Volume 29, No. 4, January 29, 2016

QUARTERLY UPDATE

CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

March 15, 2016
Year 2015 K-1's Mailed by Date

March 25, 2016
Good Friday
CWS Offices Closed

April 18, 2016
2015 Federal & State Tax Filing Deadline
1st Quarter 2016 Est. Tax Payments Due

April 19, 2016
CWS Annual Partners Meeting
Newport Beach Marriott Hotel and Spa
Newport Beach, CA (Fashion Island)

April 29, 2016
1st Quarter 2016
Quarterly Packages Mailed

May 2015 (Date/Time TBD)
CWS Capital Partners
Semi-Annual Conference Call

May 30, 2016
Memorial Day
CWS Offices Closed

June 15, 2016
2nd Quarter 2016
Est. Tax Payments Due

July 4, 2016
Independence Day
CWS Offices Closed

July 29, 2016
2nd Quarter 2016
Quarterly Packages Mailed

www.cwscapital.com

WEATHERING THE STORM

By Gary Carmell

2015 was a pretty interesting year and so is the beginning of 2016. 2015 was so challenging from an investment perspective that, according to a report on CNBC, it was the hardest year to make money in 78 years as virtually every asset class struggled. Let's go down the list of some notable events that took place.

- Oil imploded along with other commodities
- China weakened its currency
- China slowdown & massive stock market intervention
- The dollar has been on a strengthening tear
- The Fed finally raised short-term interest rates
- The junk bond market weakened substantially, particularly for energy credits
- Manufacturing has experienced a pretty material slow down
- Shia-Sunni sectarian war culminating in Saudi Arabia breaking off diplomatic relations with Iran
- Russia's intervention in Syria
- Terrorism in Paris and San Bernardino

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The increasing volatility and diminishing risk appetite among investors translated to bond market participants requiring greater compensation to own corporate bonds. The increase in the cost of credit in the corporate bond market spread into multifamily lending as Fannie Mae and Freddie Mac significantly raised their spreads (the premiums over risk-free Treasury securities for fixed-rate loans and the spread over Libor for variable-rate ones), particularly for variable-rate loans like CWS tends to use to finance our properties. For a while we hung out quietly in the corner not seeking attention regarding our focus on variable-rate loans. This suited us well as there was not a significant amount of demand for paper being backed by such loans but enough to have offered us very competitive spreads. This sanguine set of circumstances culminated in our execution of what turned out to be an impeccably-timed 18-property refinance in March and April of 2015 that in no way could be duplicated today as the spreads over Libor we locked in are now almost 1% higher than we were able to secure back then.

Much changed, however, beginning in May 2015 when Fannie and Freddie were approaching their annual lending caps midway through the year as a result of the huge demand for their very cost-effective loans. The only thing they could do was to ration credit. And they did this by raising the fees they charge to guarantee the timely repayment of principal and interest to the investors who buy their paper. They needed borrowers to seek out other lenders like banks, Wall Street, and life insurance companies to fill the gap. Compounding this was the enormous supply of variable-rate loans that were being used by Starwood Capital to finance the purchase of its $5+ billion acquisition of a portfolio of Equity Residential properties as well as another $1 billion+ acquisition. To attract more investors to purchase this paper, it necessitated higher spreads to get them off the sidelines. Hence the nearly 1% increase in spreads over Libor.

Confucius said "may you live in interesting times" and it's hard to argue that these times are not indeed interesting. And yet, there is always uncertainty when it comes to divining the future. Michael Milken summed this up brilliantly when he said:

"The past is always triple-A. We can all remember what the past was. But if we try to make the future triple-A, we have no future. The future is always single-B."

There is risk in every investment we make and yet oftentimes in hindsight it doesn't always feel that way, especially if the investments have worked out. We somehow overlook the angst and questioning we went through before finally pulling the trigger. We only jump

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to whether it worked or didn't work when looking back on our investments. If we try to create a risk-free AAA future then we will either be dangerously naive and not look for risk that should be identified and evaluated or we will see risk everywhere and not take action because we want perfect foresight and clarity. I like the advice of a Japanese military person who said "think like a man of action and act like a man of thought." We have to use our heads and have courage when the time is right.

Charlie Munger has said something similar in terms of what it takes to be successful in business and investing. One needs both a circle of competence and gumption. If the former is large, then the latter becomes very important because one does not get many fat strikes down the middle to swing at so it's critical to have the gumption to take a swing because one's circle of competence should go a long way towards lessening the risk of doing something dumb. On the other hand, if someone has great gumption then it is vitally important to stay within one's circle of competence because venturing outside of it can result in disaster.

I hope I have now done a reasonable job of making you comfortably uncomfortable. Investing should never be terribly comfortable and when it is then danger is at your door. It is cliché but change is obviously one of the only constants in life so one has to be on guard at all times to make sure that one has a margin of safety to make sure there is a strong foundation when, as Bob Dylan says, "the winds of change shift" so one doesn't get blown over when they do materialize. The collapse in oil prices and the inevitable challenges it will create for the Houston economy is a prime example of this. While we were cognizant of the extraordinary capital spending that was taking place in the energy sector far beyond the cash being generated, we did not think that prices would collapse triggered by Saudi Arabia's decision to ruthlessly protect market share. Hindsight is always 20/20 but this was a bit of a Black Swan event for the world. Nevertheless, when one invests in an economy that is unusually dependent on a particular industry or continued strong capital flows (e.g. Silicon Valley and venture capital), one has to be on guard for something not going according to plan. This was an unanticipated event but it happened nonetheless and we have to deal with the ramifications.

While I really don't know how painful it will get in Houston over the next two years when the largest amount of new supply is coming on line, at this moment in time we are far better positioned than we were during the last two national apartment downturns in 2001-2013 and 2008-2010. This is largely the result of many of our Houston properties having low cost, longer-term debt, and strong cash balances. In past downturns we had high cost, fixed-rate

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debt that was amortizing in much more competitive markets contending with easy lending in the single-family market siphoning demand from apartments. Today, the opposite is the case. We have very cost-effective, variable-rate loans, single-family competition is manageable, apartments are still capturing a large market share of household formations, and our cash reserves are stronger. The cash has been able to be built up due to our extremely low interest rates and a conservative distribution policy that has allowed us to maintain very attractive yields on invested capital while also being able to reinvest in the properties and maintain a meaningful rainy day fund. In general, we believe this should allow us to weather the storm over the next couple of years when new supply peaks. After this year, supply should drop dramatically but the market will still need to absorb the new units that will have come on line in 2015 and 2016.

Despite some of the challenges that may be on the horizon for Houston, overall our portfolio performed well with Net Operating Income advancing by approximately 6% year-over-year on a same-store basis. 2015 also resulted in us entering Seattle for the first time with two acquisitions as well as a second purchase in Phoenix, which we believe has many of the same recovery characteristics as Atlanta had. Atlanta was a market we went after aggressively and we are glad we did as rents have risen along with values. We have a similar level of optimism regarding Phoenix. We also entered into agreements to re-enter Raleigh after a long absence and we grew in Denver which helped us expand our footprint in the west.

In the face of all the global tumult I alluded to at the beginning it is important to take a step back and continue to evaluate the bigger picture fundamentals regarding apartments to see if we still have the wind at our back or if conditions are changing. With the exception of Houston catching us off guard and the more challenging credit markets, our long-term belief in apartments remains intact.

Since 2010 we have been focused on not just what we believed was a shortage of apartments, but housing in general. In the past we would focus almost solely on apartments because single-family housing was the dominant form of new supply and apartments filled an important, but lesser niche. With the collapse in the housing market there was still demand for housing but single-family homes could not fill the void due to much tighter mortgage market conditions, construction lending constraints, and the greater desire to rent. This required us to evaluate the demand for housing in a much more comprehensive manner by looking at total housing supply versus demand to see if there was an imbalance due to the dislocation in the single-family market.

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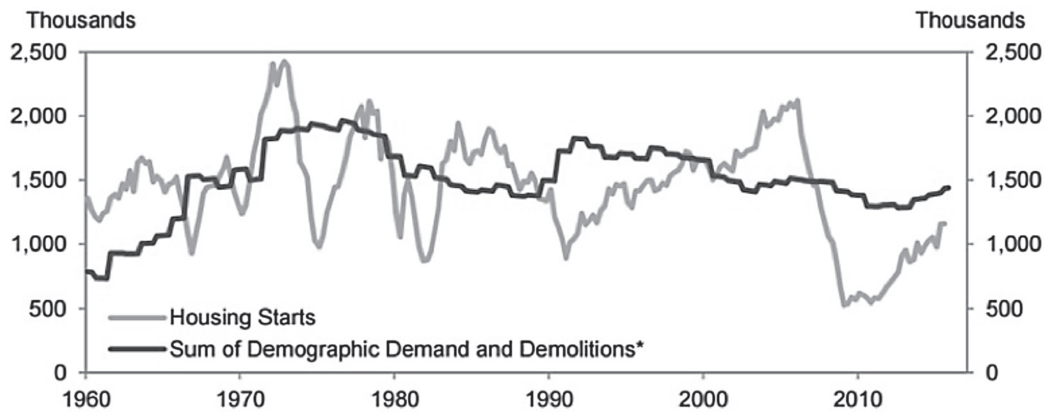
The following graph from Goldman Sachs depicts this quite dramatically. It shows what Goldman believes is equilibrium demand based on demographics and other factors versus supply.

Homebuilding Still Below Structural Demand



* Demographic demand is change in resident population divided by trend number of persons per household; trend number of persons per household is fitted value from univariate regression of persons per household on average population age; demolition rates calculated from historical data on housing stock and completions.

Source: Department of Commerce. Goldman Sachs Global Investment Research.

As can be seen from the graph above there has been a consistent undersupply of housing relative to demand. What is not so easily discerned, however, is the cumulative shortfall that has been building up since 2010 to the tune of an estimated 2 million units which is quite an undersupply and does not show any signs of diminishing materially over the next couple of years. Yes supply is catching up with demand but there is still a shortfall from previous years and there is still a gap.

And one can see from the graph below that the share of first-time home buyers is at very low levels which is supportive of apartment demand as historically moving out to purchase homes was one of the primary reasons people would leave apartments up until 2009. Even if it is still one of the dominant reasons, it has had less of an impact as the much slower pace of home purchases has significantly reduced apartment turnover rates from approximately 75% in 2005-2007 to 55% or so today.

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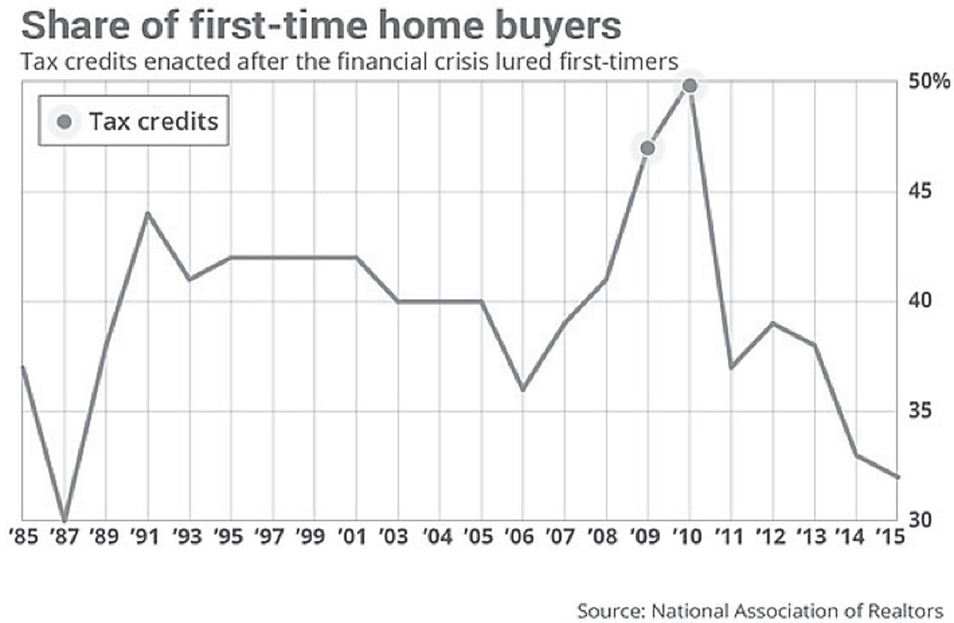

http://www.marketwatch.com/story/why-first-time-home-buyers-are-staying-on-the-sidelines-2015-12-31

Although it is more important to watch what people do versus what they say, surveys can give us an indication of the mindset of consumers. The following table shows that current renters show very little inclination to purchase a home the next time they move. Not surprisingly, once someone has crossed the Rubicon into homeownership they intend to remain home owners if they have to move again.

So for now it does look like we should continue to have relatively strong demand for apartments and still not enough housing being built to satisfy that demand. That is not to say, however, that it is not more competitive to find compelling investments as there is greater investor demand for the perceived "port in the storm" characteristics of the asset class and a more challenging lending environment. We have done our best to design CWS to follow the Zen proverb of "eat when you're hungry and sleep when you're tired." In other words, we try to keep a clear head by doing what we think is smart and not making investments to stay busy or because of financial pressure. We have a lot to keep us busy and try to manage the company with a sufficient base of recurring revenue to attract and retain the best people, invest in the systems to support our people, and allow us to make clear-headed investment decisions.

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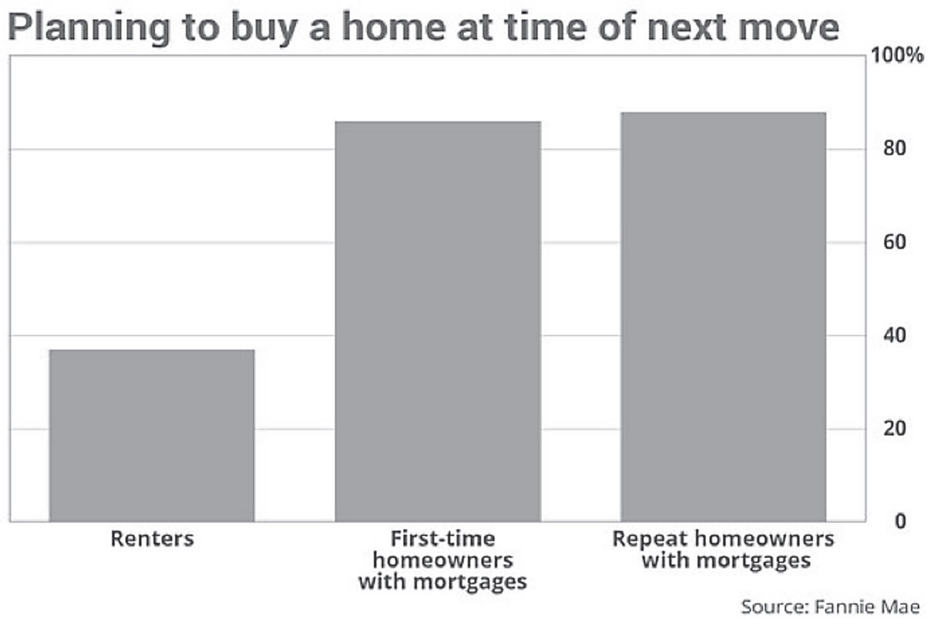

http://www.marketwatch.com/story/why-first-time-home-buyers-are-staying-on-the-sidelines-2015-12-31

We think 2016 should allow us to continue to generate compelling dividends in this very low yield environment as well as add value to our properties by prudently reinvesting capital into well-thought-out improvements and upgrades that can translate into higher revenue generation. We are also excited about three new properties we re-acquired from The Blackstone Group and a few more properties we are in the process of acquiring.

Yes there are storm clouds on the horizon, but we believe we are pretty well-positioned to weather the storms that may materialize due to being in a great asset class that prospers from uncertainty and insecurity as this leads people to delay home purchases. In addition, household formations are still occurring at a rate greater than new housing supply. When this is coupled with our high-quality portfolio with very cost-effective debt and strong cash balances, we believe that CWS should experience another good year in 2016.