Volume 33, No. 4, January 31, 2020

Quarterly Update

CWS Capital Partners LLC

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CWS

CALENDAR OF EVENTS

March 16, 2020
Year 2019 K-1's Mailed by Date

April 15, 2020
2019 Federal/State Tax Filing Deadline
1st Quarter 2020 Est. Tax Payments Due

April 10, 2020
Good Friday
CWS Offices Closed

April 24, 2020
1st Quarter 2020
Quarterly Distributions Mailed

May 21, 2020
CWS Annual Partners Meeting
Irvine Marriott (Irvine, CA)

May 25, 2020
Memorial Day
CWS Offices Closed

June 15, 2020
2nd Quarter 2020
Est. Tax Payments Due

July 3, 2020
Independence Day (Observed)
CWS Offices Closed

July 31, 2020
2nd Quarter 2020
Quarterly Packages Mailed

CWS
Enhancing Lives
50 Years

www.cwscapital.com

THE ROARING 2010s (FOR APARTMENTS)

By Gary Carmell

One of the great things about CWS and our 50+ years of longevity is that we have a tremendous amount of content that we can fall back on to review the effectiveness of our decision-making to see if there were any lessons learned to help us improve in the future. With the end of the 2010s and the beginning of a new decade, I thought this would be a good opportunity to do this.

When we started 2010 we were coming out of the Great Recession. The stock market bottomed in March 2009 after a nearly two-year period which saw catastrophic financial and societal consequences as a result of the bursting of the mortgage bubble and collapse in home prices. It was in the wake of this carnage that we saw the makings of an extraordinary investment opportunity unfolding in the apartment market. Given this, we strongly believed that we needed to have a loaded gun of capital to convince those rare sellers at the time that we were credible purchasers and had the capital to close as money was in short supply then. This culminated in the creation of CWS's first Strategic Apartment Fund. It came to be called SAF I and

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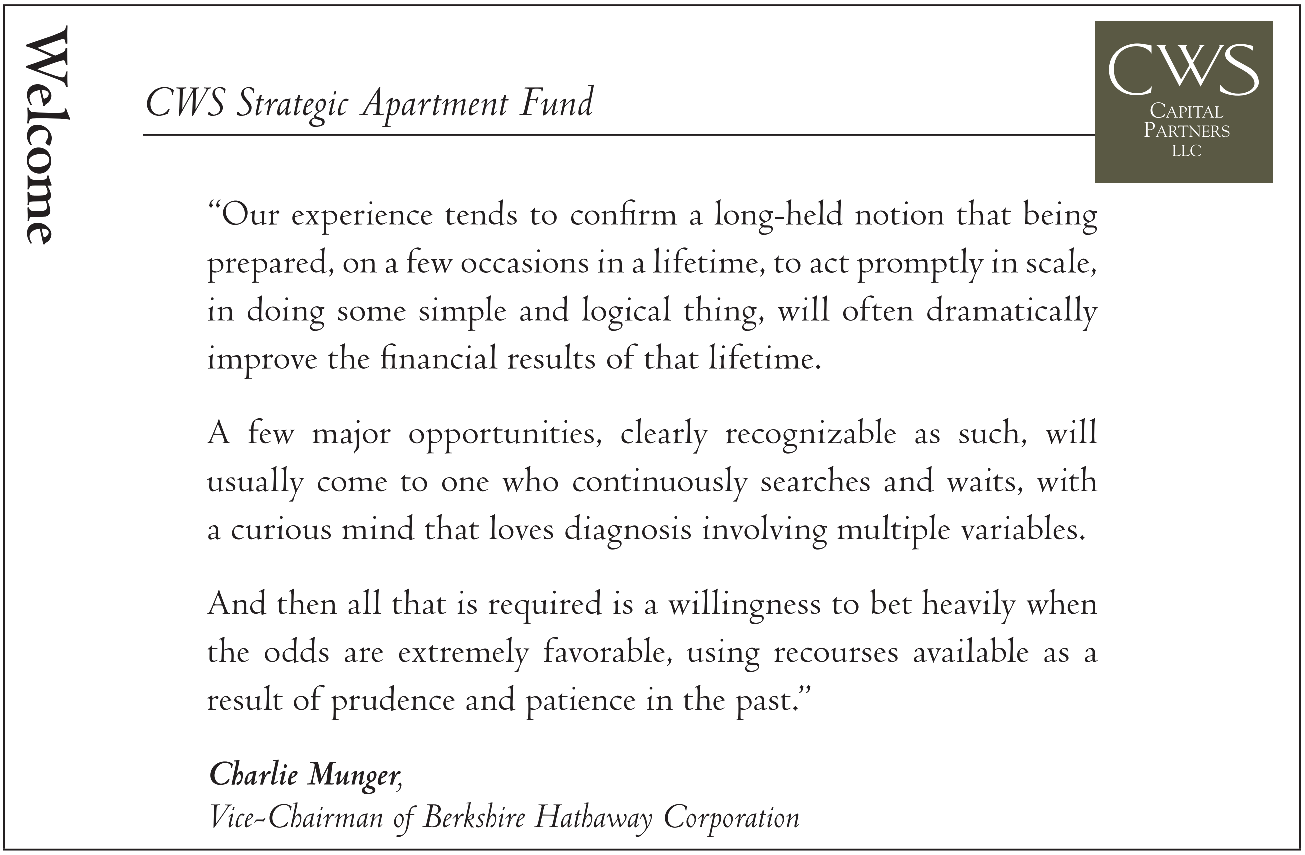
we completed the marketing materials in July 2009. And while the stock market bottomed in March the economy was still at its depths and pessimism was rampant among investors. As famed investor Sir John Templeton said, "Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria." We were clearly in the pessimistic stage in July 2009.

It is not always easy to convey the strength of one's convictions that investors should put their capital to work in the face of a hurricane of fear and pessimism and battering they may have taken. To do this we borrowed from Charlie Munger and incorporated one of his profound articulations that he used to convey how Berkshire Hathaway generated enormous returns for some of its investments. And while Munger's description was done after the fact, we strongly believed that it was going to accurately reflect what would happen in the apartment market for those who had the courage to invest. This is what he said and how we utilized it in our SAF I marketing package.



Welcome

CWS Strategic Apartment Fund

CWS
Capital
Partners
LLC

"Our experience tends to confirm a long-held notion that being prepared, on a few occasions in a lifetime, to act promptly in scale, in doing some simple and logical thing, will often dramatically improve the financial results of that lifetime.

A few major opportunities, clearly recognizable as such, will usually come to one who continuously searches and waits, with a curious mind that loves diagnosis involving multiple variables.

And then all that is required is a willingness to bet heavily when the odds are extremely favorable, using recourses available as a result of prudence and patience in the past."

Charlie Munger,
Vice-Chairman of Berkshire Hathaway Corporation

The point of highlighting Munger's insights was to illuminate our thinking at the time that conditions unfolding were so favorable to apartment investors that this was really a once-in-a-lifetime opportunity to take advantage of such a dislocation in the marketplace. The risk-

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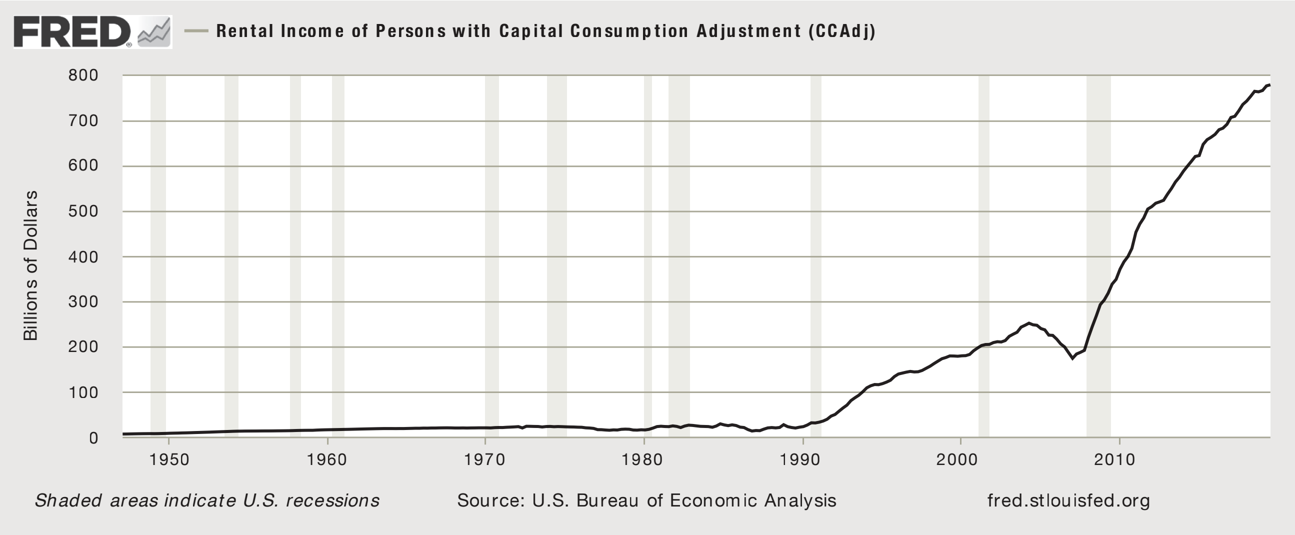
reward relationship was far more in favor of the reward while the downside risk was quite minimal in terms of the risk of experiencing a permanent loss of capital.

The following graph shows the cumulative rental income in the economy from 1947 through 2019 and corroborates our intuition and analysis.



Shaded areas indicate U.S. recessions Source: U.S. Bureau of Economic Analysis fred.stlouisfed.org

While not all of this income is attributable to apartments, the vast majority is related to rental housing so it's a good reflection of trends in our industry. One can see that our belief that this was a once-in-a-lifetime investment opportunity proved correct as rental income exploded higher from 2008 to the present. So what exactly were we thinking at the time?

As the financial crisis was unfolding, we had a few core beliefs. We were convinced that it would be very difficult to build new homes because of the disastrous situation in single-family housing resulting from the subprime mortgage debacle that lead to a large number of foreclosures and value deterioration of loan pools that severely impaired the capital position of the banking system such that they needed to be bailed out through the TARP program. As a result, we did not expect to see any meaningful new home construction as there was a vast supply of homes that could be purchased for prices substantially below replacement cost. In addition, we also believed that construction loans for apartment developers would be extremely difficult to procure because of the banks' weak capital positions, minimal job growth and household formations due to a still decimated economy, as well as the contraction of apartment development capacity due to developers having gone out of business or cutting back such that the industry's ability to generate significant amounts of new supply was curtailed.

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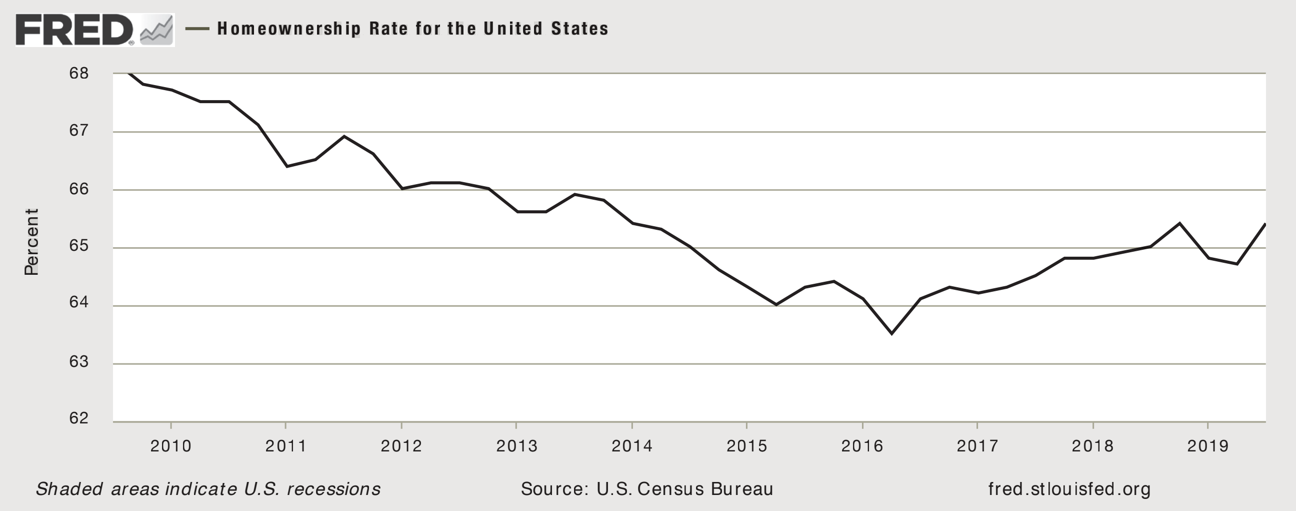
From a demand standpoint we felt that the market share of new household formations would be significantly tilted towards renting as the mortgage market had collapsed and the conditions for getting a new mortgage were extremely difficult as many people had foreclosures on their records as well as bankruptcies. These would take a long time to be removed from their credit profiles and keep them from being in a position of being able to borrow again to buy a home. And this doesn't even factor in the psychological impact that would serve to keep them out of wanting to own a home for a longer period of time as many people didn't want to enter that market given the traumatic experience of the financial losses, stress, and life disruption they had just experienced.

This led to a high probability that the amount of new housing supply was going to be shrinking and that once economic growth started to take hold then demand would pick up and almost all of the new households formed would be for rental housing, particularly apartments. As the next chart shows, the homeownership rate dropped quite a bit from 2010 through 2016 and was further corroboration that this belief was correct. More dramatically, the percentage of households renting went from about 32% to 37%, which is a 15.6% increase in its market share and represented a huge increase in demand for rental housing during this time frame. Between 2010 and 2016 renter households grew by approximately 6 million and has leveled off a bit since then as home buying has picked up.



Shaded areas indicate U.S. recessions Source: U.S. Census Bureau fred.stlouisfed.org

It was a golden age for apartment investing and we were quite active relative to our history in terms of taking advantage of this opportunity as I will soon show.

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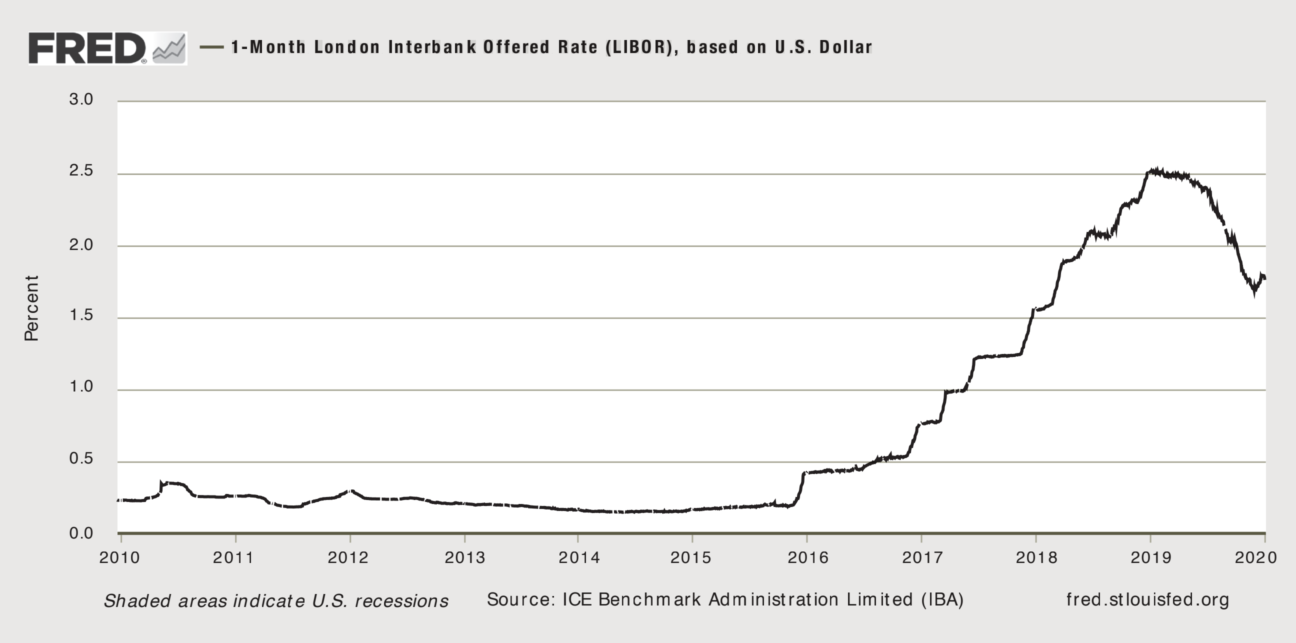
When you overlay our very constructive view of supply and demand with our other core belief that both short- and long-term interest rates would stay low, particularly the former which would result in cap rates compressing, and that borrowing using floating-rate debt would be quite advantageous, we had conditions such that not only would apartment Net Operating Income grow quite meaningfully, but that the multiple paid for that stream of income would have a high probability of expanding. In addition, by borrowing using floating-rate debt, cash returns could be magnified while preserving prepayment flexibility to take advantage of opportunities to sell or refinance when conditions presented themselves without incurring onerous prepayment penalties or forcing buyers to assume our loans.

We became aggressive floating rate borrowers with these loans tied to 30-day Libor. As the following graph shows, Libor stayed quite low through 2016 as it averaged 0.25% during these seven years. In the ensuing years LIBOR went from 0.77% in January 2017 and reached a peak of 2.52% in December 2018 and is now at 1.68%, which is the same as its average between 2017 and 2019. The average of 30-day Libor for the 10-year period was 0.71%.



Source: ICE Benchmark Administration Limited (IBA)   fred.stlouisfed.org

In comparison, the 10-year Treasury on January 4, 2010 was 3.85%. The following charts shows the trajectory of 10-year Treasury yields during the 2010s. The average rate during this 10-year period was 2.40%, still quite a bit higher than the 0.71% average for 30-day Libor.

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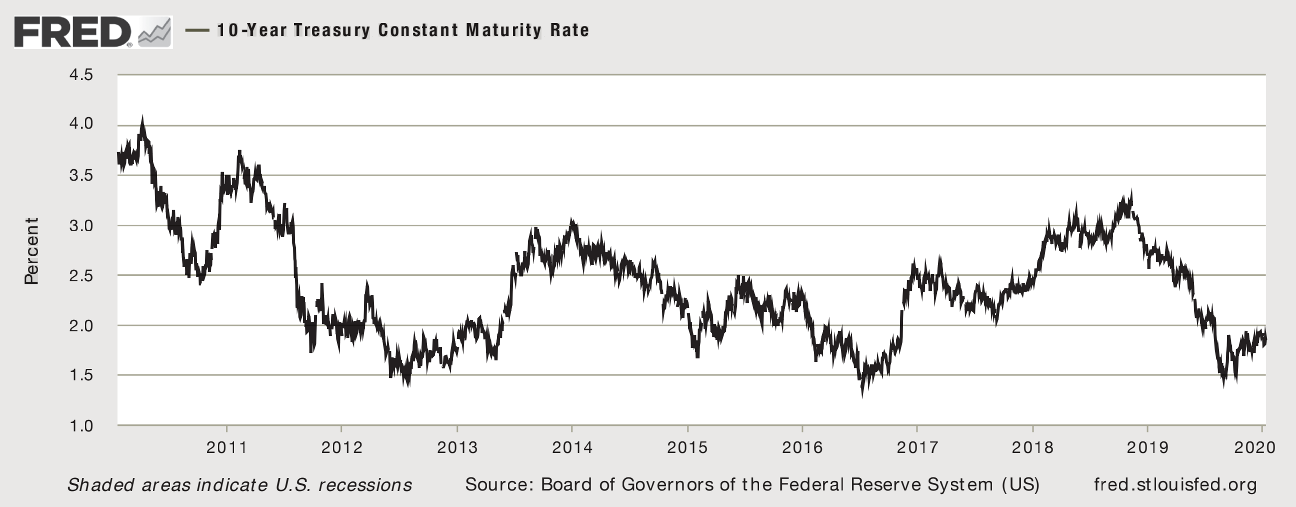

Assuming that spreads over Treasuries were 2.00% for fixed-rate loans, then the 10-year rate would have been 5.85%. Assuming a similar spread of 2.00% for floating-rate loans, then in this example the average rate would have been 2.71% during the decade of the 2010s. Not only did this result in a substantially lower cost of funds, but it also provided much greater prepayment flexibility than the fixed-rate loan which would have been extremely costly to prepay, especially as interest rates dropped and lenders wanted to be compensated for having to reinvest their principal at a lower rate. Of course the variable-rate example assumes that this loan would have been in place for the full 10 years during this particular time and this was obviously not the case for the loans in our portfolio since they were originated at different times and were rarely in place for the full 10 years. The point of highlighting this average is that it shows that our belief that short-term interest rates would remain low proved to be correct over this 10-year period.

Enough of what we thought would happen. One of my favorite retorts to someone who espouses certain theories or beliefs is “So, what are you going to do about it?” This is what CWS did.

Although we started marketing SAF I in July 2009, we didn’t make our first investment for SAF I until December 2010 as it was very difficult to find opportunities at the time because there were very few sellers as people learned from past downturns that staying power is very important and one should always avoid selling under duress. At the same time, raising money was difficult as pessimism was rampant and many investors were financially on their heels from losses that they had taken as a result of the tremendous downturn in the stock market and the illiquidity of some of their investments which may have required capital calls to service them, to pay down loans, and to cover negative cash flow.

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After a slow start we began to hit our stride in 2011 through 2019 as we almost doubled the size of the portfolio. At the end of 2009 we owned 55 properties comprised of 15,011 units. A decade later our portfolio is comprised of 106 properties and 29,942 units. We took Charlie Munger's words to heart and aggressively expanded our portfolio size and organizational capabilities over the decade of the 2010s. This nearly doubling of our portfolio size, and more than that in value, masks a lot of other important activities that took place during this time. These include 107 refinances paying off approximately $2.4 billion in debt and 53 property sales. We also recapitalized 15 properties by purchasing the ownership positions of the majority investor. Including these recapitalizations, we acquired a total of 108 properties in the 2010s. We expanded to Atlanta, Seattle, and Phoenix and grew in our other markets of Raleigh, Charlotte, Denver, Austin, Dallas, Fort Worth, Houston, and San Antonio.

We added an asset management team, capital projects department, regional maintenance directors, floating community directors, and compliance, as we fell under the regulatory oversight of the S.E.C. in addition to FINRA. We also greatly expanded our capabilities in information systems and the technology we have deployed, risk management, property management, human resources, investor services, tech support, and accounting, just to name a few of the major investments we have made in our organizational capabilities.

We are proud of our accomplishments over the 2010s. Our bullishness on apartments has rewarded our investors over the years through dividends, aided by our variable-rate strategy, and appreciation for those properties that have sold. As shown above, we have not rested on our laurels as we have reinvested significantly back into the organization to make sure that we deliver first-rate service to our residents and investors and support our employees so that they can do their jobs effectively and efficiently while offering growth opportunities for them personally.

We believe apartments continue to be well-positioned for the next decade, although we do not believe the conditions are as ripe for investors as they were at the beginning of the 2010s. Nevertheless, we are optimistic about continuing to grow in the apartment business through prudent acquisitions as well as development.

Thank you for your support during the last decade and being part of such a great decade for apartment investors.