return Extensions Due

October 30, 2020
3rd Quarter 2020
Quarterly Reporting Packages Mailed

November 26-27, 2020
Thanksgiving Holiday
CWS Offices Closed

December 24-25, 2020
Christmas Holiday
CWS Offices Closed

January 1, 2021
New Year's Day Holiday
CWS Offices Closed

January 15, 2021
4th Quarter 2020
Est. Tax Payment Due

January 29, 2021
4th Quarter 2020
Quarterly Reporting Packages Mailed

50 CWS Enhancing Lives Years

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THE POWER OF RESILIENCE

By Gary Carmell

I don't think one can overstate the importance and value of resilience in life. Events will take place that we are not prepared for financially, emotionally, physically, logistically, etc. We can either face the challenges head on or bury our heads in the sand and pretend that nothing has changed and ignore the new reality. COVID-19 is a real-time example of the importance of resilience. While most of us have read about concerns that one day there will be a global pandemic, we have never really assigned a high probability to it actually occurring. Ebola and SARS caused some global consternation but they were brought under control or localized so we could file these away as victories that should not cause us to worry in the event another virus manifests itself. In the case of COVID-19 we were wrong and now we are paying a steep price for it as the economy has been decimated with the loss of millions of jobs, especially ones that cater to people congregating together and traveling.

We are now operating in a very different world that has changed consumer behavior and what people value. We have to do our best to think about what changes are permanent and what new goods and services will come out of this. There are obvious immediate losers and winners. For example, while many people ascribe the severe economic contraction to government imposed lockdowns which led people to stop frequenting certain businesses and no longer traveling, the reality, based on recent research, is that most of the pain came from individuals voluntarily avoiding those businesses for fear of contracting the virus. Here is a summary of the findings from a paper written by two economists from the University of Chicago:

> *While overall consumer traffic fell by 60 percentage points, legal restrictions explain only 7 of that. Individual choices were far more important and seem tied to fears of infection. Traffic started dropping before the legal orders were in place; was highly tied to the number of COVID deaths in the county; and showed a clear shift by consumers away from larger/busier stores toward smaller/less busy ones in the same industry. States repealing*

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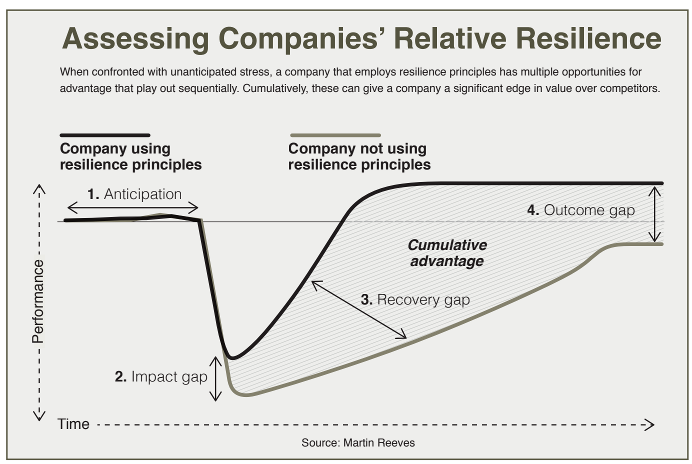
their shutdown orders saw identically modest recoveries--symmetric going down and coming back. The shutdown orders did, however, have significantly reallocated consumer activity away from "nonessential" to "essential" businesses and from restaurants and bars toward groceries and other food sellers.

Is the dramatic shift in consumer behavior permanent such that economic output will not recover for many years to come, if at all, and correspondingly the jobs associated with that output will not return? And will the winners stay elevated? Will automation be required, and therefore reduce the demand for labor, for those negatively impacted industries to enable them to rebound? What new inventions and services will come out of this for which people will value and generate a replacement to offset some of the lost economic output? How will real estate be utilized differently? What experiences will people shy away from and gravitate to? What will happen to the global supply chain? Will geopolitical tensions continue to escalate? What will happen socially as the economic carnage exacerbates inequality and the political and social divide run the risk of growing even wider?

We're at the stage where formulating the right questions is more important than the answers because it's too early to know what the answers will be. There are too many unknowns so it's better to try to come up with the most powerful unknowns so they can become, as Donald Rumsfeld famously said, "Known Unknowns". The right questions will allow one to think more expansively about the ramifications of COVID-19 on one's life and business and help one lessen the number of blind spots and better prepare for what may lie ahead.

I talked about how so few of us were prepared for what we're dealing with in the COVID age. But what if one's approach to life were to focus on avoiding disaster and ruin so that you're always on the playing field and can capitalize as one of the "last men standing" versus trying to maximize profits in the short run? It's a very different approach to life and running a business. The goal of the game is to always keep playing and you don't measure your success by how well you do in the good times, but were you able to survive and prosper during the difficult times and the ensuing recovery? While we in no way have been immune from the ramifications of challenging times, after 51 years in business CWS has learned from its mistakes and we have tried to incorporate these lessons into creating a more resilient organization.

I recently read an article from the Harvard Business Review about building more resilient businesses. The article included the following graph that I think has great applicability to all aspects of life, and not just business.



The most important first step is to have had an anticipatory mindset to think about what could go wrong internally and externally that can harm the business and take action to plan for such disruptions. If a management team can do this effectively, then they will be less hurt by the shock than one's competitors as the chart on the right shows. The chart assumes that no one is immune from the shock but the better prepared firms will be less impacted and will not have to be 100% on defense solving problems as compared to their competitors. The real separation will take place during the recovery when the better prepared firms expand the gap with their competitors such that they not only get back to where they were before the crisis but grow past it while their competitors are still lagging below.

CWS has tried to build a resilient organization by focusing on the following:

- Being in a good business with stable and growing demand fundamentals. Namely, rental housing in growing areas.
- Having a stable and experienced management team that has navigated the company through challenging times in the past.
- Having a diverse portfolio of properties in different locations throughout the country and catering to different customers.

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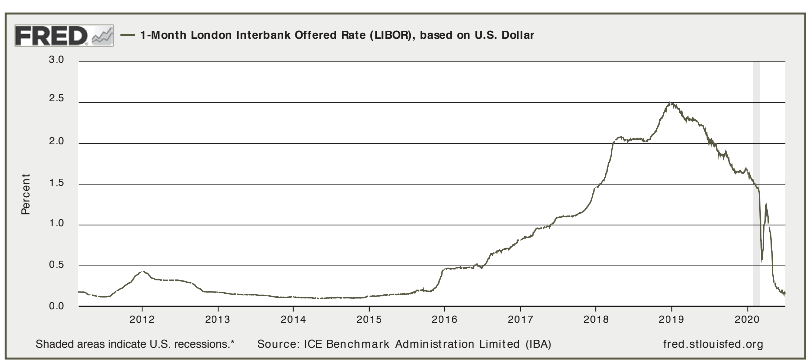
- Having no cross-collateralization of assets with debt. In other words, we don't have a situation where a problem with one loan can drag down a healthy property.
- Avoiding loans with covenants that create significant constraints on us, especially when financial performance deteriorates.
- We have built a fully-integrated organization that can handle all aspects of the apartment business from sourcing acquisitions, carrying out the due diligence, accessing debt and equity capital, handling the property management, asset management, and all of the ancillary services such as information technology, capital projects, development, human resources, training, compliance, accounting, tax preparation, regional maintenance teams, risk management, and investor relations. This gives us more control to take action quickly and to design a more resilient organization. It also provides us with more real-time information about market conditions to course correct if necessary.
- We have diverse capital sources such that we are not overly reliant on any one investor whose unique issues or points of view may diverge from ours and lead to sub-optimal decisions.
- We have an intense focus on building redundant information technology systems and disaster recovery plans as well as a very vigorous and diligent cybersecurity program to lessen the chances of an outside threat taking us down.
- We have focused on securing loan terms typically for 10 years and taking less leverage to secure the longest interest-only periods available to keep our debt-service costs lower so that if difficult operating conditions materialize, then we have less risk of losing the property due to payment defaults.
- We make sure that we make our investors aware of the critical importance of financial and emotional staying power when times get tough. It's inevitable that problems will arise that may require the need for additional capital to be invested so it's important to be financially prepared for this. We have also cultivated a large, loyal, and growing investor base that we can turn to in the event problems arise and properties need capital infusions that require funding outside of the ownership of the challenged properties. If a funding need falls short, then we have other investors willing and able to fund the shortfall.
- Approximately $2.7 billion of our $3.3 billion of debt is variable rate, which has probably created the most resilience for CWS.

This last point is something I have talked about quite often over many years. It has gotten so much attention because I believe it is at the heart of why I think we will be less negatively impacted than our competitors, which will allow us to play less defense and to enable us to organize and mobilize organizational and financial resources to capitalize on opportunities that may materialize out of the pandemic and its economic ramifications.

Our variable-rate strategy has resulted in us having a lower cost of funds than the fixed-rate alternatives that were available at the time our loans were originated. With that being said, there were some months when this was not the case and our cost of funds were at a premium. But we were not using this strategy to capitalize on the upside part of the cycle from a cash flow standpoint. The flexibility of this debt is what we looked to in order to do that as the lower pre-payment penalties could allow us to sell to take advantage of compelling values or refinance if better loans were available. Our true aim was to have a cash flow hedge in the event of a downturn. Our thought was that an economic downturn would probably not spare apartments and put pressure on our rents and occupancies but would also have a high probability of short-term interest rates coming down which would lower our debt service. And this has definitely played out. The following chart shows what has happened to 30-day LIBOR since 2011.



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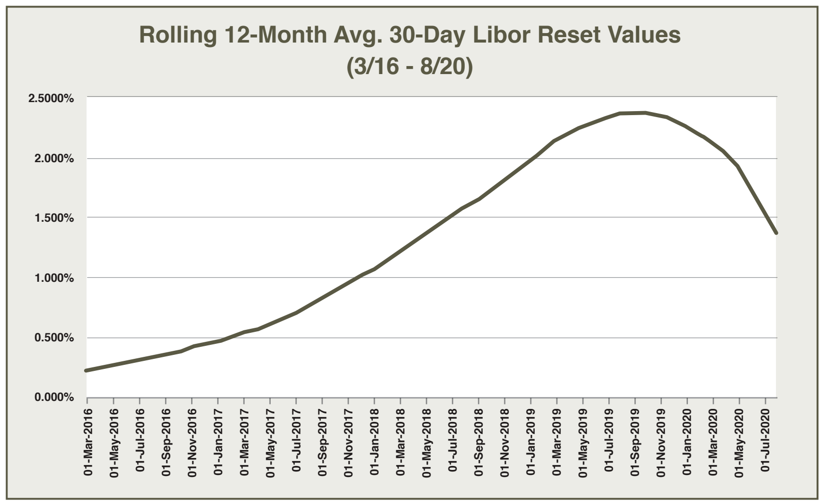
One can see that it stayed at a very low level for about four years and then started moving up in 2016 until it peaked in December 2018 at 2.52%. It then collapsed after the COVID outbreak and economic cataclysm with the Federal Reserve reacting aggressively by cutting interest rates to 0% and expanding its balance sheet rapidly and quite significantly. The average cost of our variable-rate loans is now approximately 1.85% based on the August payment, far less than the fixed-rate equivalent of nearly 4% at time of origination, thereby providing us with a debt service cushion of approximately $70+ million per year if rates stay this low for our variable-rate properties (currently 84 of them). And with Fannie Mae being our largest lender and CWS usually being its second or third largest variable-rate borrower, we know we are unusually concentrated with a large amount of variable-rate financing compared to the industry as a whole. Thus, it's highly probable that our output gap depicted in the chart earlier can be far greater than our competitors during the down cycle given our reliance on low cost, interest-only variable-rate loans with an average term of seven years remaining.

This next chart shows the rolling 12-month value for 30-day LIBOR used to calculate our interest rate for one of our loans. This is representative of most of our variable-rate loans. One can see that it has started to come down and now has an average index value of 1.37% between September 2019 and August 2020. What's important to note, however, is that index value for August is 0.162%, so on a go forward basis, assuming no change in LIBOR, which is a good assumption based on the Fed saying they are highly unlikely to increase interest rates before 2023, that we will have a tremendous tailwind with regard to our debt service over the next 12 months versus the previous 12 months and the last few years prior to that. As a frame of reference the average 12-month value for LIBOR in March 2016 was 0.232%, so there is a good chance we will be lower than that over the next 12 months.



While there are still too many unknowns to state with confidence that the debt service we expect to remain in place for the foreseeable future will translate into higher distributions given the uncertain economic long-term consequences of COVID-19, we do believe that we are afforded much greater financial and operational resilience as a result to compete as effectively as anyone in the industry.

And for those of you interested in how to build resilience to better handle COVID, here is the abstract from recent research done to test whether people who watch horror films and read frightening fiction are better able to cope with the effects of the pandemic. This is what they said.

> *Conducted during the COVID-19 pandemic, this study (n = 310) tested whether past and current engagement with thematically relevant media fictions, including horror and pandemic films, was associated with greater preparedness for and psychological resilience toward the pandemic. Since morbid curiosity has previously been associated with horror media use during the COVID-19 pandemic, we also tested whether trait morbid curiosity was associated with pandemic preparedness and psychological resilience during the COVID-19 pandemic. We found that fans of horror films exhibited greater resilience during the pandemic and that fans of "prepper" genres (alien-invasion, apocalyptic, and zombie films) exhibited both greater resilience and preparedness. We also found that trait morbid curiosity was associated with positive resilience and interest in pandemic films during the pandemic. Taken together, these results are consistent with the hypothesis that exposure to frightening fictions allow audiences to practice effective coping strategies that can be beneficial in real-world situations.*

Stay safe, stay variable, and watch horror films if you want to make it through COVID in decent shape!