Volume 36, No. 2, July 29, 2022

QUARTERLY UPDATE
CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

September 5, 2022
Labor Day Holiday
CWS Offices Closed

September 15, 2022
3rd Quarter 2022
Estimated Tax Payments Due

October 17, 2022
2021 Tax Return Extensions Due

October 28, 2022
3rd Quarter 2021
Quarterly Reporting Packages Mailed

November 24-25, 2022
Thanksgiving Holiday
CWS Offices Closed

December 26, 2022
Christmas Holiday (Observed)
CWS Offices Closed

January 2, 2023
New Year's Day Holiday (Observed)
CWS Offices Closed

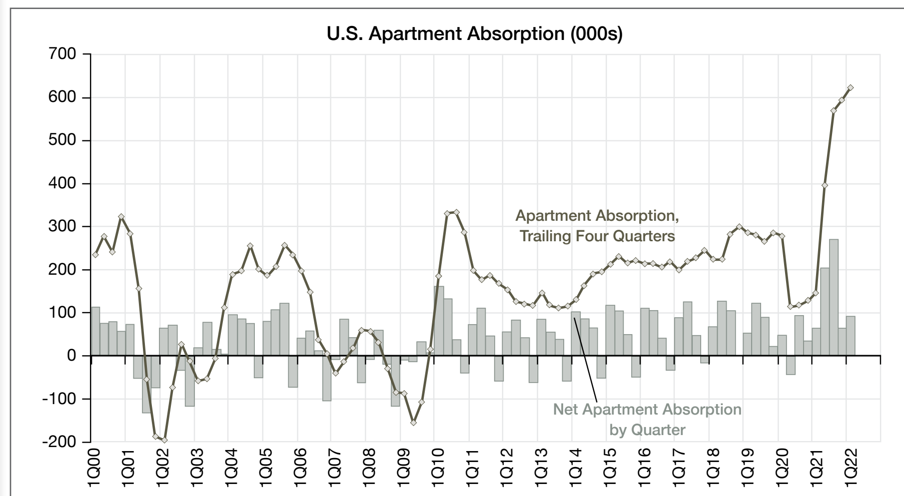
50 CWS Enhancing Lives Years

www.cwscapital.com

SUN SHOWERS

By Gary Carmell

If the tremendous demand for apartments is an economic indicator, then the weather conditions are quite pleasant and favorable to remain that way. This graph from Witten Advisors shows the huge demand for apartments and how it has greatly exceeded any other time frame in the last 20 years.



And while the economic outlook, independent of apartments, looks far less favorable on the horizon (showers, and more on this later), if we do go into a downturn, apartments should provide a shelter from the storm, as well as housing overall, as

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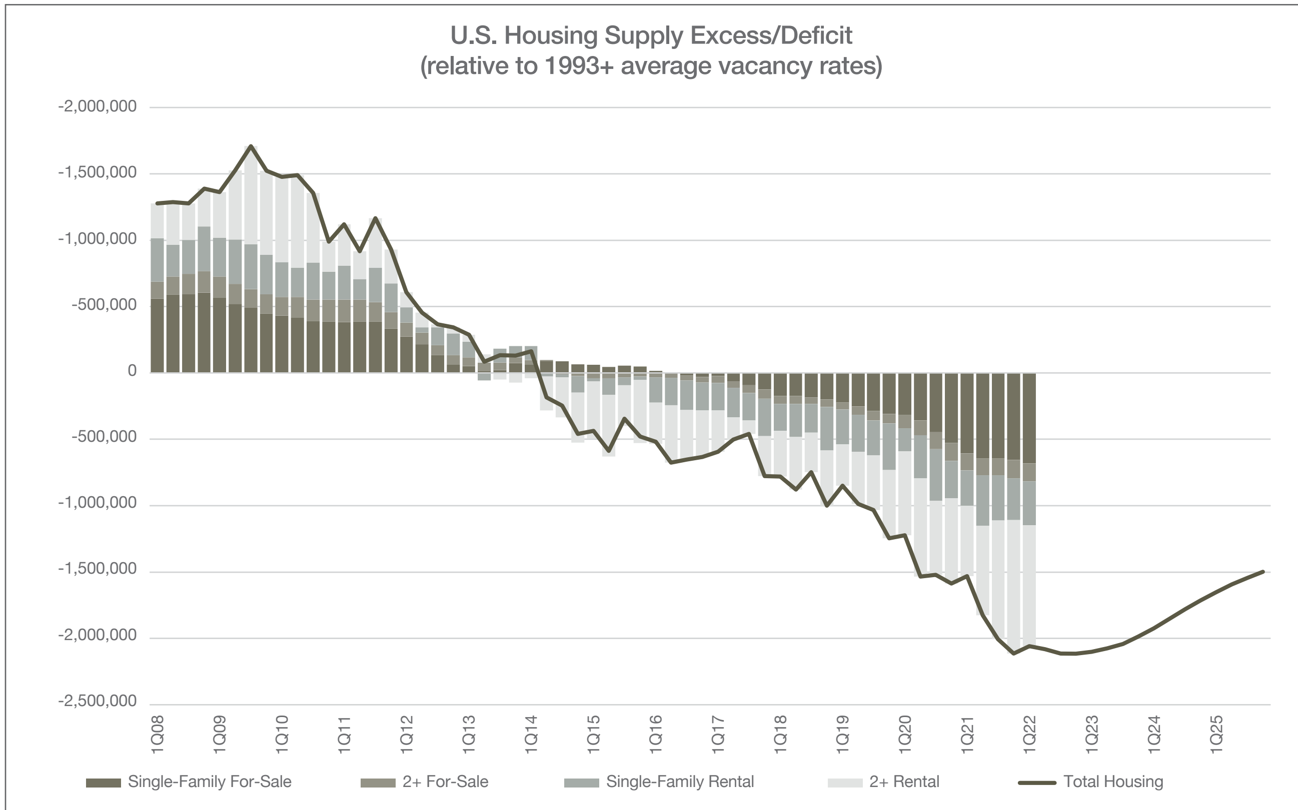
it is materially undersupplied as this chart from Witten Advisors shows. This housing shortfall has been building up for almost 10 years and has become particularly acute.



On a more micro level we are seeing similar trends in our CWS portfolio, which has translated to robust rent growth. Currently, we are in the process of transitioning to a new property management software so we are getting reports from two systems. The vast majority of our properties are still on the old system, however, so the data from this group is a very good sample size from which to draw conclusions. In that group for the month of June we showed the following:

	New Leases	Renewals
# Signed	1,836	1,680
New Rent per Sq. Ft.	$1.96	$1.81
% Change from Previous Lease	20.7%	14.5%
New Rent vs Avg. at Property	+16.7%	+7.7%

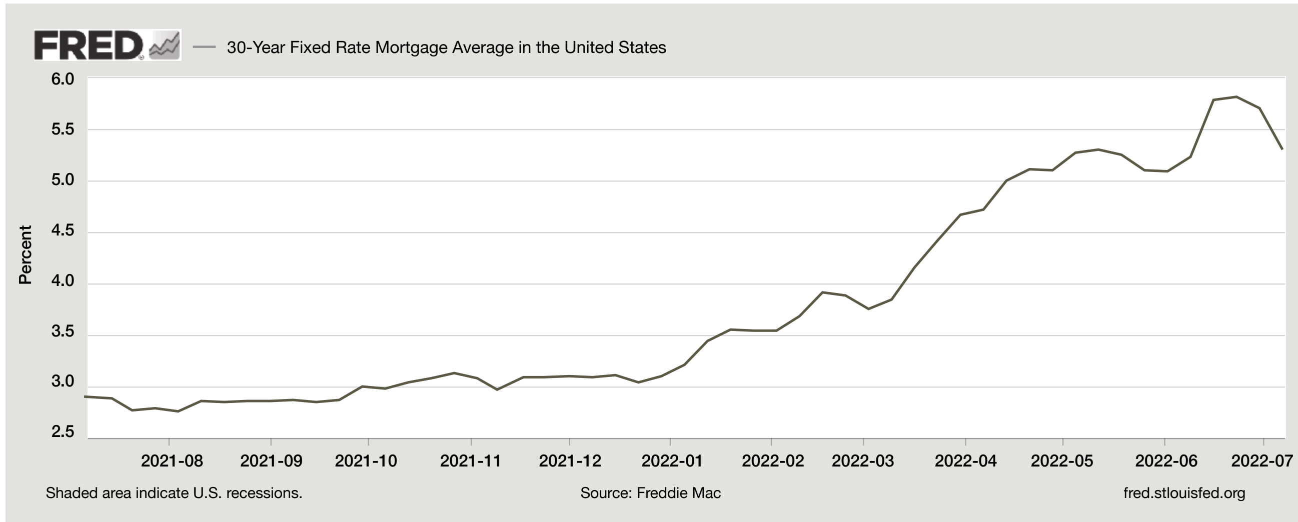
Given there is still a meaningful gap between the rental rates we are achieving for residents moving into vacated apartments and for those renewing, if we can keep attaining the same rent levels for new leases signed and those renewing, then one year from now we should have average rents in our portfolio higher by approximately 10%. And this is on top of the growth we have already experienced. Over the past year the average rent in this large sample has increased by approximately 12% with no impact on occupancy. If we are able to achieve

Continued on Page 3

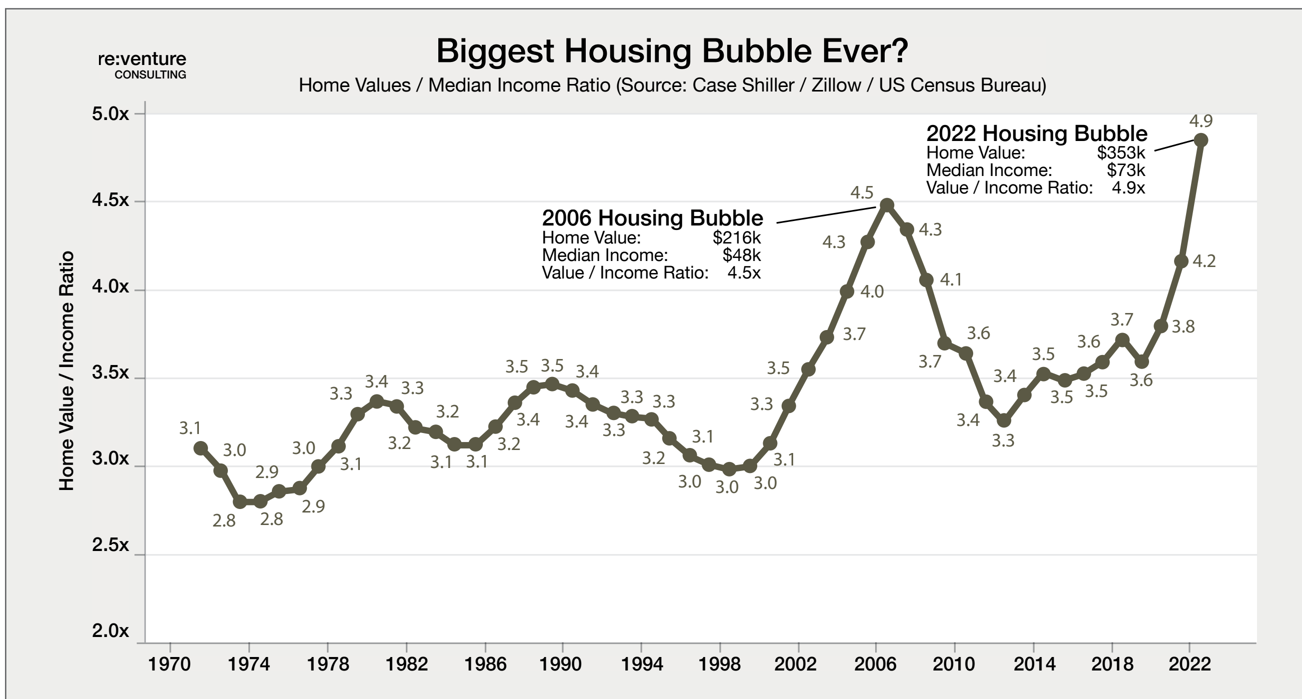
Continued from Page 2

an additional increase of 10% over the next year, then this would generate a cumulative 23% increase over that two-year period.

And while higher interest rates will clearly impact us negatively (discussed below), it should keep people renting longer than would otherwise be the case given the much higher cost of owning a home due to mortgage rates having gone up quite significantly, although they are down from their recent peak.



The following graph shows how home prices have become quite elevated relative to incomes. This made some sense when interest rates were quite a bit lower (and payments were more affordable) but becomes a much more challenging proposition with higher rates and a correspondingly much higher monthly payment.



https://twitter.com/nickgerli1/status/1544772458875703298?s=20&t=qo8ZLgxCmWYJjZUg6FQULA

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So where are the showers coming from? The first contributor is a much more hawkish Federal Reserve that is committed to squashing inflation via higher short-term interest rates, making financial conditions tighter, and shrinking its balance sheet. If this comes at the cost of economic growth and job losses, then "Damn the torpedoes!" That's just the cost of doing the dirty work it's been entrusted to carry out.

Higher interest rates negatively impact our floating-rate loans in terms of larger interest payments. In addition, the prospect for the economy to slow down, or even contract, can lead to less household formations such that supply may exceed demand and diminish pricing power of apartment owners like CWS.

The hawkish Fed is definitely going to have an impact on our debt service costs for our floating-rate loans. Our budgets assumed that the indices upon which our floating-rate loans are based, 30-day LIBOR and Overnight SOFR, would average 0.75% for the year. Through August (Our August 1 payment is based on LIBOR or SOFR at the end of June), 30-day LIBOR will have averaged 0.59% while SOFR will have averaged 0.31%. So far so good. Unfortunately, the market is pricing in a very aggressive Federal Reserve tightening path which would bring our projected average for 2022 to 1.32% for 30-day LIBOR and 1.25% for SOFR. Thus, it is highly likely that we will have a negative variance for our budgeted debt service for 2022.

One positive offset to this negative variance, however, relates to an interest rate cap that we purchased in mid-2020 for a number of our properties that expires on December 1, 2022. It pays those hedged properties in the event LIBOR exceeds 1.25%. Since 30-day LIBOR already exceeds this level, we should start receiving payments beginning in August and ending on December 1st. For those properties covered by this cap, then this would result in our hedged 30-day LIBOR averaging 0.76%, which is very close to our 0.75% budget. The purchase of this cap, which cost approximately $1,000,000 for over $1.7 billion of loans, is expected to pay our hedged properties over $6 million through December 1, representing a very good return on investment.

Most of our lenders require us to reserve for the future purchase of interest rate caps by having us escrow dollars each month. For years these cap costs were very cheap, not very volatile, and a minimal expense. They were especially cheap during the depths of the Covid economic downturn when investors believed that the Fed would keep interest rates very low for many years to come. And then inflation reared its ugly head and the Fed pivoted from believing inflation was transitory to becoming a much more embedded economic challenge that needed to be addressed head on. Its answer was to reverse course by aggressively raising rates and shrinking its balance sheet. This has only just begun and we're already seeing the cost of credit go up materially and the Fed's aggressive posturing has resulted in the cost of interest rate caps exploding.

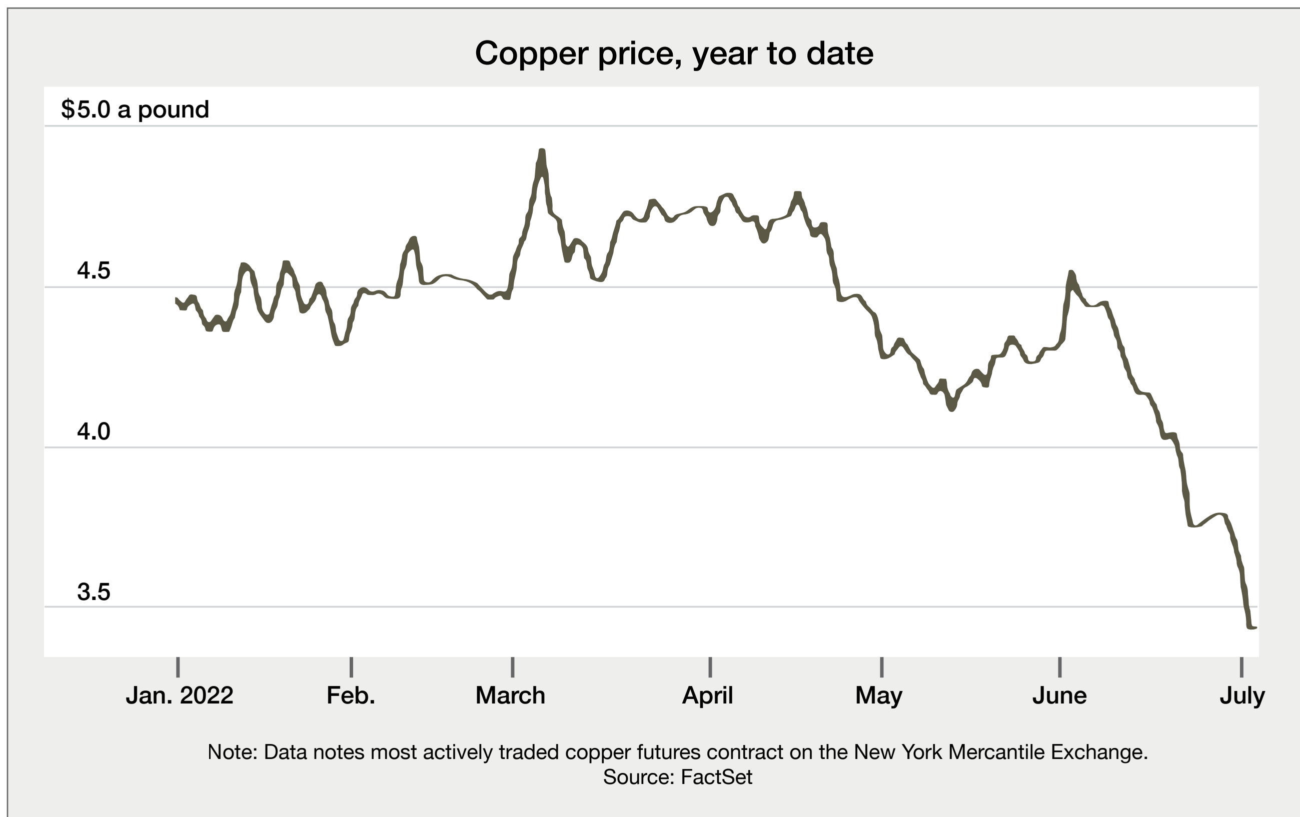
Our monthly impounds are going to go up materially which will impact our cash available for distributions. We are in the process of working with some of our lenders to see if we can

Continued on Page 5

Continued from Page 4

come up with less costly solutions so that we don't have to buy what we believe is extremely overpriced and almost worthless insurance. We don't need the caps because most of our loans have very low spreads over their indices and our leverage levels are very conservative. We have the ability to handle materially higher interest rates for the vast majority of our portfolio and still generate positive cash flow. That doesn't mean distributions won't be impacted (probably more of a 2023 risk versus 2022 for most of our properties) but the chances of having cash flow difficulties are relatively low. For this reason, we think purchasing caps is honestly a waste of money, but we are obligated to do so pursuant to our loan documents. We are working diligently to manage this exposure so that we can avoid spending our money in unproductive ways.

The other economic risk that may cause showers even while the sun is shining for our apartments is a materially slower economy or even a contraction. Copper is considered a very good barometer of economic activity and its prospects because it has so many industrial uses. One can see from this chart that it has fallen precipitously, which is not a good sign for the global economy.



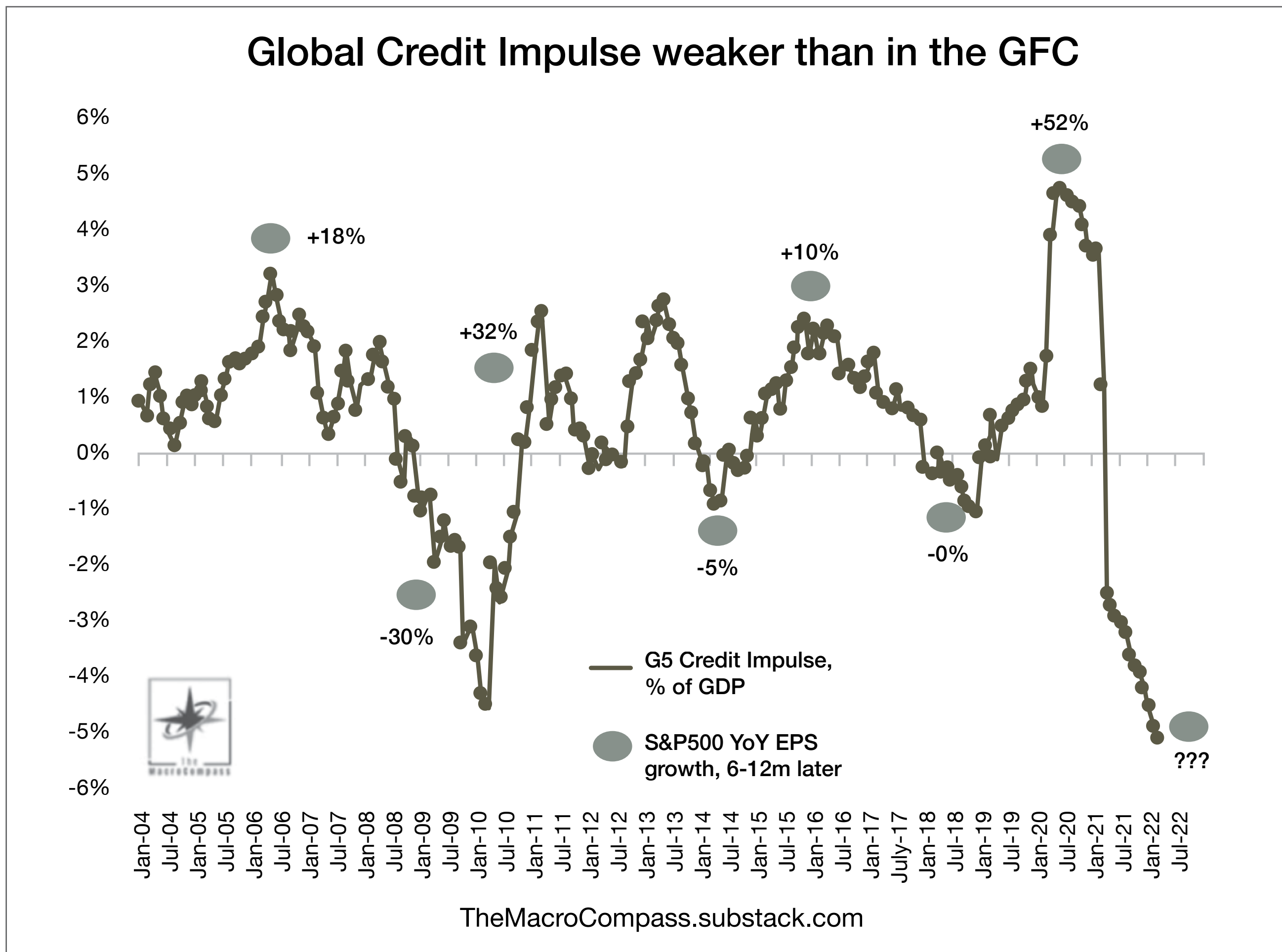
The same is happening with energy prices as well as oil which has dropped below $100 per barrel and gasoline which has also had a meaningful pullback.

With the Fed seemingly hell bent on slowing the economy and even pushing it into a recession to fight inflation, investors and providers of credit are getting more risk averse and this is

Continued on Page 6

Continued from Page 5

showing up in much tighter financial conditions. One can see from this chart that conditions were incredibly loose during Covid when the federal government was running huge deficits and the Fed was extremely accommodating via lowering rates and keeping them there while also buying huge quantities of Treasuries and mortgage-backed securities. These are now all in reverse and it is showing up as very tight financial conditions, at least via this indicator. If history is any guide, then this is not good for corporate earnings as it will put pressure on businesses to contain costs and eventually lead to layoffs, which are now starting to materialize.



https://twitter.com/MacroAlf/status/1545104357875519488?s=20&t=qo8ZLgxCmWYJjZUg6FQULA

I think it's a distinct possibility that we start to see a meaningful slowdown in job growth, especially among tech firms that have been raising large amounts of capital from venture capital firms and other equity providers predicated on a very robust IPO market to generate liquidity. That window has been slammed shut for now and more firms

The New York Times

Start-Up Funding Falls the Most It Has Since 2019

The drop was another fallout of rising inflation and widespread economic uncertainty, and a retreat after years of a funding boom.

By: Erin Griffith, July 7, 2022

Continued on Page 7

Continued from Page 6

are finding it more difficult to access capital as credit spreads have widened and investor uncertainty has grown with the advent of a very hawkish Fed that seems hell bent on tightening into weakening economic conditions.

"Venture capitalists, such as those at Sequoia Capital and Lightspeed Venture Partners, have cautioned young firms to cut costs, conserve cash and prepare for hard times. In response, many start-ups have laid off workers and instituted hiring freezes. Some companies — including the payments start-up Fast, the home design company Modsy and the travel start-up WanderJaunt — have shut down." — *New York Times*

Even hugely profitable firms like Facebook, Amazon, and Salesforce are tightening their belts.

TECH · META

Mark Zuckerberg warns staff Facebook will be 'turning up the heat' to weed out underperformers: 'You might decide this place isn't for you, and that's OK with me'

BY **SOPHIE MELLOR**
July 1, 2022 5:06 AM PDT

And while the labor market is still strong, it does appear that the best of this cycle is behind us as we face more headwinds. This is from job placement firm Challenger, Gray & Christmas' monthly report detailing job cut announcements.

"Layoff announcements have soared in the second quarter after an extremely low level of cuts in the first three months of the year. Through June, the annual total of 133,211 is down 37% from a year ago, but the second quarter is the highest quarterly total since Q1 of 2021."

"'Employers are beginning to respond to financial pressures and slowing demand by cutting costs," said Andrew Challenger, the firm's senior vice president. "While the labor market is still tight, that tightness may begin to ease in the next few months'."

This tweet shown on the right sums up much of my thinking as well as that of many investors.

The Atlanta Fed has developed a real time model of its estimates for real GDP that it updates daily as new information is released. One can see that the prospects are not pretty for the next GDP report.

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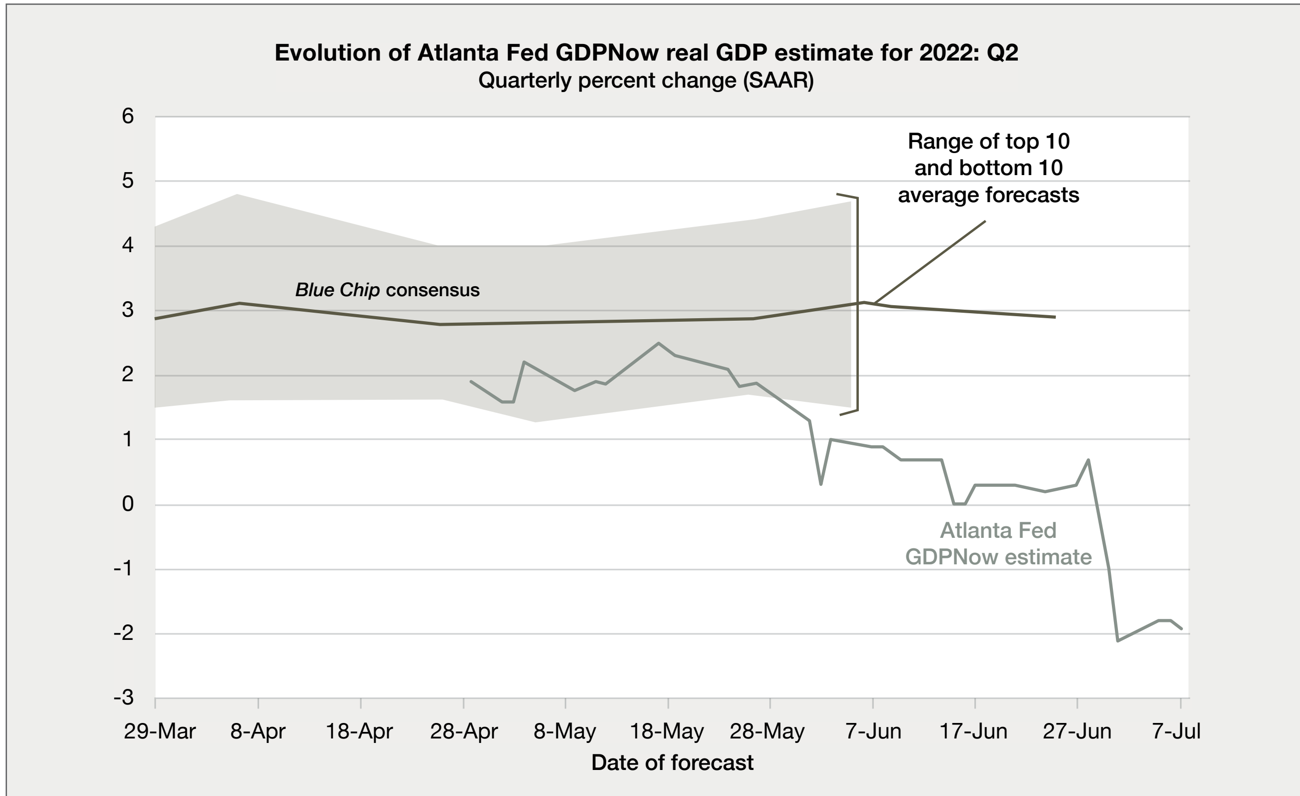
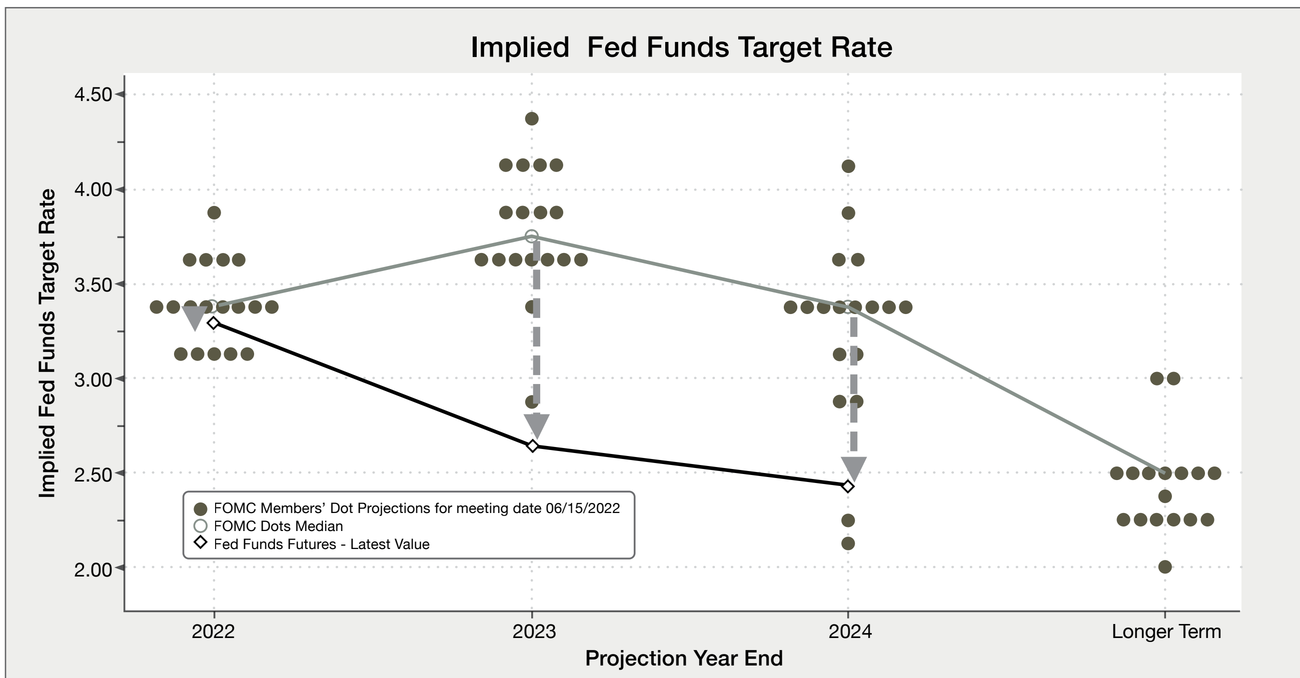


Investors are increasingly convinced that the Fed will have to reverse course in 2023 and start to cut rates once again as its hawkish approach will cause too much harm to the economy and inflation will no longer be its primary concern. This graph shows the growing gap between how the market sees the trajectory for the Federal Funds Rate and the forecast of Federal Reserve members.



Source: Zerohedge

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The one thing we do know is that in our lifetimes the sun will always exist. What will come and go are clouds, rain, and storms. The name of the game is to not let the storms sweep you away so that you can't enjoy the opportunities that arise when the sun shines again. We also want to be able to enjoy the rain when it does come because it can be refreshing, a nice change, and keeps life more interesting and us better prepared.

We continue to believe that we are in a great business which serves a fundamental need that is not easily disrupted. We have chosen to invest in properties in high demand metropolitan areas that cater to customers with a strong capacity to pay today's rents and higher ones in the future. And we have made a concerted effort to finance these properties with prudent leverage levels, pre-payment flexibility, and long loan terms such that we do not find ourselves backed into a corner having to repay loans at inopportune times. Finally, we have aligned ourselves with partners who have invested their equity with us with the understanding that their capital will be invested for long periods of time. The combination of the right debt and equity should provide us with the runway, patience, emotional fortitude, and financial staying power to weather the storms that will inevitably pass through.

And yet, despite the clouds forming on the horizon that are increasing the chances of rain, it is possible, given the housing shortage and the much less competitive single-family home market, that we could still have the sun shining on our business while rain is falling more generally. We believe we are prepared for this to not be the case, but if it is, then apartments could offer shelter from the storm.

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