Volume 35, No. 3, October 29, 2021

QUARTERLY UPDATE
CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

October 15, 2021
2020 Tax Return Extensions Due

October 29, 2021
3rd Quarter 2021
Quarterly Reporting Packages Mailed

November 25-26, 2021
Thanksgiving Holiday
CWS Offices Closed

December 24, 2021
Christmas Holiday (Observed)
CWS Offices Closed

January 3, 2022
New Year's Day Holiday (Observed)
CWS Offices Closed

January 18, 2022
4th Quarter 2021
Est. Tax Payment Due

January 28, 2022
4th Quarter 2021
Quarterly Reporting Packages Mailed

50 CWS Enhancing Lives Years

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INITIAL CONDITIONS AND THE ROAD TO DEVELOPMENT

By Gary Carmell

We have been spending a lot of time internally discussing why there has been such a dramatic increase in rents throughout most of our portfolio, as well as for most other large apartment owners. In the wake of the pandemic, there have been a number of variables which have been supportive of an increasing demand for apartments as well as housing overall. Any one of these in and of itself would not be enough to move the needle materially but, when combined together, we have what Charlie Munger calls the Lollapalooza Effect. This is when the combination of a number of variables produces an outsized, exponential effect, far beyond what would have been predicted. This seems to be the case in the wake of Covid-19 which led to the shutting down of large aspects of our economy and society that were focused on people congregating together. The following table is my attempt to identify the key variables and their effects/consequences.

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Variable	Effects/Consequences
Stimulus from federal government and states	Allowed people to not only preserve, but in many cases, enhance their buying power, as they could make more money by not working. This led to people staying in their homes or even being able to form new households despite a cratering job market.
Eviction Moratorium	This kept units occupied that otherwise may have become vacant, thereby pushing up rents for the smaller stock of available rental units. This limiting of supply gave landlords more pricing power in the face of improving demand.
Urban Flight (initially)	This had the effect of putting a lot of pressure on suburban rentals as these were cheaper and of more value since urban amenities were no longer valuable due to restrictions on congregating together and in some cities urban unrest created a less safe and desirable environment. For firms like CWS with a large suburban presence, this far outweighed the deterioration we experienced in our smaller urban portfolio. And now, with cities like New York coming back to life, landlords are starting to regain pricing power in some urban areas as well.
Work from Home	This has benefitted apartment owners with a large presence in lower cost, high quality of life areas like the cities in which CWS is invested. Metros like Austin, Dallas, Raleigh, Charlotte, Phoenix, Denver, and Atlanta have seen an influx of people taking advantage of a lower cost of living as their employers have allowed them to work remotely.
Aggressive Federal Reserve	The Fed has aggressively loosened monetary policy and lowered interest rates which has resulted in a steep drop in mortgage rates which has created more buying power for prospective home buyers.
Foreclosure Moratorium	This kept homes off the market that would have led to distressed sales. This curtailed supply which helped to not only stabilize prices but also contributed to them rising as Covid unleashed a tremendous demand for home purchases.
Covid Increasing Demand for More Space	With more people working from home the desire for more space increased significantly which has led to a big increase in demand for larger apartments, purchasing homes, and single-family rentals.
Supply Chain Disruptions	This has delayed the completion of new homes and pushed up the cost of construction which has further constrained supply in the short run and led to people renting longer as homes are taking longer to complete and pushing up home prices as well.
Initial Conditions – Shortage of Housing	As our internal debates and conversations unfolded, experience has shown us that when looking at any situation, initial conditions are very important. Had we been going into Covid with a surplus of housing, then the country would most likely have experienced a much more muted level of home price appreciation and rent growth, even in the face of builders naturally pulling back for fear of cratering demand. Instead, we already had a healthy apartment market and tight home ownership market that was not prepared for the unleashing of such strong demand. The only way for homes to clear the market was through higher prices. This was also the case for single-family rentals, as a meaningful number of such homes were sold, thereby reducing rental supply.

Since we are ascribing an outsized impact of the initial conditions of the U.S. housing market, particularly on the ownership side of the ledger, I wanted to spend the rest of this article showing graphical representations of this.

I have come to learn to never underestimate how important initial conditions are when evaluating various situations. If I am healthy when I get sick, then my chances of recovery are much greater than if I'm not healthy and have to fight a disease or other serious ailment. If I have had a bad day and someone comes to me with an issue, then my reaction to that person may be very different than if I were on Cloud 9. China is perceived to be turning more within and an increasing threat to global peace and prosperity. This situation and increasing set of tensions creates a lot more risk in our frazzled global supply chain and all its interconnections, in which China is at the epicenter, than if relations were strong and trust were high. China pulling back even more represents a very big risk to economic growth as well as of course doing harm to its own economy.

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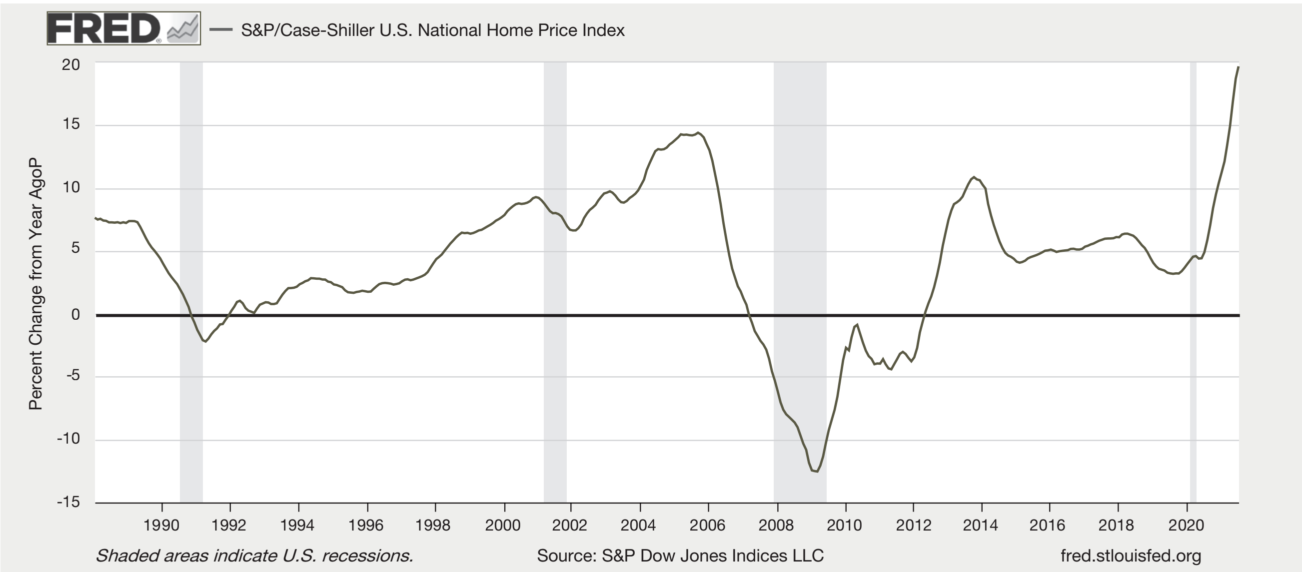
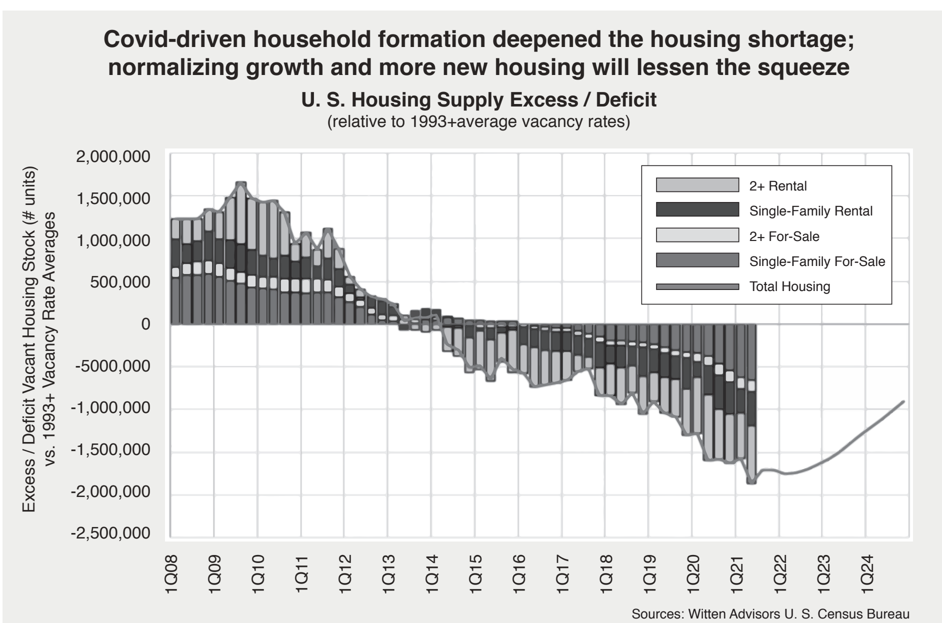
I bring this up in order to create some context for why I think when assessing most situations one should try to understand the initial conditions because absent that one may come to wrong conclusions and take on more risk than one expected or miss out on compelling opportunities.

One thing that most analysts seem to agree on is that we have a housing shortage in this country. Pricing behavior alone should confirm this as the following graph shows. The annual appreciation rate of home values has never been higher since the Case-Shiller Index was created.



What is up for debate, however, is how undersupplied housing is. One well-known analyst, Ivy Zelman, believes we are about 1 million units short in the United States. At CWS we subscribe to research done by Witten Advisors, whose focus is on rental housing, and they believe it's about 1.8 million as the following chart shows.



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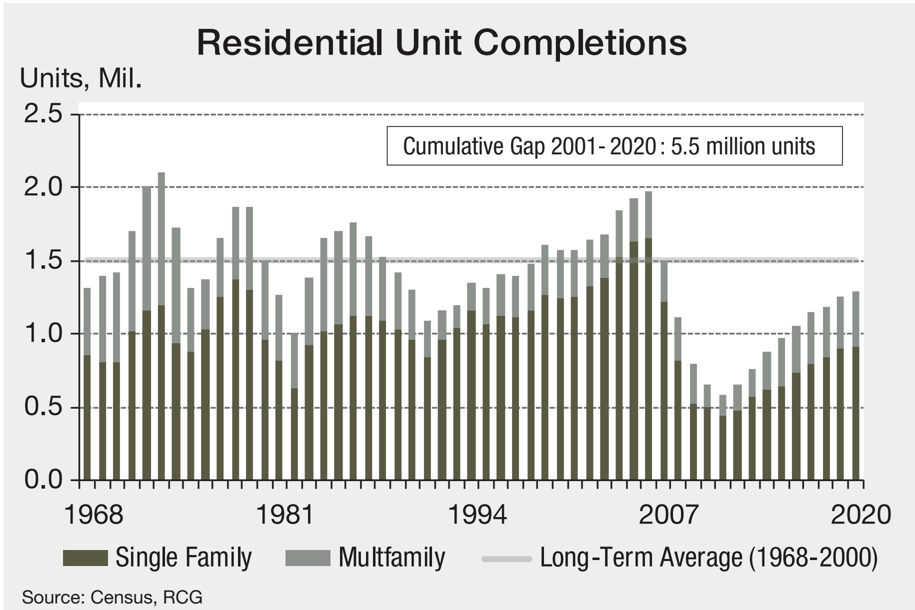
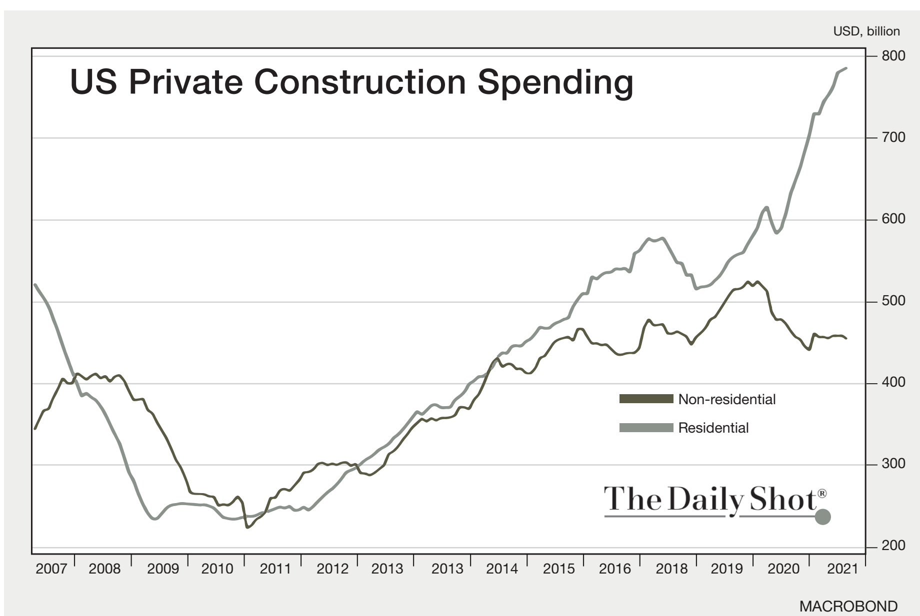
Ken Rosen is a very well-known housing consultant and analyst and he is one of the authors of a recently released report entitled *Housing is Critical Infrastructure: Social and Economic Benefits of Building More Housing*. The authors peg the undersupply at a much higher 5.5 million units. I will use a number of the report's charts to show how it does appear we have a meaningful deficit. Whether it's 5.5 million I really don't know, but I think it's safe to say that there is more demand than supply for housing and these conditions look to remain in place for a number of years.

The authors are coming up with the 5.5 million undersupply estimate by assuming that equilibrium demand is 1.5 million units per year based on the average number of units built between 1968-2000, prior to the previous housing boom taking off. This methodology is probably up for debate based on demographic factors, societal changes, economic growth rates, etc. Regardless, we are still building a lot less even 14 years after the subprime debacle and Great Recession.



One may draw a different conclusion from the following table, but I think the tremendous increase in the value of residential construction is much more a function of higher costs than more units being produced annually.



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This next chart shows how the annual growth rate of the U.S. housing stock has slowed quite markedly which speaks to the rapid increase in the dollar volume of construction being a function of significantly higher costs.

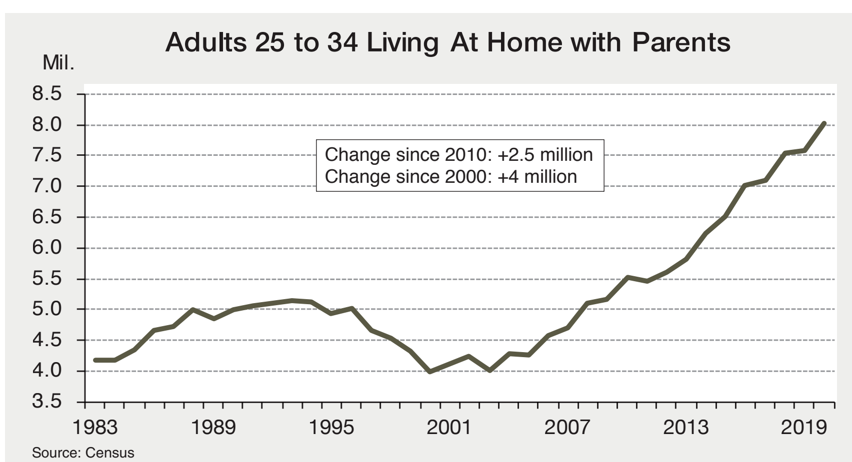
The next table shows the authors' estimates as to how each major category of housing is undersupplied. Interestingly, multifamily housing (5+ units) has the highest deficit, with it being quite a bit larger than single family as a percentage of its stock of housing since there are many more single-family homes than units in buildings with five or more units. And while not all 5+ units are rental, the vast majority are.

Residential Underbuilding from 2001 to 2020 (units)

Building Type	Long-term Average (1968-2000)	2001-2020 Averge	Annual Gap	Cumulative Gap (2001-2020)
Single Family	1,041,000	940,000	101,000	2,020,000
2-4 Units	74,000	19,000	55,000	1,100,00
5+ Unit	387,000	267,000	120,000	2,4000,000
Total Completions	1,501,000	1,225,000	276,000	2,520,000

Sources: Census, RCG

We have been talking a lot over the years of potential pent-up demand for household formations from children living at home. What is even more surprising is the significant number of 25- to 34-year-olds who have not moved out of their parents' home. This cohort represents a



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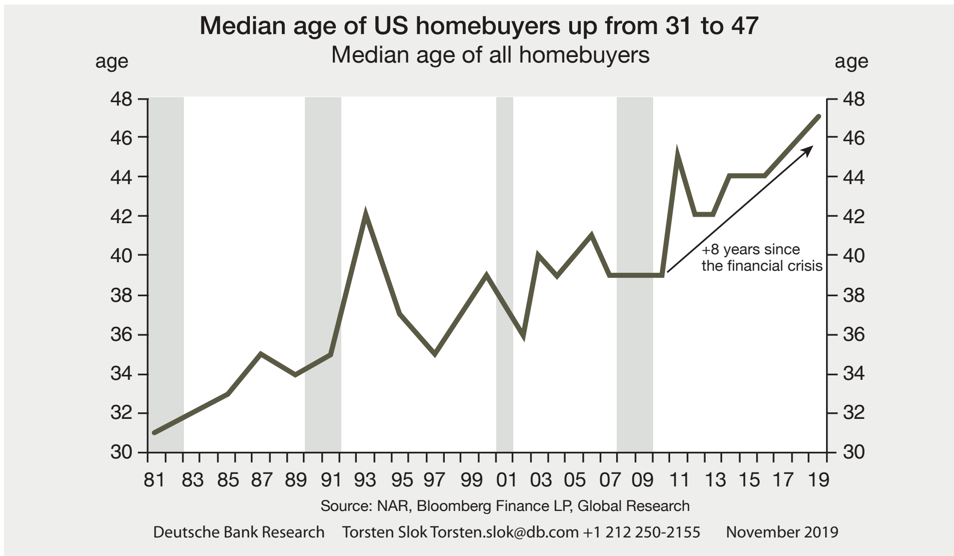
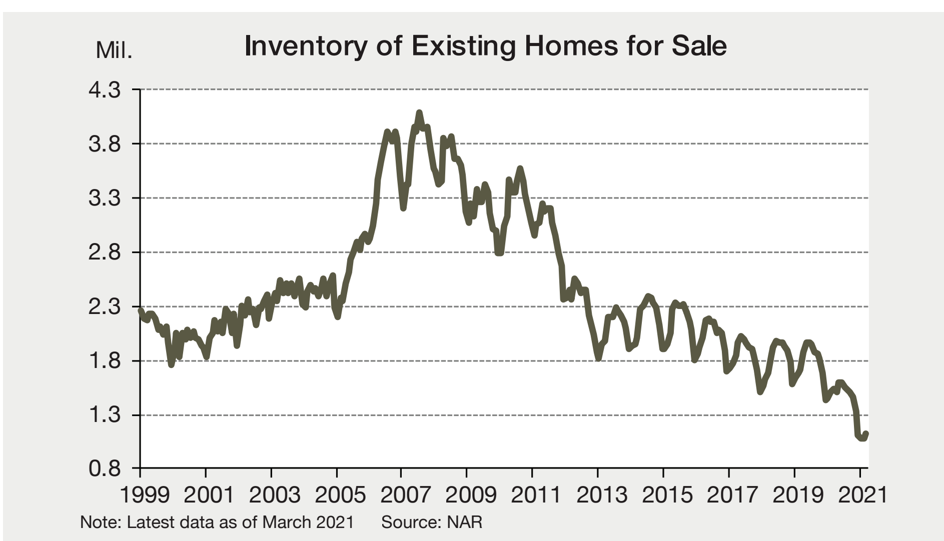
very large potential source of demand in the years ahead provided they have the inclination, life skills, and financial wherewithal to form their own households.

The median age of home buyers has increased significantly as well which has helped apartment occupancies remain strong as people are renting for longer.



The strong demand and curtailed supply have resulted in the number of homes available for sale being at very low levels. This is a combination of homes selling quickly and sellers being reluctant to sell for fear of not feeling comfortable about where they will move next and whether they want to pay the high prices, even though they will be selling into a strong market that will free up much more equity they can use to purchase their next home.



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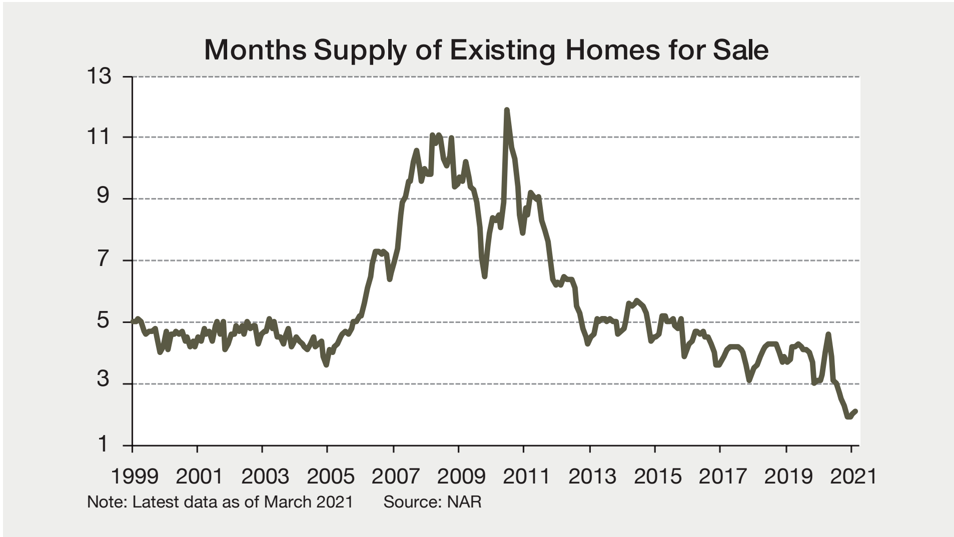
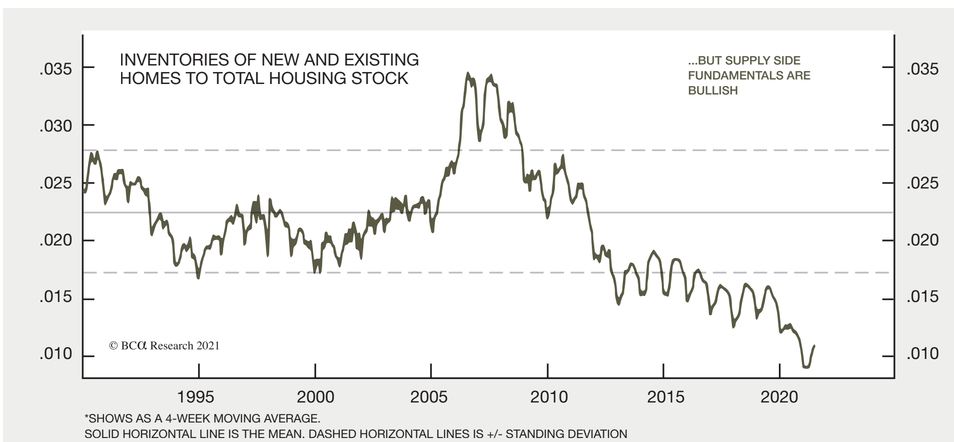
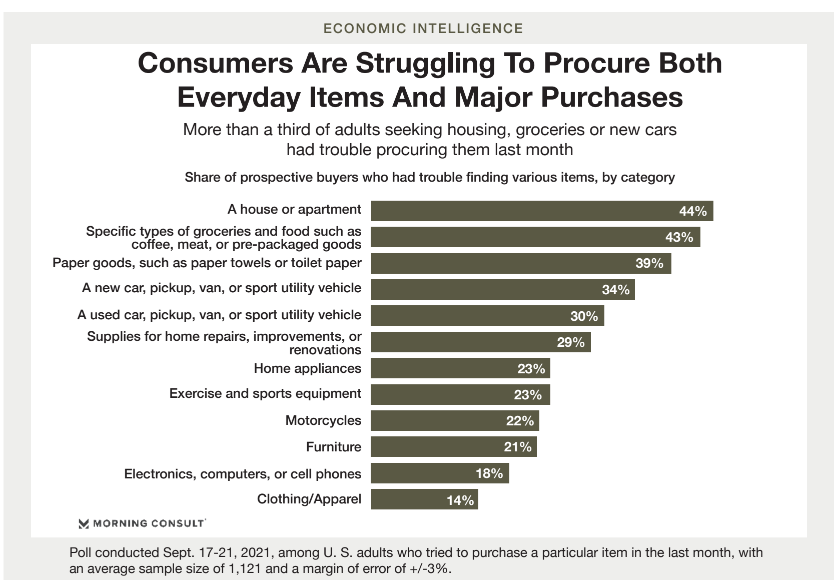


This next chart shows how the inventory of homes for sale as a percentage of the overall housing inventory is near its lowest level over the last 30 years.



This consumer survey shows how housing is the item that is perceived to be in the shortest supply.



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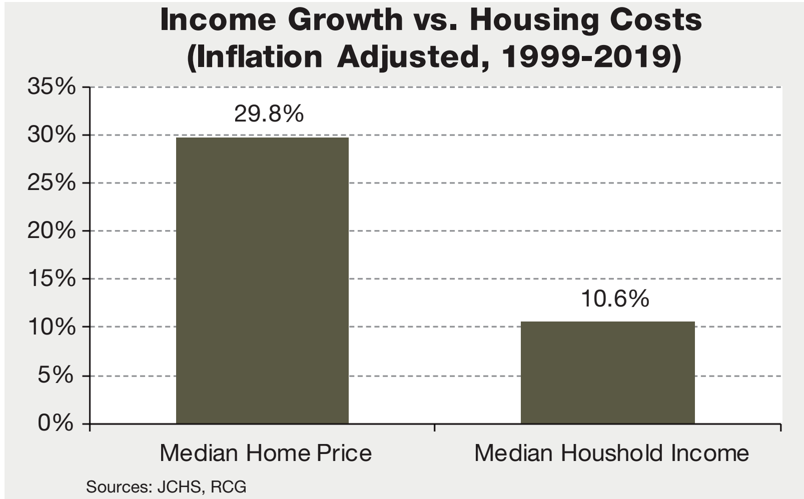
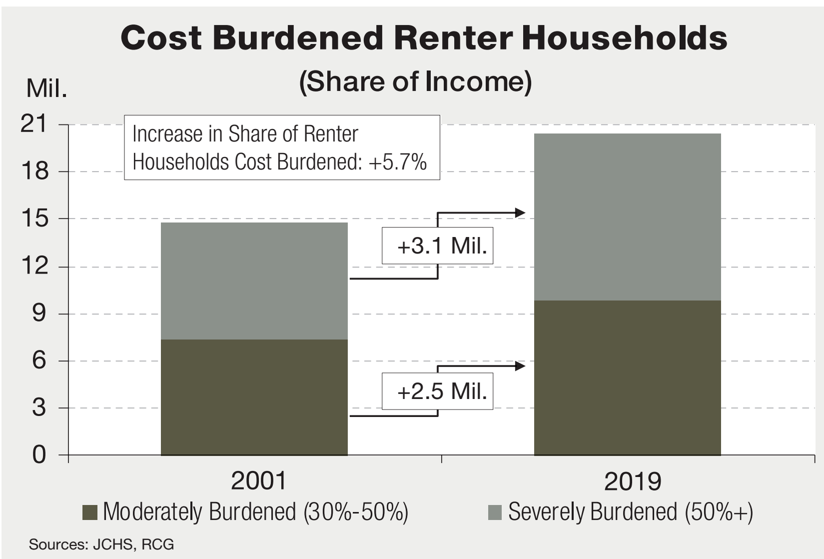
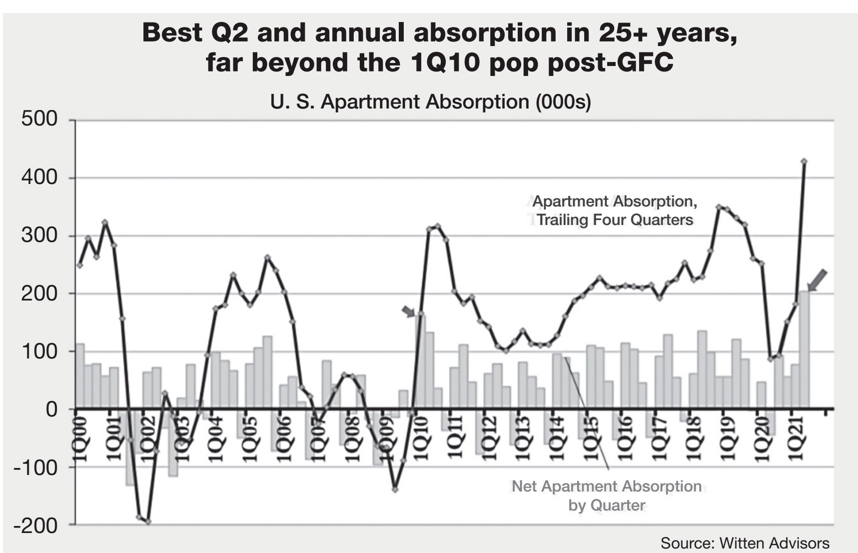
Lower mortgage rates, which has helped fuel this high demand, have contributed to pushing home values far beyond the growth of median household income between 1999 and 2019. And with the ferocious appreciation that has taken place over the last two years, this gap has only widened.





This has spilled over to the rental market as rents have outpaced wage gains which has created a larger number of cost-burdened households.

And this is only going to get more challenging as one can see from this chart that the number of apartments leased over the past year is the highest since Witten Advisors has been tracking this indicator.



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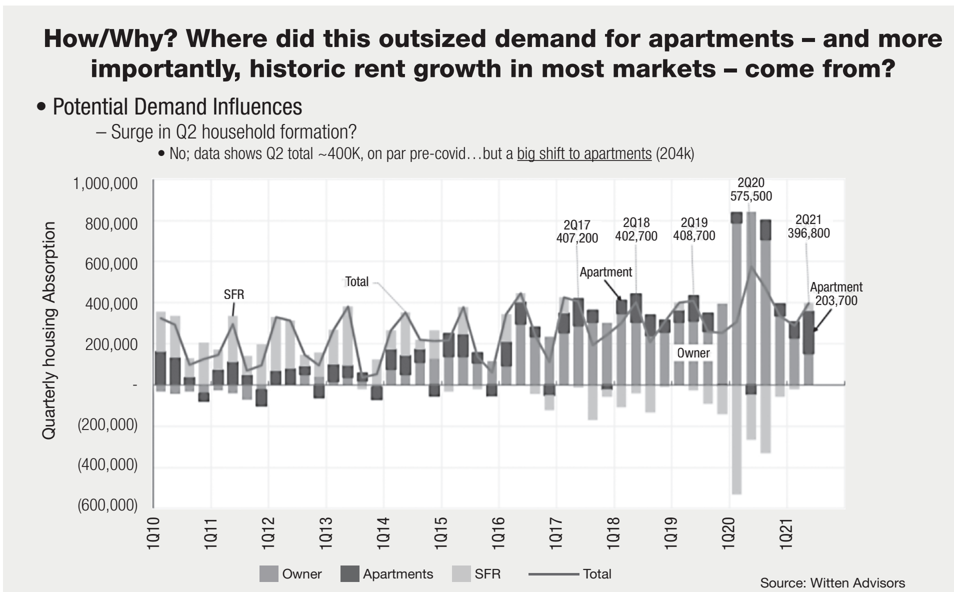
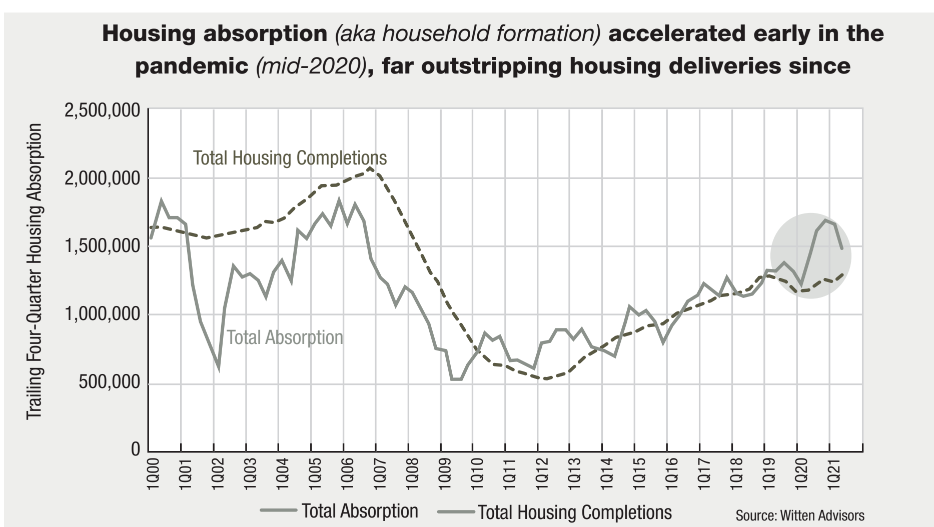
The next chart attempts to identify the variables leading to such strong demand for apartments and quantifying their impact. There was a huge increase in household formations among home purchasers. This was partially fueled by a significant reduction in single-family rentals that were sold and taken out of the rental pool. After such a meteoric rise in owner-occupied households, this growth has slowed down quite a bit and the slack, relative to pre-Covid household formations, has been made up by a sharp increase in renter households. Perhaps homes have become too difficult to buy with the steep competition, they have become too pricey, or a combination of both. One of the byproducts of this has been a record demand for apartments.



This chart shows how household formations have grown at a much more rapid pace than new housing deliveries which further explains the rapid appreciation in home prices and rents.



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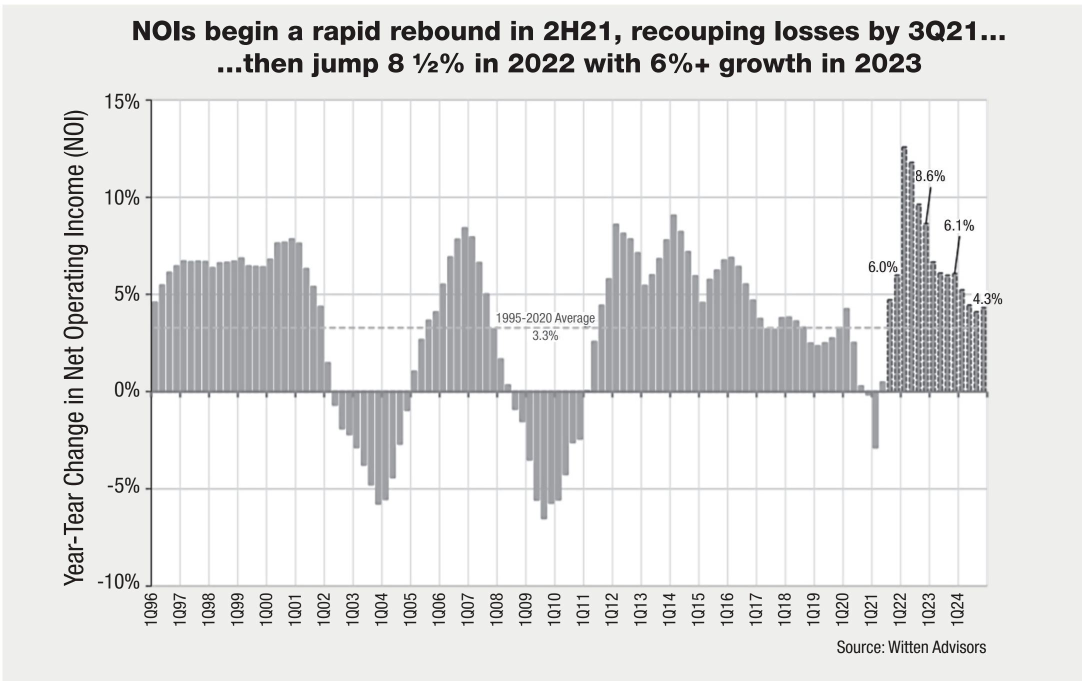
For apartment owners like CWS, this rapid demand has materially improved our Net Operating Income (revenues minus expenses). This is Witten Advisor's estimate of what has happened to apartment owners' Net Operating Income. After dropping during Covid, which should not have surprised anyone, it has roared back such that they are projecting even stronger growth in 2022 and continued strength, albeit at a lower rate, in 2023 and then decelerating some after that. If this materializes this would be very fortuitous for large owners of apartments.



CWS is very fortunate to be focused on rental housing in the markets in which we're invested. We are benefiting from the unprecedented demand for housing that is exceeding supply. This, in combination with an extraordinary amount of capital wanting to invest in apartments, is creating tremendous competition to buy quality apartments in growing areas like those in which we are invested. This has led to a historic expansion in the multiple being paid for apartments. These charts and the many factors impacting the demand for housing and the challenge in meeting that demand with new supply, leads us to conclude that developing new apartments offers us a very compelling risk-reward trade off and is something that CWS will not only continue to focus on, but will expand this part of our business more aggressively in the years to come. We have five communities in some stage of development in Austin and we are working on two in Phoenix. We are excited to allocate more capital and organizational resources in this area that we hope will continue to offer our investors compelling returns in this era of what appears to be a sustained housing deficit.