Volume 36, No. 4, January 27, 2023

Quarterly Update

CWS Capital Partners LLC

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CWS

CALENDAR OF EVENTS

March 15, 2023
Year 2022 K-1
Target Mail by Date

April 7, 2023
Good Friday Holiday
CWS Offices Closed

April 18, 2023
2022 Federal/State Tax Filing Deadline
1st Quarter 2023 Est. Payments Due

April 28, 2023
1st Quarter 2023
Quarterly Reports & Distributions Delivery

May 29, 2023
Memorial Day Holiday
CWS Offices Closed

June 15, 2023
2nd Quarter 2023 Est. Tax Payments Due

July 4, 2023
Independence Day Holiday
CWS Offices Closed

July 28, 2023
2nd Quarter 2023
Quarterly Reports & Distributions Delivery

50 CWS Enhancing Lives Years

www.cwscapital.com

LESSONS FROM WARS, OFFICE BUILDINGS, AND INVERTED THINKING

By Gary Carmell

2022 was a brutal year for most investors as this headline conveys.

The year of Black Swans: Over $30 trillion lost on global stock markets in 2022

Sentiment is expected to remain negative in the first half of 2023, but a recovery may begin in the second half in anticipation of the halt in interest rate hikes

Sophie Shulman 20:11, 01.01.23

https://www.calcalistech.com/ctechnews/article/r0qnufevb

And when bond returns are factored in, the loss of market value is even more dramatic. The upper left-hand chart on the following page from Financial Times shows how unusual 2022 was in terms of both stocks and bonds losing money. Bonds typically provide a hedge against stock market losses, but not in the inflationary carnage of 2022. The negative returns fed off each other and kept dragging the other one down like a person trying to help rescue someone drowning at sea.

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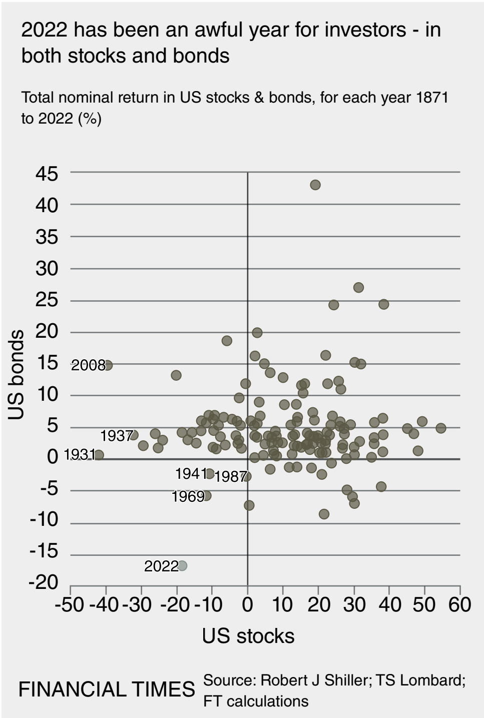
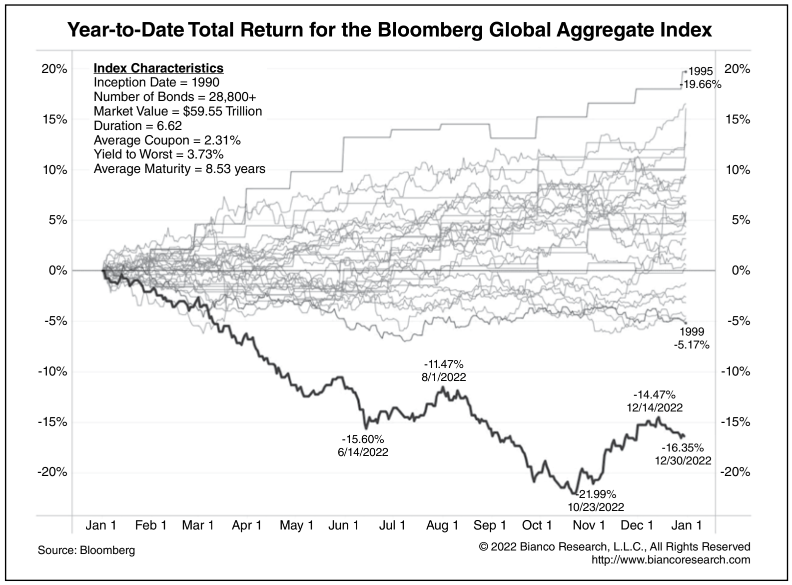
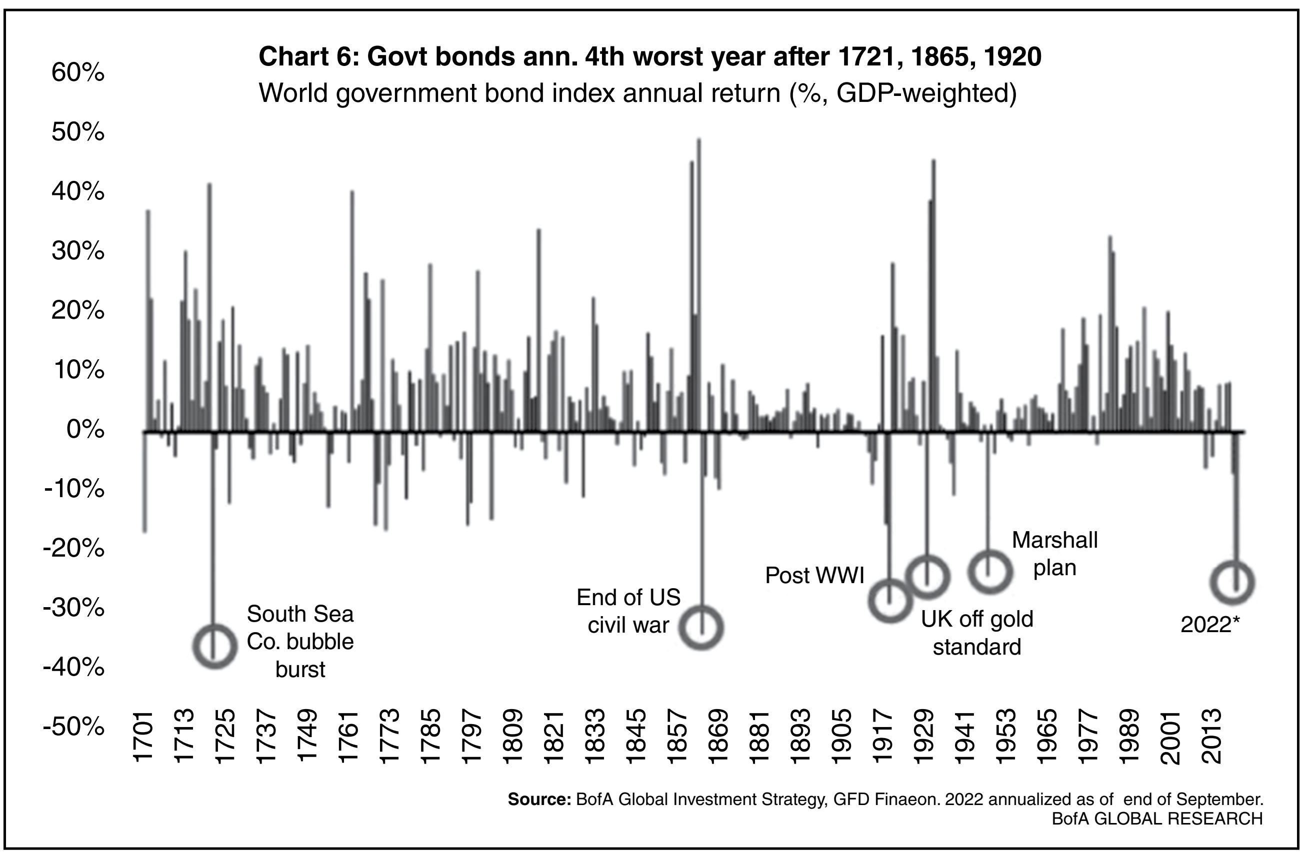


To put the bond market losses in even more perspective, this chart below shows just how bad bond returns were compared to each of the past 32 years.



And if this data is to be trusted, then here's the showstopper. 2022 was the 4th worst year for government bonds going back to the 1700s!!



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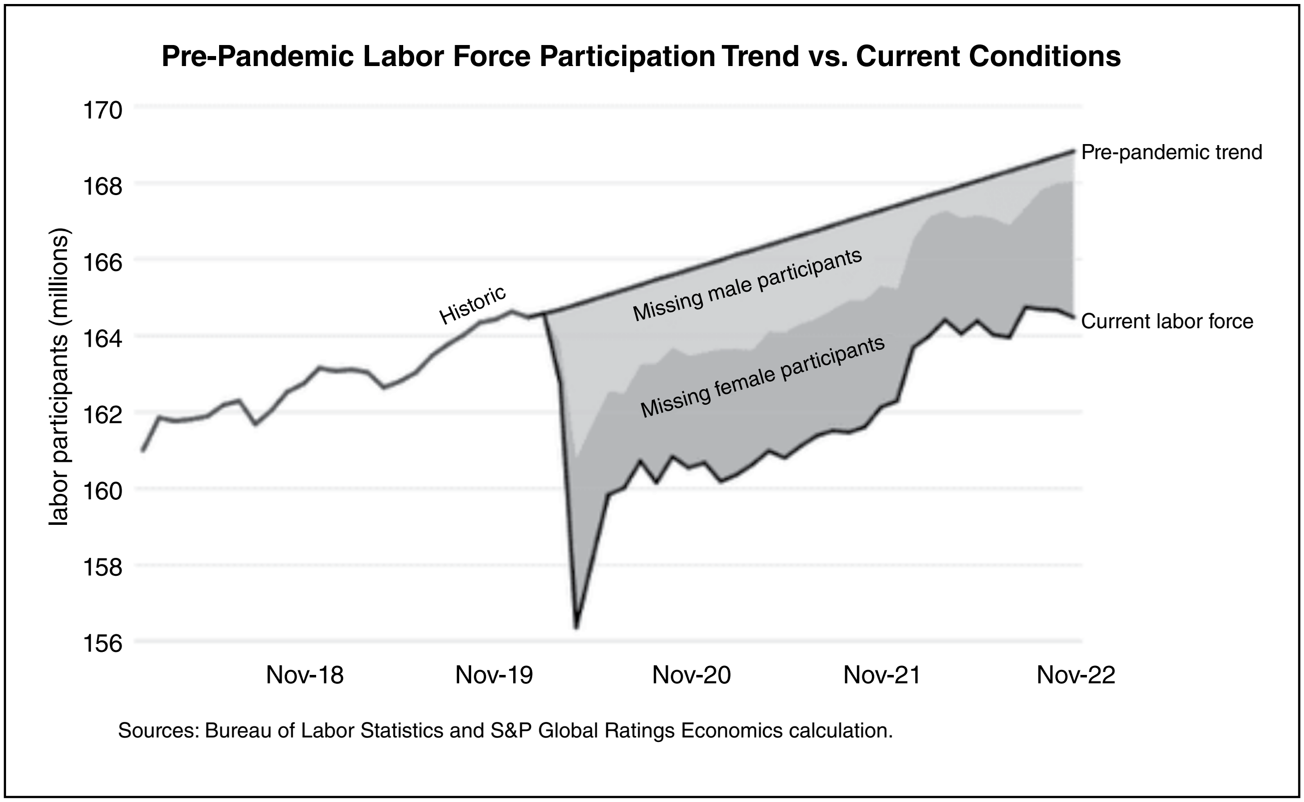
It is interesting to look at the bond market routs since 1865 and see that three of them (1865, 1920, and 1946) transpired after wars had ended and inflationary booms ensued. I'm guessing that this was related to the return of soldiers who consumed very little while fighting and now were coming back as a big cohort of domestic consumers at a time when economic output was geared to supporting the war effort. This led to an imbalance between supply and demand as consumer demand for non-war related goods and services skyrocketed while the supply was not sufficient to meet the increased demand.

Fast forward to 2022 and the spillover effects of Covid and the associated massive fiscal and monetary stimulus. There seems to be some similarities to these post-war situations. Production had to transition from services to goods as people either chose not to congregate or were prohibited from doing so which resulted in them staying at home for much longer periods of time. This created major supply chain issues and at the same time many people left the labor force due to health problems, childcare requirements, early retirement, and government payments such that the supply of labor contracted as the following chart shows.



The ending of Covid lockdowns (mandatory or self-imposed) unleashed a fury of pent-up demand for services such as dining out as well as for travel and hospitality. Like the soldiers coming back from wars, the economy was faced with more service sector demand from the newly liberated consumers while not having enough supply to satisfy the explosion in demand. Conversely, the areas of the economy that really prospered during Covid are now dealing

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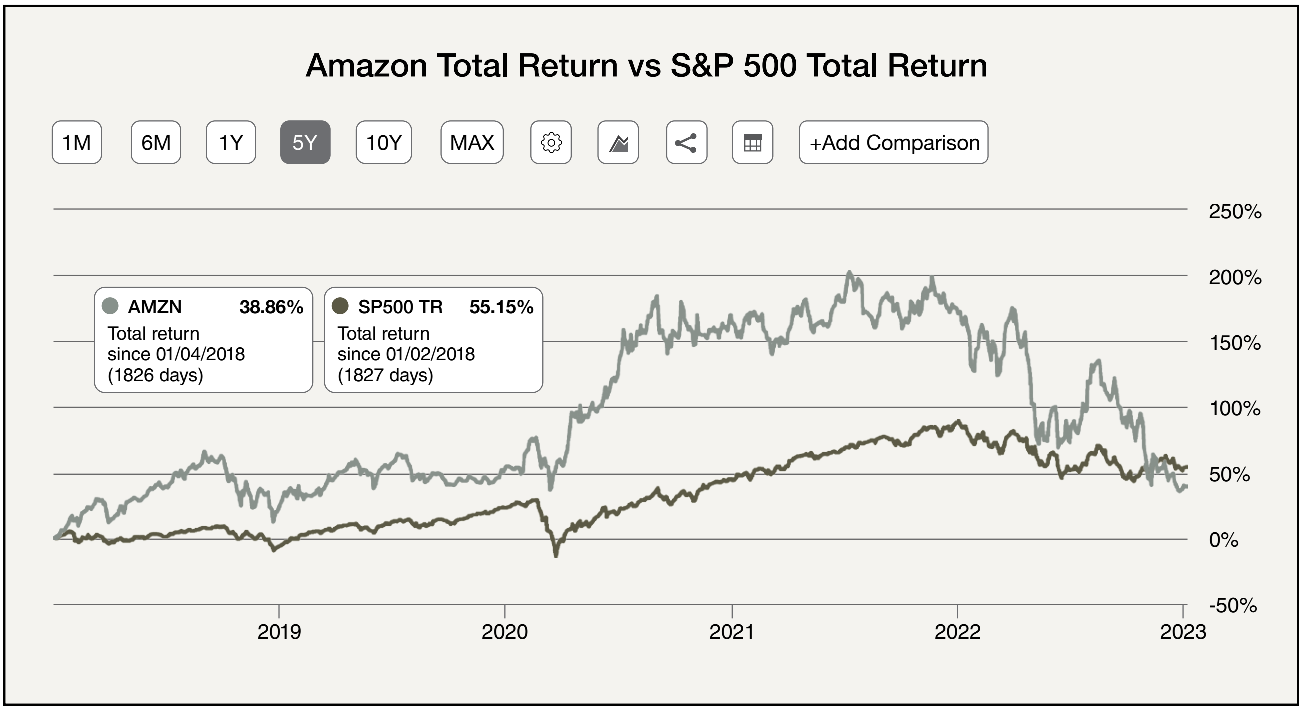
with the hangover resulting from over hiring and expanding based on more normalized demand during a more steady-state economy. Amazon is a perfect example of this as it hired huge amounts of people to help satisfy the demand for its e-commerce items. Now that consumer spending has shifted back to a more normal allocation to items that Amazon sells, it finds itself with too many people and warehouses.

TECH

Amazon Layoffs to Hit Over 18,000 Workers, the Most in Recent Tech Wave

Cuts focused on the company's corporate staff exceed earlier projection and represent about 5% of the company's corporate workforce

One can see that at the time of this writing Amazon's stock has now actually underperformed the S&P 500 over the last five years. This is after a dramatic outperformance during the Covid boom which has now been reversed due to society no longer spending nearly as much time at home.



Another Covid trend was the large number of people moving to less crowded areas due to the necessity of having to work remotely. One can see how home prices in more far out suburbs really took off as remote work exploded. And while prices are now starting to decelerate in the suburbs, they have still performed much better than the urban cores. The latter experienced an exodus of people due to homelessness, crime, quality of life issues, and not finding value in paying an urban premium if one couldn't benefit from the amenities that require large numbers of people being in proximity.

And if urban housing performed unimpressively in the aftermath of Covid, then office buildings have been horrendous. Charlie Munger has often said that it's important to use inverted thinking to gain insights to help know what to pursue and equally important, what

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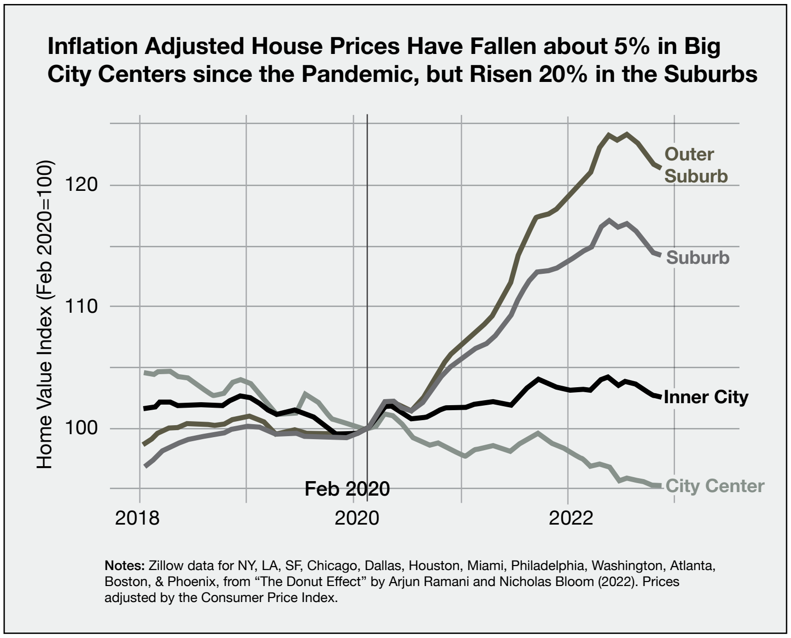
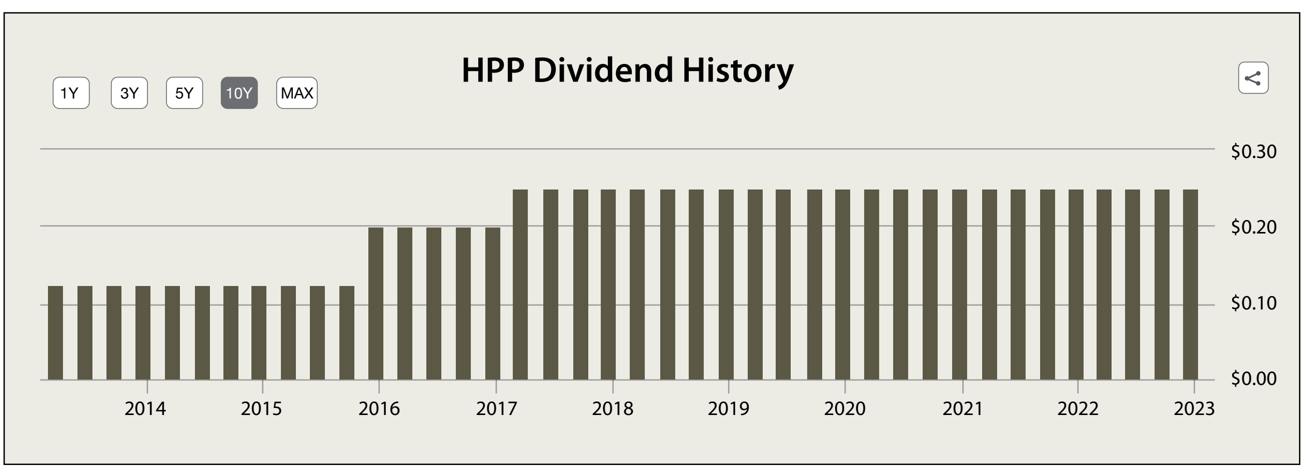


to avoid. For example, if one wants to learn how to live a great life, then, counterintuitively, it is often best to first determine what constitutes a bad life so you can start by avoiding those actions and mental states that bring about such an undesirable outcome. Rather than initially discussing the positive attributes of apartments as quality, long-term investments, I thought I would apply Munger's inversion technique by looking at a publicly traded office building REIT to help ascertain what we should avoid.

Distributions vs Value

Let me first say that by now many of our investors should be aware that beginning this quarter we will have cut distributions at several of our properties. While painful, this is something we felt was needed to do given the expiration of our very cheap (and quite profitable) interest rate cap that covered over $1.7 billion of our floating-rate debt coinciding with short-term interest rates having risen at an unprecedently fast rate. With the caps having expired we are now left with having to pay debt service at much higher rates without the same interest rate protection. This has led to debt service growing faster than our operating income, thereby putting a squeeze on distributable cash. The charts presented earlier about 2022 being one of the worst bond markets in history is a result of one of the most hawkish Federal Reserves in modern times and we have not been able to fully shield ourselves from the effects of its actions.

The office REIT I wanted to use as an example is Hudson Pacific Properties (HPP). Here is a chart showing its 10-year dividend history.



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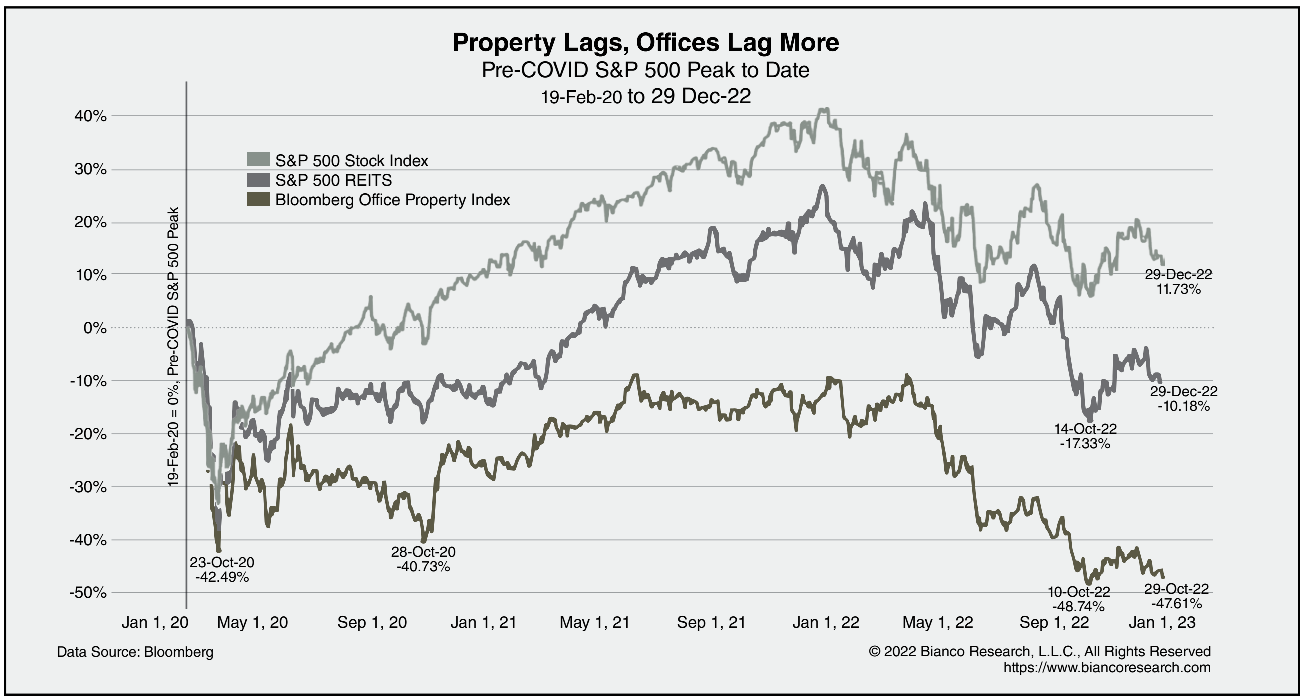
One can see that after two dividend increases its per share dividend has remained constant for the past five years or so. For income-oriented investors the lack of dividend volatility is understandably appreciated. For investors who are also sensitive to the total rate of return (income plus appreciation or depreciation), however, dividends can sometimes mask what is happening with the fundamentals of the business both good and bad.

For example, office buildings typically have longer-term leases such that leases signed during good times will still be paying above market rents when supply exceeds demand and rents start to fall. This can allow for dividends to remain steady, but the risk of future cuts could be rising beneath the surface as leases that are expiring may be renewed or replaced with new tenants paying lower rents.

With the onset of Covid and remote work, office utilization plummeted and led to every company with at least 25 employees to wrestle with how much space they really needed to occupy if the world was going to be transitioning to a hybrid work schedule. And while it does appear that more people are returning to the office, utilization rates are still far below pre-Covid levels. If stock market returns are any indication, then this is not a temporary phenomenon. This chart shows the performance of office REITs compared to the S&P 500 and a broader REIT index since prior to Covid.



The chart clearly shows how office REITs have gotten hammered, which is what one would expect if there is a fundamental shift in their long-term earning power. In addition to lower office utilization, tech giants that gobbled up a lot of space are now trying to unload some of it. The major source of demand is now transitioning to potentially a competitive source of supply via sub-leases. Salesforce is the latest tech giant to announce layoffs and the need to cut its occupancy costs.

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TECH

Salesforce to Lay Off 10% of Workforce, Reduce Offices

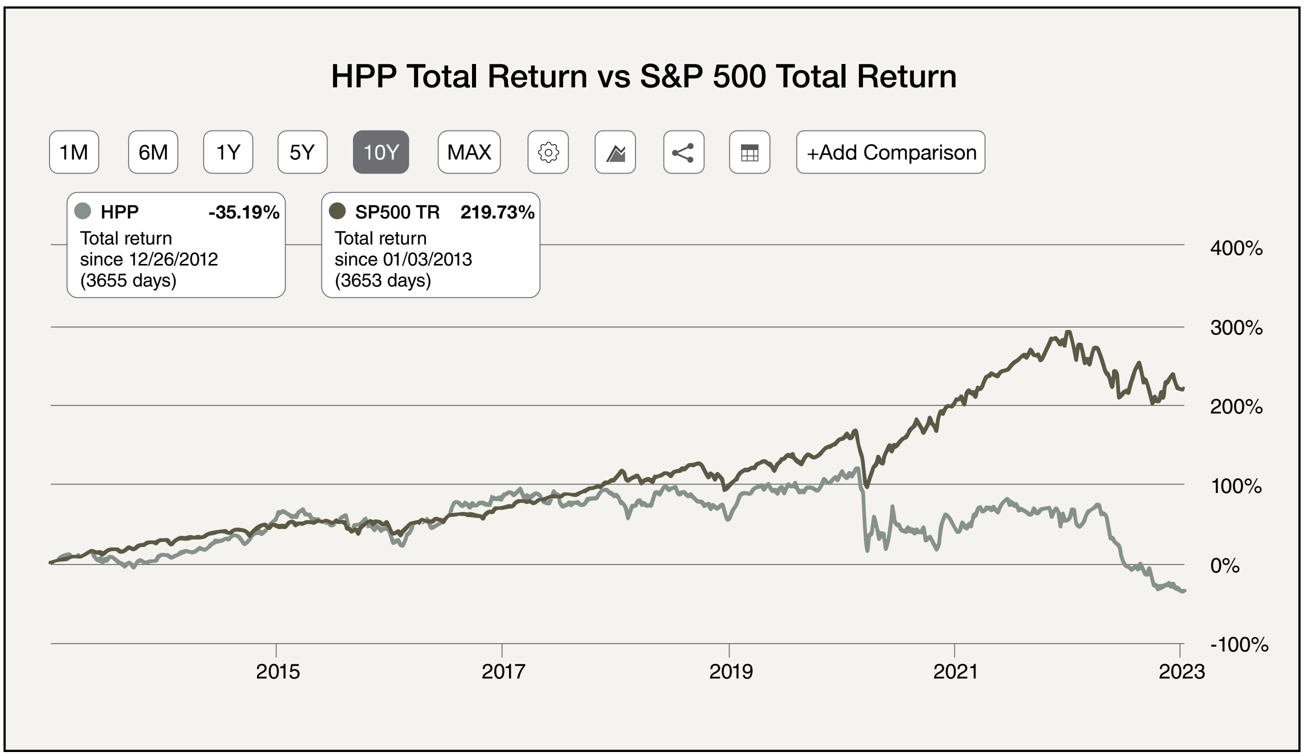
Co-CEO Marc Benioff says cuts come as customers pull back spending

Meta (formerly Facebook) is cutting back its office space in New York by 250,000 square feet.

Meta ditches office space at Hudson Yards as tech giant cuts costs

By Ariel Zilber November 30, 2022 | 3:41pm | Updated

Returning to Hudson Pacific, below is a chart showing its performance relative to the S&P 500 over the past 10 years. Up until Covid, while it was underperforming, it was not at an alarming rate. Since 2020, however, when the overall market took off, Hudson Pacific cratered, and the underperformance has been drastic, and the alarm bells are definitely ringing.



This next table shows the dramatic underperformance, particularly in the last year. I focus on the Hudson Pacific Total Returns versus the S&P 500 Total Returns. Being invested in a sector that has a fundamental change in its business prospects, demand fundamentals, and overall profitability is a recipe for losing money. What was a relatively solid investment between 2012 and 2020 collapsed in 2021 and 2022 such that its 10-year returns have been a negative 35% versus the S&P 500 more than doubling.

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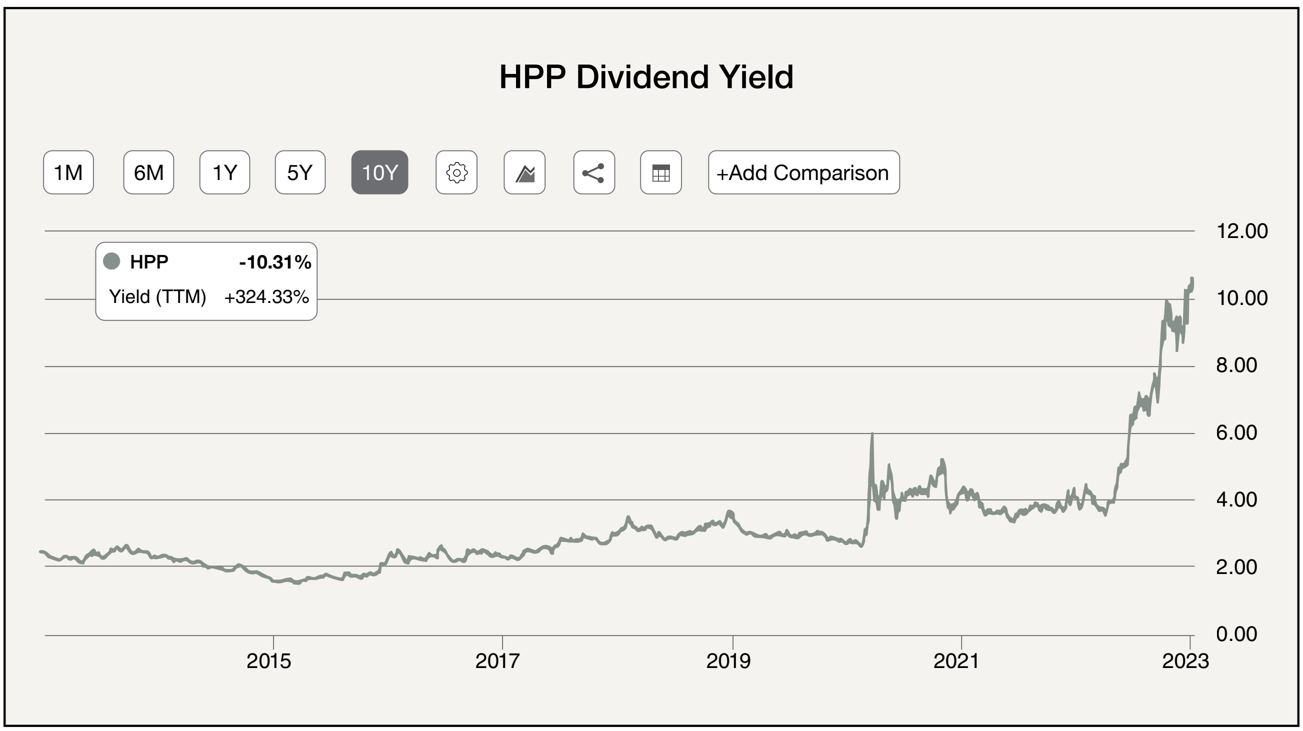
HPP vs S&P 500 - Price Performance								
	1W	**1M**	**6M**	**YTD**	**1Y**	**3Y**	**5Y**	**10Y**
HPP Price Return	-0.31%	-14.31%	-36.60%	-0.31%	-63.57%	-73.86%	-70.85%	-52.87%
S&P 500 Price Return	0.35%	-5.37%	0.72%	0.35%	-19.62%	19.11%	41.45%	162.74%
HPP Total Return	-0.31%	-12.23%	-33.80%	-0.31%	-61.03%	-69.70%	64.13%	-34.68%
S&P 500 Total Return	0.36%	-5.25%	1.60%	0.36%	-18.29%	25.05%	54.50%	218.65%

And if the above performance metrics are not convincing you that the market has deep concerns about future office building cash flows, then this chart should. This shows the historic dividend yield for Hudson Pacific. One can see that prior to Covid it was generally in the 2% to 3% range. And even after Covid, with the exception of the temporary spike to 6%, it was generally around 4%. All of this changed however starting in 2021 with the dividend yield now exceeding 10%. The market is either saying that the current dividend rate is unsustainable, or if it can be maintained, then investors are requiring a huge yield premium to compensate them for the risk of continued deterioration in asset values and potentially losing properties to lenders.



Office buildings have extremely high fixed costs, tenant concentration risk, costly leasing commissions and tenant improvement requirements, and long leases which can be good and

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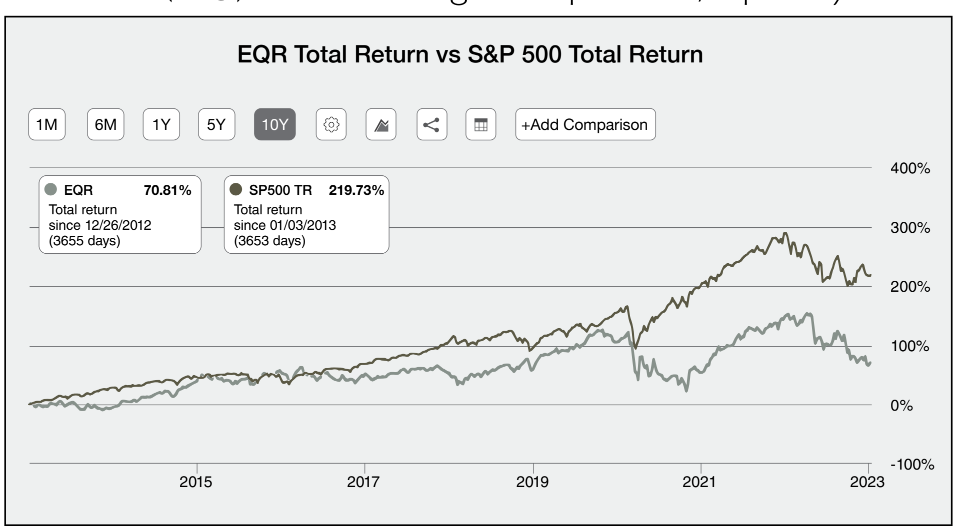
bad. Most of the biggest office investments are also in urban cores which have been hit very hard by Covid and office building usage there has particularly suffered. This makes the prospect of lease renewals daunting as many firms are questioning whether they need as much space. It also gives leverage to large tenants. Throw in much higher interest rates, new supply of office space hitting the market, and the prospects for a slowing economy, and it's not surprising that companies like Hudson Pacific have seen their share prices obliterated.

Fortunately for us, apartments, on the other hand, have a much better risk profile. Shelter is an essential need in our society. The leases typically average approximately 11 months so the rents can be reset more rapidly, which has its plusses in an up cycle but can be painful when markets soften. Over time, rents tend to grow fairly consistently and the risk is much less concentrated because a handful of tenants do not make up a large percentage of the revenue generation unless it's a very small number of units. And while capital expenditures can be significant, they are far less as a percentage of revenue than they are for office buildings. In addition, the leasing commissions are not nearly as high either. We also have very sound and reliable lenders, Fannie Mae and Freddie Mac, who have a government mission to provide financing to the apartment industry, especially for affordable units, that helps keep liquidity flowing when financial markets periodically go haywire.

Apartments have ridden a tremendous wave after the Great Recession and propelled even higher during Covid as people gravitated to lower cost, faster growing areas, and the need to work from home led to less occupants per unit, thereby increasing demand beyond normal levels. At the same time, labor supply issues along with supply chain challenges resulted in the large pipeline of apartments under construction taking longer to complete. This led to unprecedented rent growth of which CWS was very much a beneficiary.

Not all apartment investment strategies performed equally, however. Those companies focused on high cost, urban areas have underperformed quite significantly, although they have still produced positive returns, unlike office building owners. One of the largest apartment REITs is Equity Residential (EQR) which has a big urban presence, especially in very tenant-friendly, somewhat anti-business locations like New York City, Los Angeles, San Francisco, and Seattle. This chart shows its 10-year performance versus the S&P 500. And while positive, it too took a turn for the worse after 2020.



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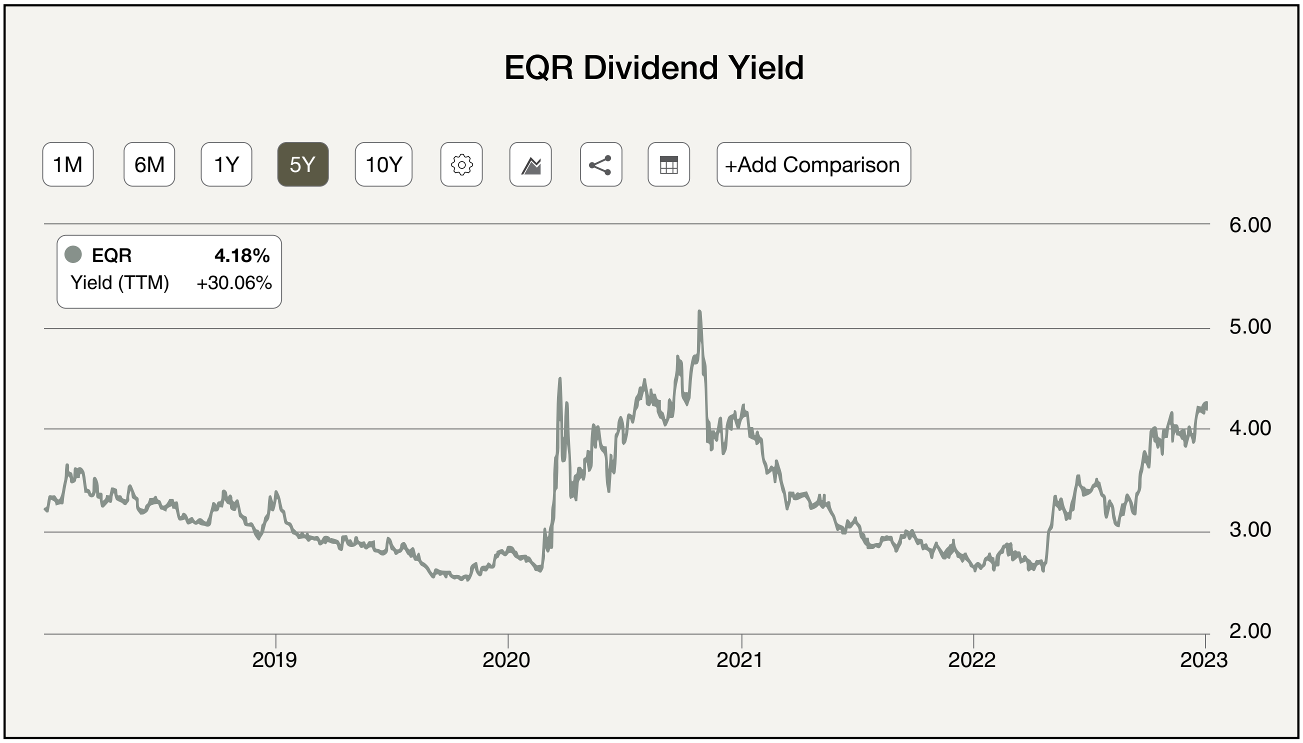
And one can also see that despite the underperformance, the yield investors are requiring is far lower than Hudson Pacific's which suggests that investors feel much more comfortable owning apartment companies, even those not ideally situated from a location perspective, than office building companies. One can attribute the bulk of this yield increase to higher interest rates versus concern about the durability of the cash flows of the asset class.



Now let's look at Mid-America Apartment Communities (MAA), which is a large REIT that has much more overlap with CWS than does Equity Residential given its sunbelt exposure and most of its properties being in the suburbs. One can see that despite underperforming the S&P 500 over the past year, MAA has outperformed it over 3, 5, and 10 years. This is a testament to picking the right markets, catering to the right customers, and purchasing assets at fair prices.

MAA vs S&P 500 - Price Performance

	1W	1M	6M	YTD	1Y	3Y	5Y	10Y
MAA Price Return	0.48%	-3.97%	-10.09%	0.48%	-30.63%	20.35%	63.33%	140.05%
S&P 500 Price Return	0.35%	-5.37%	0.72%	0.35%	-19.62%	19.11%	41.45%	162.74%
MAA Total Return	0.48%	-3.97%	-8.64%	0.48%	-28.78%	31.15%	91.38%	241.34%
S&P 500 Total Return	0.36%	-5.25%	1.60%	0.36%	-18.29%	25.05%	54.50%	218.65%

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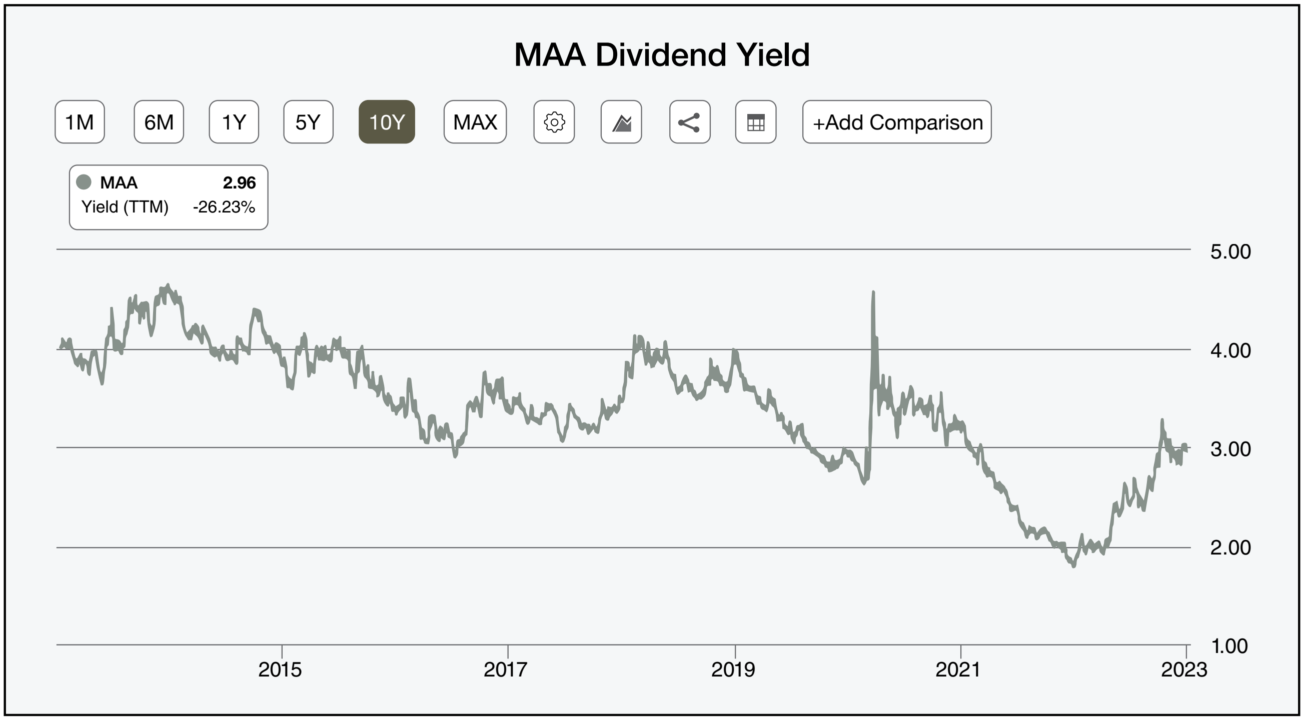
And while the dividend yield has gone up from its lows, it's still at the lower end of its more typical 3% to 4% range, once again showing how the market has great confidence in the company's future earning power.



I bring the examples of Hudson Pacific, Equity Residential, and Mid-America up to convey that, while unfortunately we had to reduce distributions at several of our properties, we believe the bulk of our portfolio's value has actually held steady and that the distribution reductions are not necessarily indicative of values having deteriorated. We are invested in an asset class that has great durability and our assets are located in very dynamic, growth-oriented markets that should continue to see strong demand due to their pro-business environments, quality of life, cost advantages, appeal to well-educated workers, and international appeal.

In many cases the values for a large percentage of our properties, particularly our more seasoned ones (owned for three years or more) will have held steady or even risen as compared to how we valued them last year via our Personal Annual Investor Reports (PAIR). This is the case because for many of our properties the growth in our 2022 Net Operating Income was stronger than the expansion of the cap rate (yield required by investors if properties were purchased without using debt) that has taken place in the market. During a recent webinar we held for our investors, Steve Sherwood presented this table which shows the math behind how property values can stay flat despite investors paying a smaller multiple for a $1 of operating income.

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	Dec. 31, 2021	Oct. 31, 2022	% Change
Income	$2.00	$2.28	14%
Expenses	$1.00	$1.06	6%
Net Operating Income	$1.00	$1.22	22%
Cap Rate	3.70%	4.50%	22%
Value	$27	$27	0%

At CWS we find ourselves in an interesting position given our emphasis on using floating-rate debt. If the Federal Reserve continues to increase interest rates and holds them at 5% or so, then this presumably means that the labor market is holding up well and wages are growing nicely. This should be supportive of apartment demand as jobs growth is often a catalyst for household formations which, in turn, should be further aided by the difficulty in buying homes due to much higher mortgage rates. On the other hand, if the economy weakens to the point where job growth slows materially or starts to contract then apartment demand will probably be negatively impacted but this should also lead the Fed to start cutting rates which should give us a very strong hedge against this weakness and can even be beneficial if rates get cut at a faster rate than any deterioration in our operating income. Thus, there's an argument we could benefit under either scenario, although I would say we would most likely benefit more from economic and labor market weakness leading to lower interest rates.

Mark Twain said that if he had more time then he would have written a shorter letter. I must have had a lot of time on my hands given the length of this article. In all seriousness, however, this is a serious topic. We know our investors are disappointed by having their distributions reduced or suspended at many of our properties and it's not an action we take without deep consideration. On the other hand, we strongly believe that we are invested in a terrific asset class with durable earning power in very dynamic locations. On a portfolio basis we do believe that our values have held up over the past year, although of course there will be individual exceptions. We believe we are well positioned if the economy continues to remain healthy and even more so if it weakens such that it leads the Federal Reserve to cut short-term interest rates.