Volume 35, No. 4, January 28, 2022

QUARTERLY UPDATE
CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

March 15, 2022
Year 2021 K-1's Mail by Date

April 15, 2022
Good Friday Holiday
CWS Offices Closed

April 18, 2022
2021 Federal/State Tax Filing Deadline
1st Quarter 2022 Est. Tax Payments Due

April 29, 2022
1st Quarter 2022
Quarterly Reporting Packages Mailed

May 30, 2022
Memorial Day Holiday
CWS Offices Closed

June 15, 2022
2nd Quarter 2022
Est. Tax Payments Due

July 4, 2022
Independence Day Holiday
CWS Offices Closed

July 29, 2022
2nd Quarter 2022
Quarterly Reporting Packages Mailed

50 CWS Enhancing Lives Years

www.cwscapital.com

PASSING THE BATON

By Gary Carmell

Much of this article is based on information discussed during our semi-annual investor webinar in November, but it is still highly relevant.

In my 34 years at CWS I have never seen such significant rent increases as we are experiencing today. For example, in the fourth quarter of 2021 we had 2,805 new leases signed for people moving into our communities. These are not people renewing, but new occupants. The average lease rate was $1,660 with an average unit size of 911 square feet. One year previous, 3,209 new resident leases were signed at an average lease rate of $1,340 with an average unit size of 917 square feet. This equates to an approximate 24% rate increase over that one-year period. For those who renewed their leases the increase was a more modest, but still substantial, 10% on average.

While what is happening in our portfolio is quite remarkable, we are by no means unique. The demand for apartments is on fire. Over the last year, over 600,000 units have been absorbed. This is by far a record amount during the 16+ years of data covered by RealPage and I would venture to guess it's probably the highest since the 1970s.

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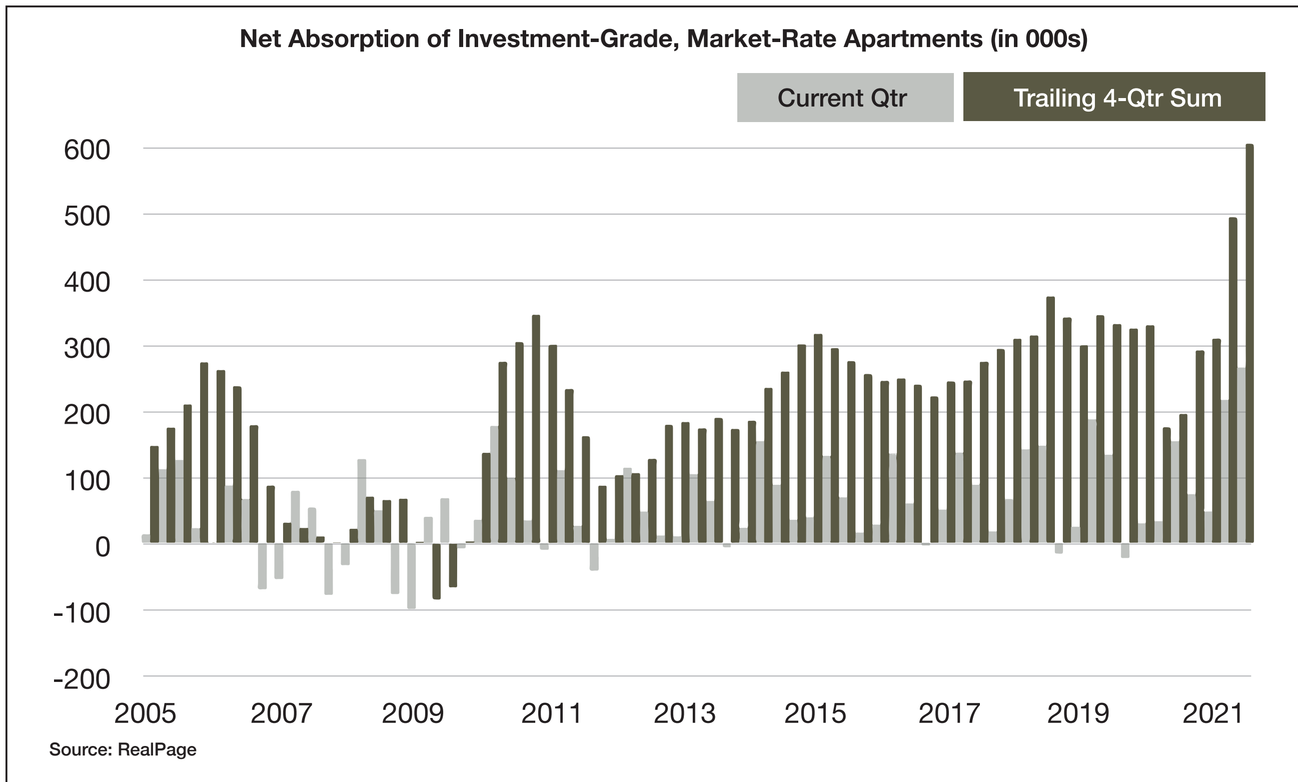
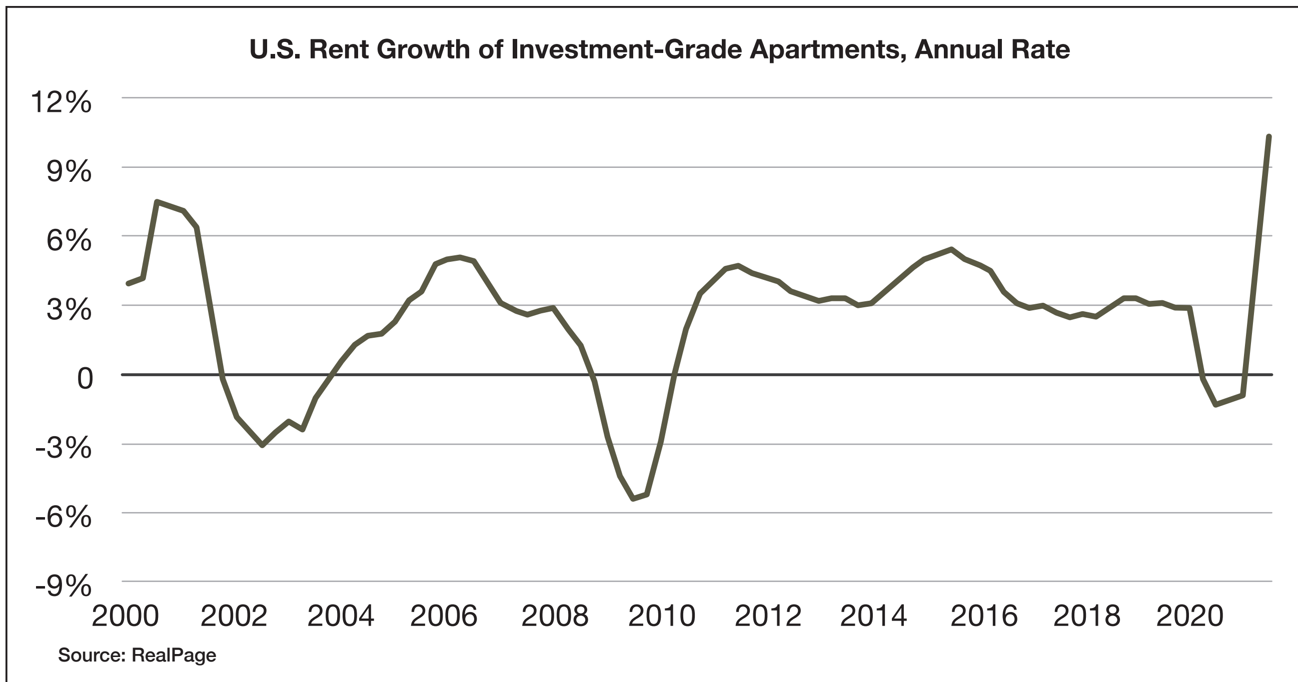


With demand far exceeding supply, rents have spiked.



Austin is one of CWS' largest markets and this graph shows how strong the recovery in apartment rents has been, similar to the spike in national rents.

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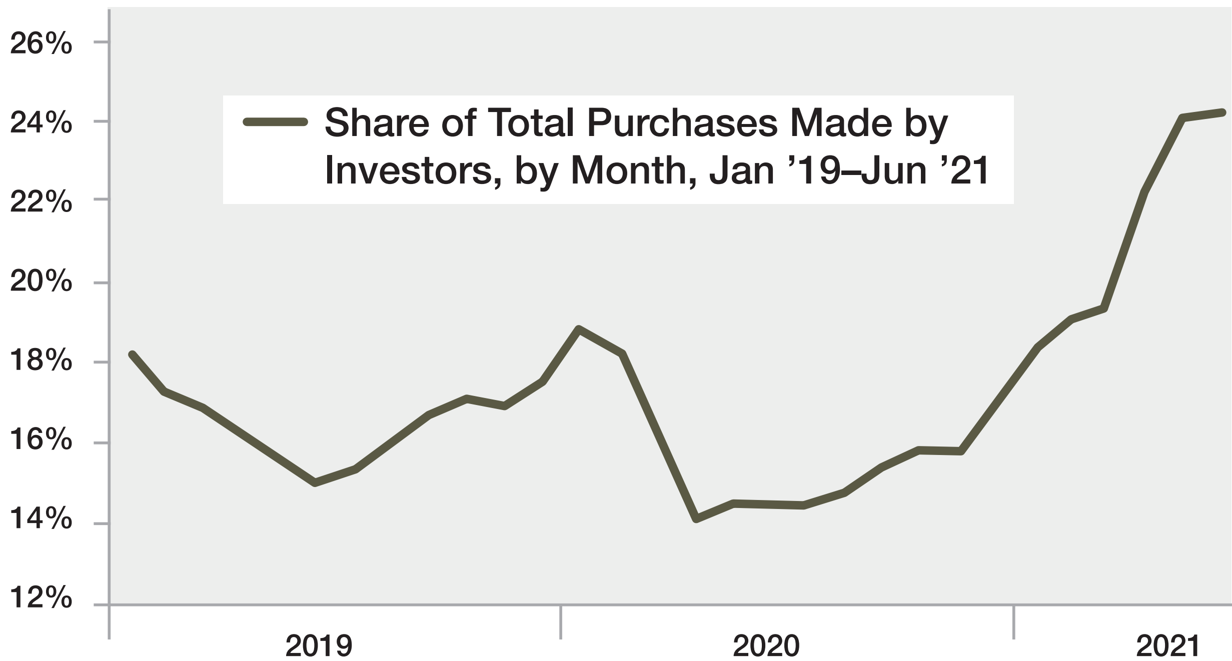
COVID's remote work requirement has unleashed people migrating to different locations, particularly those that are business friendly, have a lower cost, and good quality of life. This is creating significant demand pressures for apartments. At the same time, single-family home ownership is becoming much more challenging to attain as the competition for homes is fierce with low mortgage rates, COVID fever inspiring people to want more space, inflationary pressures having created more demand for tangible assets, and a large pool of investors buying homes to rent as the following chart shows.



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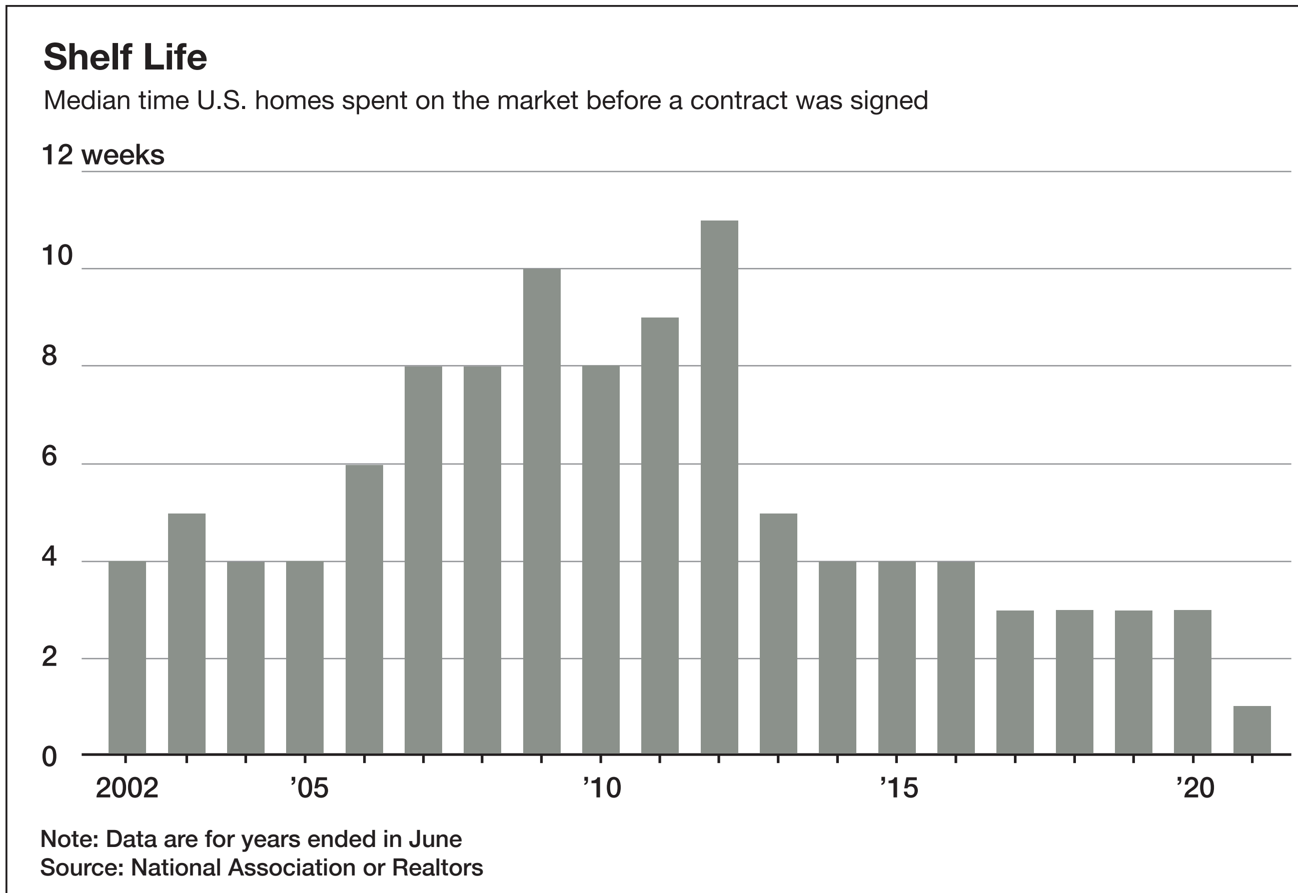
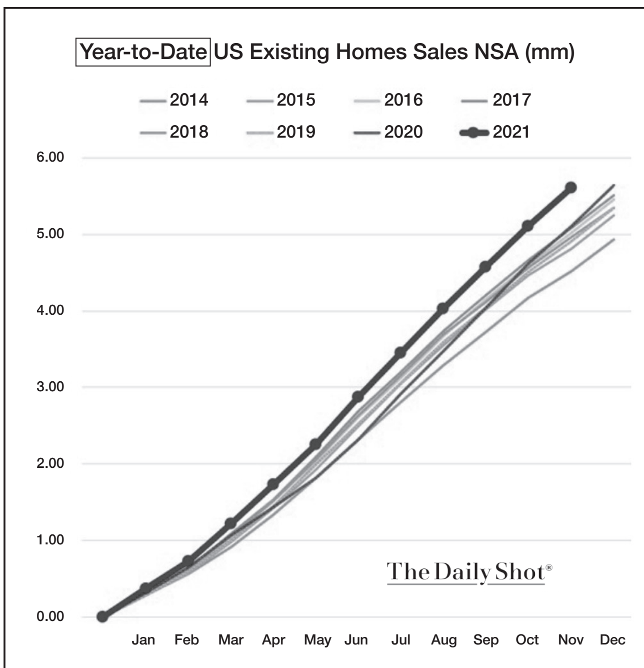
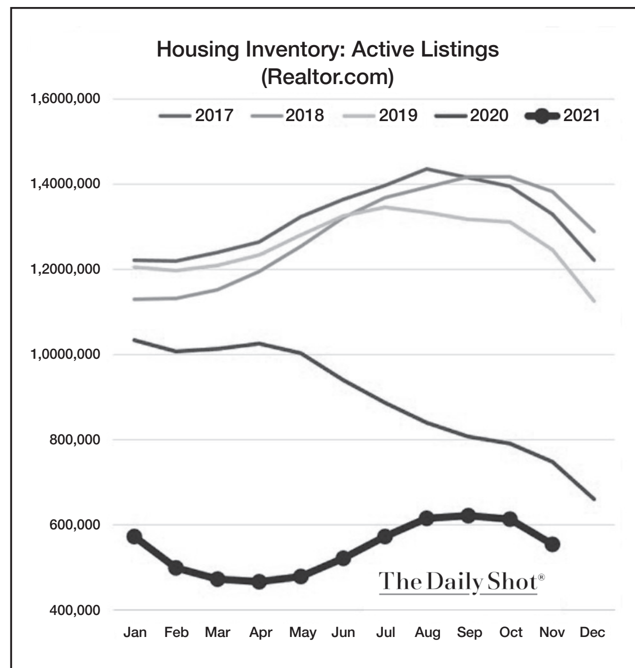
Homes listed for sale are selling almost as soon as they hit the market.



Homes are selling so fast because demand is far exceeding supply as the following charts show.





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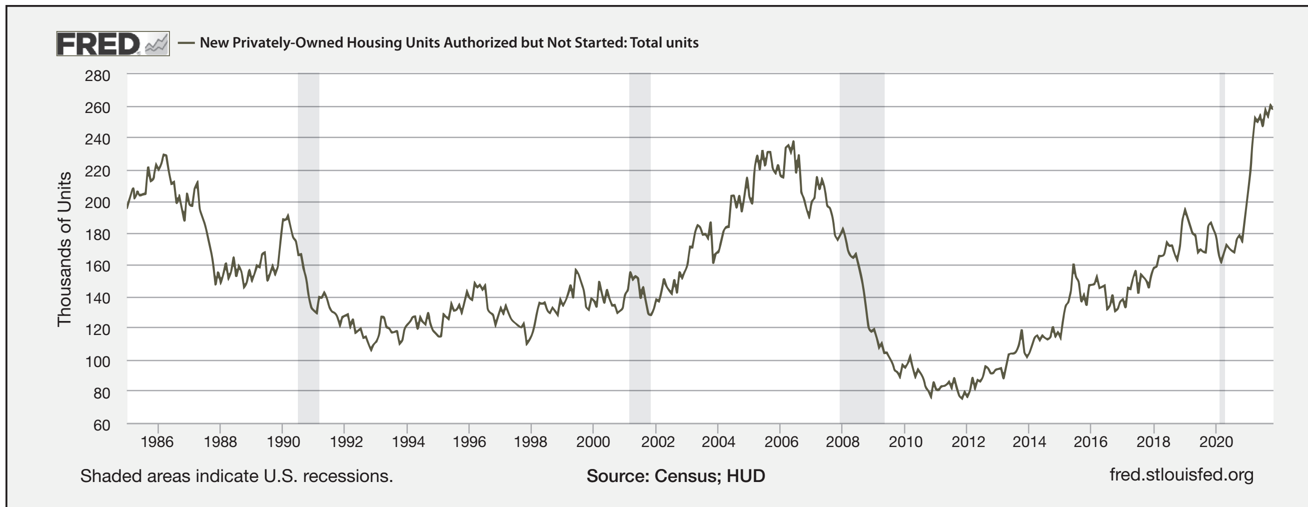
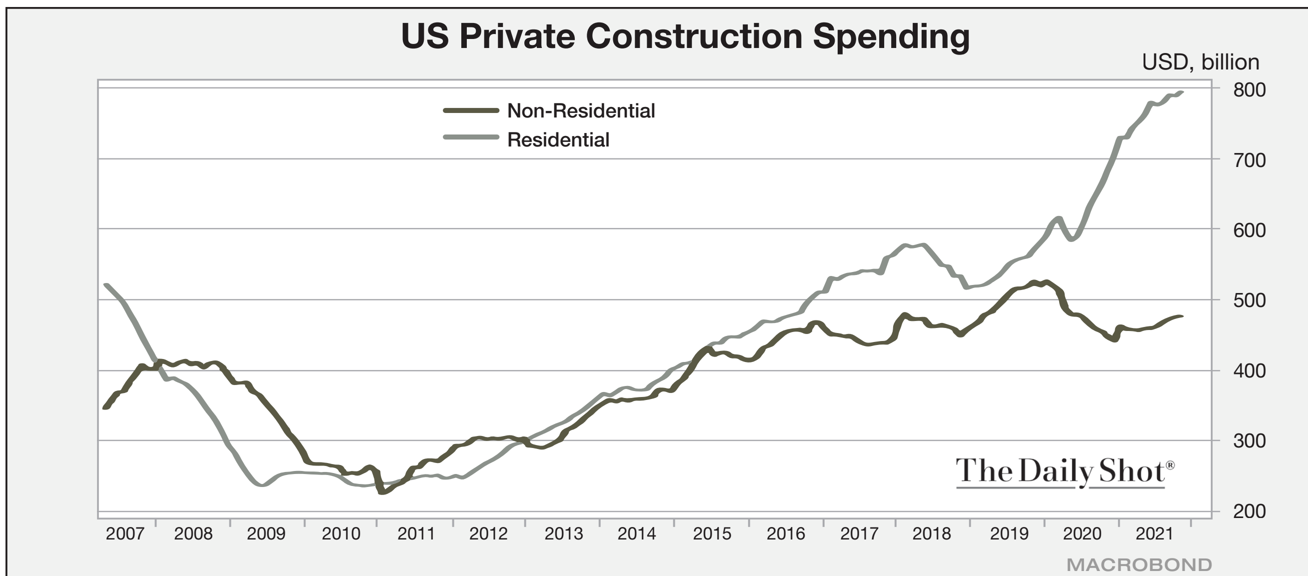
Construction delays and supply chain issues are also resulting in a large number of homes that have received permits to commence construction, but have not yet started.



Residential construction spending has exploded higher while non-residential spending has stagnated at much lower levels.



All these factors are serving to keep people renting longer. This has been a major factor in rents rising so rapidly throughout the apartment industry.

Rents have been growing faster than expenses which has led to the operating income of apartment owners growing quite significantly. The combination of increasing Net Operating Income with the tremendous amount of capital that has been accumulated to buy apartments has led to values spiking. Apartments have proven themselves to be quite resilient during COVID. The resilience and stability of the asset class have made apartments increasingly appealing to investors, particularly when factoring in the yield it generates in such a low interest rate environment. In addition, future demand will be aided by solid fundamentals and what

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looks to be a persistent and pronounced housing shortfall which should keep people renting longer.

CWS is almost always buying and selling at any given point in time with the former usually being much more voluminous than the latter. Currently, however, it is much more balanced between the two given how high values are. Because we almost always carry out 1031 exchanges, we also find ourselves buying in a very competitive market as well. Our goal is to redeploy our capital into assets in which the long-term cash flow is more durable and has better growth prospects. This is generally leading us to sell older assets and exchange into newer ones that require less ongoing capital maintenance.

There is a very high demand for older assets with strong perceived upside from carrying out renovations and upgrades to generate strong rent growth. And while we don't necessarily disagree with this strategy, we do think that prices being paid for these opportunities leave very little margin of safety for any execution challenges that can lead to delays and targeted rents not being attained due to excessive optimism and affordability challenges. In addition, we are also targeting to sell assets in markets that have political risk, social issues, or populated with buyers whose view of the future is much more optimistic than ours.

From a debt perspective, our variable-rate strategy really paid off as it allowed us to weather the storm of the pandemic quite effectively. Our same store cash flow through November 2021 compared to 2020 grew by nearly 15%, of which approximately 83% of this came from interest savings due to 30-day LIBOR dropping in response to the Federal Reserve lowering short-term rates. This has allowed us to increase distributions for most of our properties while also reinvesting in our properties and keeping them in good working order. We have reinvested $36.4 million into our same store communities during the first 11 months of 2021, which is up from $31.6 million in 2020.

With 30-day LIBOR at approximately 0.10% and the spreads on many of our loans being lower than current market spreads, there is not much more benefit we will be able to get over the next year from our floating-rate loans as we do not expect rates to drop or our spreads to compress via refinances. Fortunately, we are now in a position where the next phase of cash flow growth can come from improved operating performance via higher rents. This should allow us to continue to provide our investors with growing dividends (on a portfolio basis) for 2022.

Because of our reliance on variable-rate loans, the question we must contend with is will we give back much of our savings via materially higher interest rates in the future? Our budgets for 2022 assume that 30-day LIBOR will average 75 basis points, which is probably a bit conservative as the forward curve is projected to average closer to 55 basis points. In addition, our January payments have been made and our February rates are already known, which has 30-day LIBOR at approximately 0.10%. As a result, LIBOR would have to average

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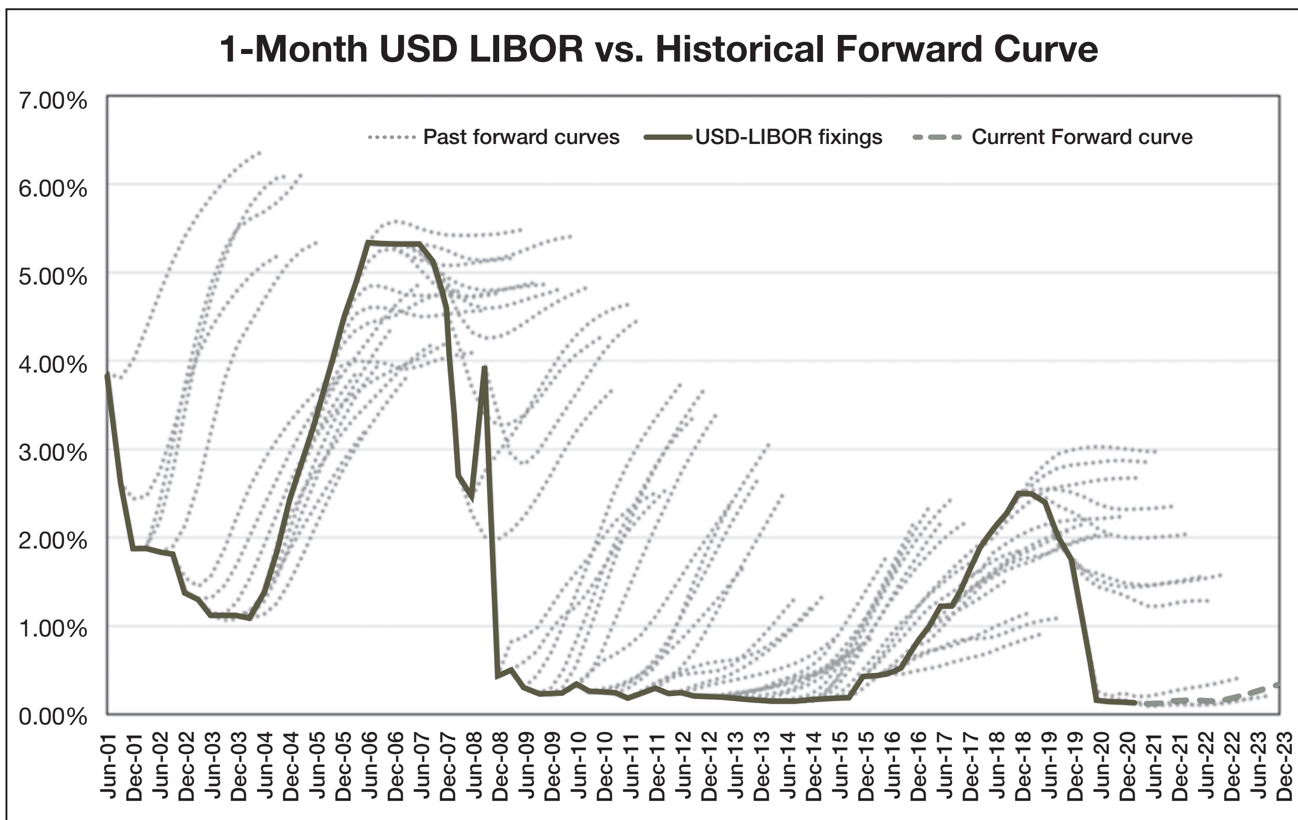
approximately 88 basis points for the remaining 10 months to have averaged 75 basis points for all of 2022, which I think is unlikely. If LIBOR gets to 1.00% then our weighted average interest rate for our variable-rate loans would be approximately 2.75%, which is still quite attractive. According to the forward curve, LIBOR is projected to reach approximately 1.85% over the next 10 years which would move our rates to approximately 3.60%. Of course, they could be higher or lower because this is only an unbiased estimate of future short-term rates. Nevertheless, the market is not pricing in materially higher rates over the next 10 years.

This chart shows how the market has typically overestimated future short-term rates in that the Fed has ended up being less aggressive than the market has priced in. There are clearly times, however, during tightening cycles when the market has been wrong and the Fed has raised rates more quickly and higher for a period of time than the market was pricing in. Over long periods of time, however, the market has been much more aggressive than the Fed has actually been in terms of its estimate of future short-term rates.



Source: Chatham Financial

As previously mentioned, the forward curve is projecting 30-day LIBOR in 10 years to be approximately 1.85%. If the market believed future inflation were to remain elevated at today's levels or higher than one would think, then the market would be pricing in higher short-term rates. This is clearly not the case, nor is it the case for longer-term, 10-year Treasury yields projected into the future as this chart shows.

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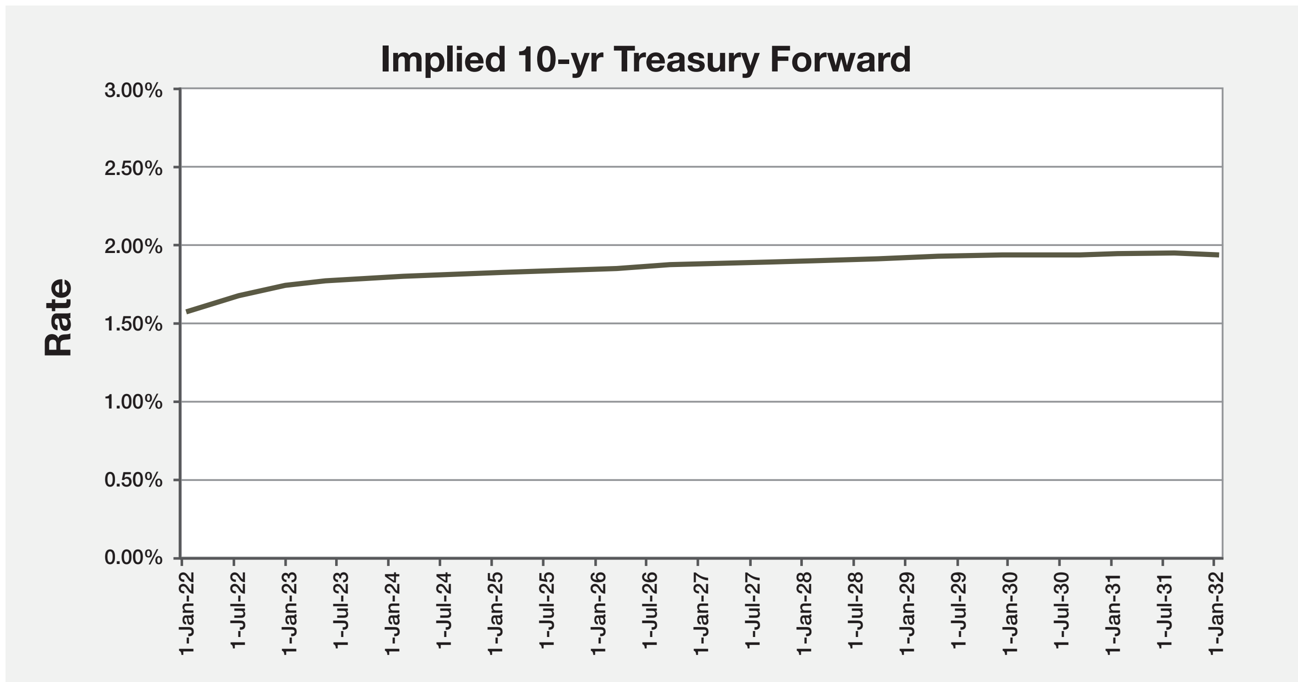
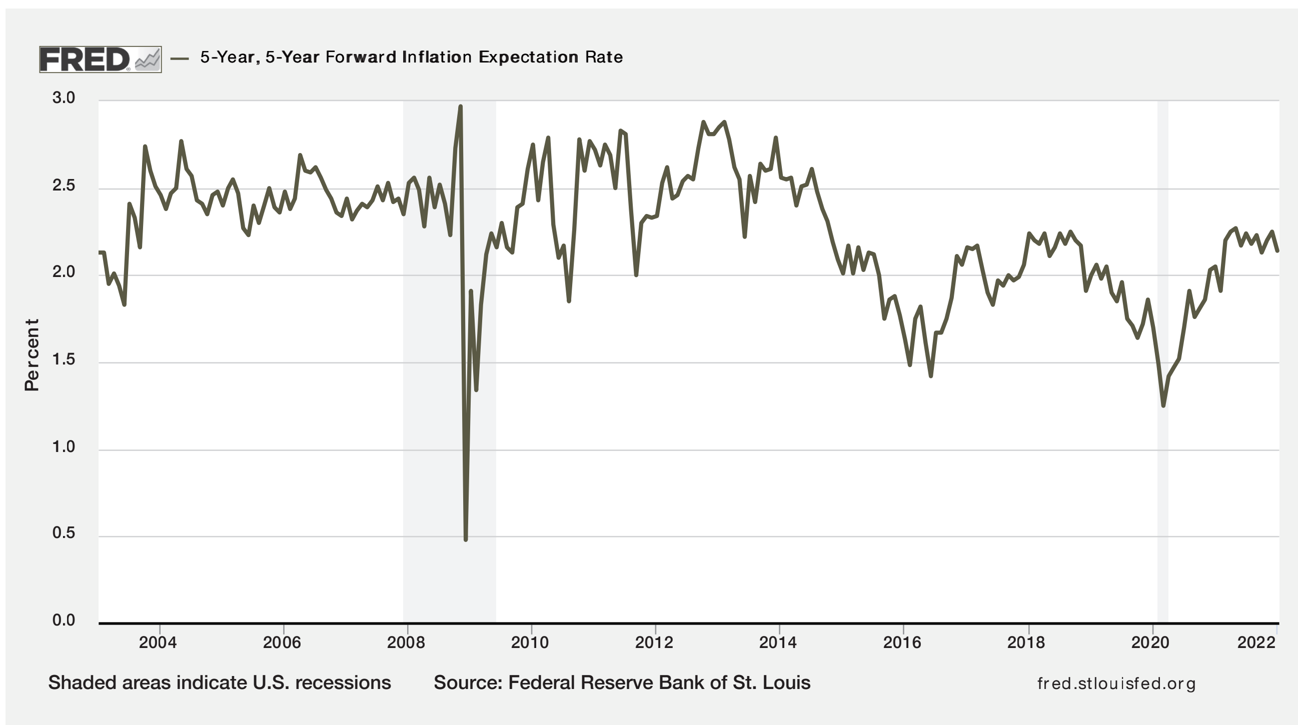


The following chart also shows how investors are not pricing in materially higher inflation in the future. Although elevated from the 2020 lows, the current levels are within the historical range. This series is a measure of expected inflation (on average) over the five-year period that begins five years from today.



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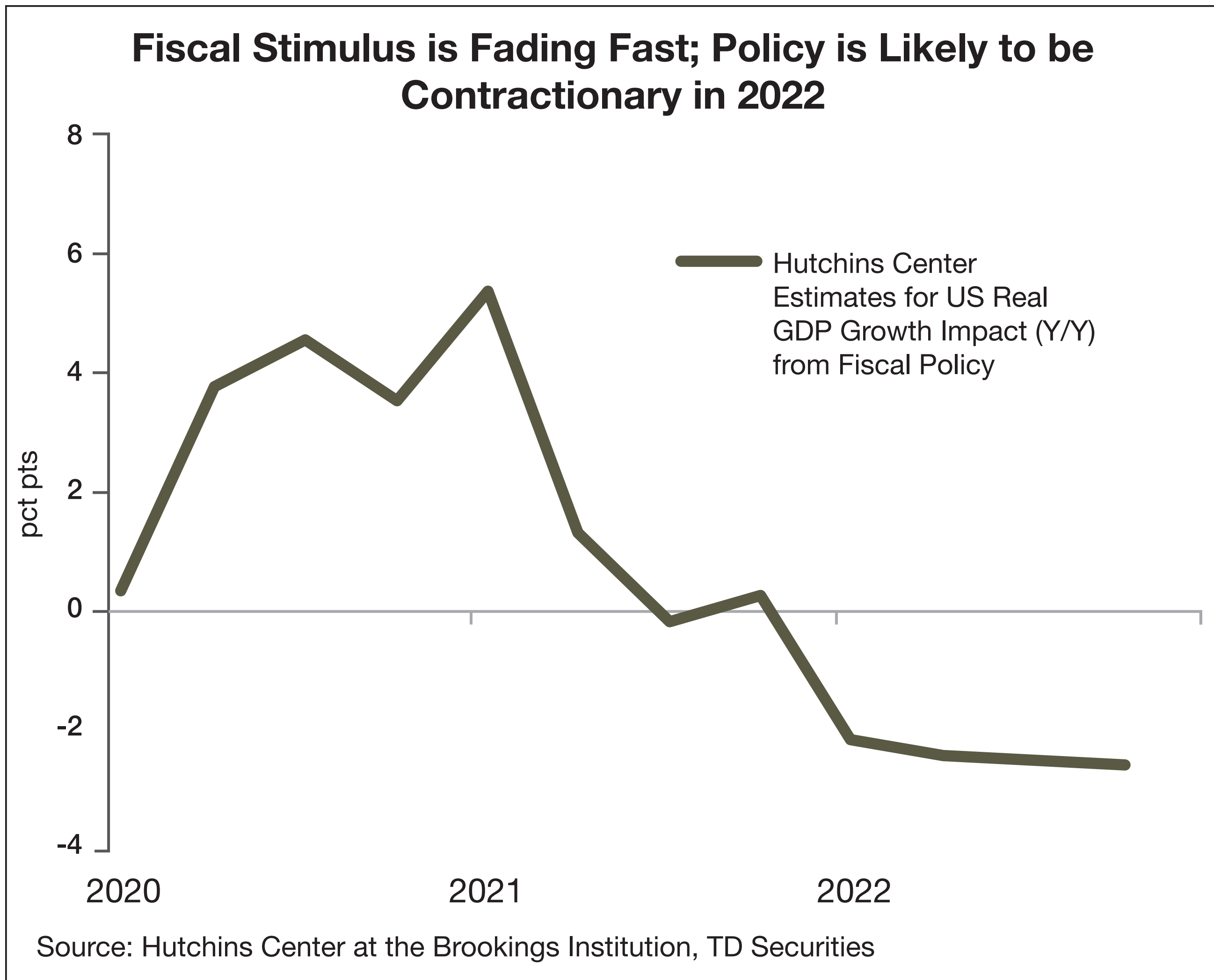
If government stimulus was a large contributor to the inflationary pressures present today then if this were to be reversed, perhaps inflationary pressures would subside. The following chart shows how federal spending will go from a GDP growth contributor to a detractor.



In summary, our apartment portfolio held up well during COVID and our variable-rate loan strategy paid off by lowering our interest costs and increasing our cash flow. We are now seeing the baton being passed from cash flow growth coming mostly from lower rates, to it being generated through improved operational results.

We continue to believe:

- We are in the right business
- We are in the right locations
- We have the right assets
- With the right customers
- With the right investors
- With the right financing
- With the right capabilities

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