Volume 27, No. 1, April 26, 2013

Quarterly Update

CWS Capital Partners LLC

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CWS

CALENDAR OF EVENTS

May 2013
CWS Capital Partners
Semi-Annual Conference Call

Monday, May 27, 2013
Memorial Day
CWS Offices Closed

Thursday, July 4, 2013
Independence Day
CWS Offices Closed

July 15, 2013
2nd Quarter 2013 Estimated Tax Payment Due

July 26, 2013
2nd Quarter 2013 Quarterly Packages Mailed

Monday, September 2, 2013
Labor Day
CWS Offices Closed

Ocober 15, 2013
3rd Quarter 2013 Estimated Tax Payment Due

Friday, October 25, 2013
3rd Quarter 2013 Quarterly Packages Mailed

Thursday, November 28, 2013
and Friday, November 29, 2013
Thanksgiving Day and Day After
CWS Offices Closed

Tuesday, December 24, 2013
and Wednesday, December 25, 2013
Christmas Eve and Christmas Day
CWS Offices Closed

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How Did We Do?

By Gary Carmell

Note: This is adapted from my presentation at our 2013 Annual Investor Meeting that was held on April 10.

There is a line from a Talking Heads song that says, "Say something once, why say it again?". I am usually a firm believer in this "less is more" communication approach… usually because I am on the receiving end of repetitive reminders (often justifiably so) of how I fell short from my lovely wife's perspective. When it comes to investing, however, and communicating one's thought process and strategy, it sometimes makes sense to repeat oneself. We have come through quite a remarkable period from the bottom of the recession in 2009 through today and we were pretty explicit in terms of how we thought key economic and social trends would unfold and what it would mean for apartments and our investments.

With enough time having passed, I thought it would be appropriate to review what we said to see if what we communicated came to fruition. I think it is vitally important for our investors to understand our thought process to determine if our strategy is well thought out and logical. In addition, our writings can serve as a diary to allow investors (and ourselves) to go back and read what we were thinking

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at the time. Everything can be reconstructed favorably in hindsight, but the true test of investment acumen is long-term success and this typically requires an accurate assessment of the economic, political, and social environments and the corresponding risks and rewards that are anticipated to materialize. Some situations require more aggressive course corrections than others to avoid calamity and to take advantage of opportunity. Our communications are intended to convey, when such strategic shifts are necessary. So, in the famous words related to Watergate: What did we know and when did we know it? Here is a brief journey back to 2009 and 2010.

At the depths of the financial crisis in 2009, we at CWS determined that in times of such immense and pervasive fear, it is vital that we keep a clear head and calm demeanor, because it is out of such pessimism, chaos, and wreckage that opportunities materialize. As an owner, operator, developer, and investment manager of apartment communities and related investments, we strongly believed that apartments had a very bright future. It was so bright that we embarked upon our first campaign to raise capital via a fund format when previously we always made specified, one-off investments. We determined it was critical to have a loaded gun in order to convince sellers that we were buyers that could close because we had capital in a capital-starved environment. Pre-committed capital via a fund structure was the best way of accomplishing this objective. To communicate the magnitude and rarity of this opportunity to investors we turned to Charlie Munger, Warren Buffett's partner at Berkshire Hathaway. This was prominently featured in the marketing material for CWS Strategic Apartment Fund I. This is what Munger said:

> "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 resources available as a result of prudence and patience in the past."
>
> Charlie Munger,
> Vice-Chairman of Berkshire Hathaway Corporation

We were convinced that we were on the precipice of one of those rare opportunities Munger was referencing. This is how we described the apartment investment opportunity in 2009-10:

Recent events have led to a substantial opportunity to purchase real estate assets at significant discounts to replacement cost not seen since the Savings and Loan crisis of the late 1980's. The August 2007 implosion of the

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85- year old investment bank, Bear Stearns, awakened the world to the reality that financial companies had far more exposure to risk than realized; the bankruptcy of Lehman Brothers further reinforced this fact. Not since the Great Depression has there been such a wholesale movement away from risk into safety. This resulting fear and financial weakness has led investors to disregard long-term fundamentals and has created an opportunity. For the first time in a very long while, investors can buy quality assets in premium locations at prices significantly below what it would cost to build new product, and with positive leverage (debt rates below that of the property's unlevered cash flow yield), providing healthy current returns.

The Opportunity

- The global liquidity crisis has opened a window to purchase quality assets at compelling prices.
- Undercapitalized owners are being forced to sell at steep discounts due to the inability to refinance or to access money to support other problem investments.
- Companies with strong track records and access to capital will be best positioned to capitalize on these opportunities.
- If history is a guide, then the nation's GDP and job losses should begin to stabilize in 2010. We concur.
- Companies that have a market presence in high-growth target markets will have a competitive advantage in buying assets with the best long-term potential.
- Supply and demand fundamentals in the multi-family sector are shifting back in favor of the landlord due to a lack of new apartments being built, a growing 20 to 30-year old demographic, and reduced home purchasing.

How Did We Get Here?

Multi-family real estate has fundamentally strong characteristics that position the asset class favorably during this recession. CWS sees the global liquidity crisis as a window to purchase assets with positive leverage and strong cash flow, in an environment that appears to be positioned well for long-term rent growth. Tighter underwriting standards by lending institutions have made real estate development increasingly difficult. In fact, there has been a virtual halt of new development projects. With the development timeline for an apartment project ranging from 12-24 months, and with little or no construction financing committed since the beginning of 2008, CWS expects that most new developments will have been completed by the end of 2009 and few new projects will be started. This lack of new supply, coupled with the long lead time to develop new projects, should result in several years of positive absorption of apartments, which will push occupancies and rents higher as supply and demand fundamentals shift back in favor of the landlord. In addition, the period of 1994 to 2006 saw home ownership increase from 64% of all households to 69%. Today, lenders are requiring better credit and larger down payments that make it more difficult for renters to buy homes. This, combined with rising residential mortgage defaults, will lead to a shift back to more normal rates of home ownership as has already begun to occur. After hovering around 69% from 2004

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through 2006, the home ownership rate has fallen to 67.3% as of the first quarter of 2009, a level not seen since 2000.

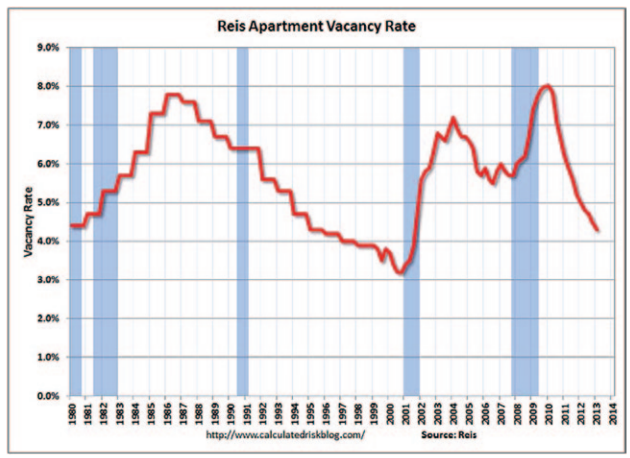
Summary

CWS believes that the global financial crisis, spurred by greed, terribly inadequate risk-management systems, and shockingly poor judgment driven by misaligned incentives, has created an opportunity to buy great real estate. We expect to see opportunities that will offer purchase prices far below replacement cost and with positive leverage, that will provide healthy current returns. Continued population growth, a soon-to-occur supply shortage of new apartments due to a lack of construction financing, and a larger renter pool caused by stricter lending practices limiting new home purchases, should lead to higher occupancies and increasing rents in the long term. Companies best positioned to capitalize on the opportunity must possess strong track records, access to capital, and a market presence in cities with educated populations and pro-business policies that are focused on trade, technology, energy, and medicine.

How Did We Do?

In 2012 we had 48 properties that we owned in 2009 and 2010. In 2010 they produced a combined Net Operating Income (revenue minus expenses) of approximately $85 million. By 2012 those same properties produced approximately $102 million of NOI, or 20% higher, while generating revenue growth of 14%. Because we were able to refinance a number of those properties during those three years and take advantage of lower interest rates, our debt service dropped from $61 million to $55 million, thereby producing cash flow (before capital expenditures) that grew from $23 million to $46 million, doubling over a two year period. I would say we did very well and much better than we had expected.

The following chart is a good depiction of the strength of the apartment markets across the country as the vacancy rate has dropped significantly from its peak in 2010.



Although multi-family development has expanded, we believe there is still not enough new housing being generated in our markets given the level of job growth that is occurring. Over long periods of time we have found that for every one job created there are approximately 0.7 new permits issued (exclusive of 2-4 units) for the construction of housing. The following table shows peak permits on a rolling 12-month basis, current permits, 70% of the last 6 months' job growth, and how under-supplied the market is based on this analysis.

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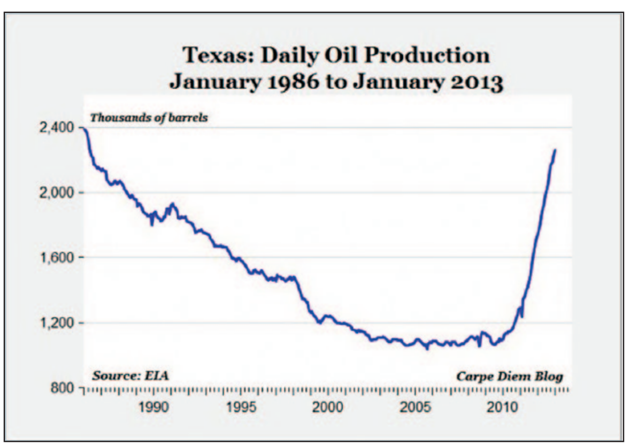
	Peak Permits	Permits*	70% of Job Growth**	(Under)/Over Supply
Atlanta	73,455	15,000	36,097	(21,097)
Austin	26,719	21,022	21,233	(211)
Charlotte	26,901	12,990	18,072	(5,082)
Dallas/Fort Worth	61,910	33,944	69,942	(35,998)
Denver	28,130	11,870	24,710	(12,840)
Houston	64,318	39,630	77,548	(37,918)
San Antonio	22,617	7,892	13,977	(6,085)
* Last 12 months permits for single-family residences and structures with 5 or more units.				
** 70% of the average annual job growth for the last 6 months (Sept. 2012 - Feb. 2013).				

Sources: Bureau of Labor Statistics and U.S. Census Bureau

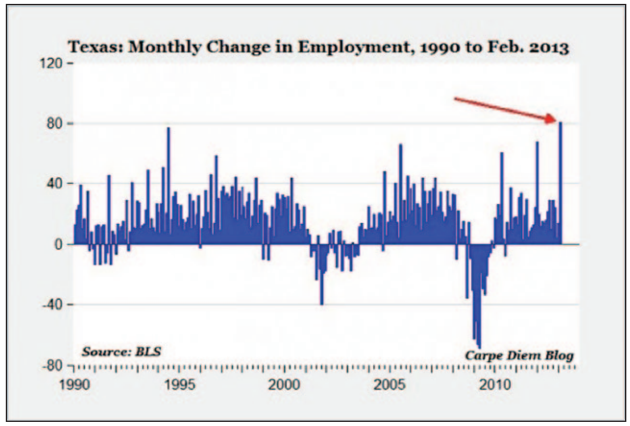
With the exception of Austin, each market is experiencing a meaningful under-supply of housing based on this analysis. In many cases, permits would have to come close to doubling to satisfy the demand based on the current level of job growth.

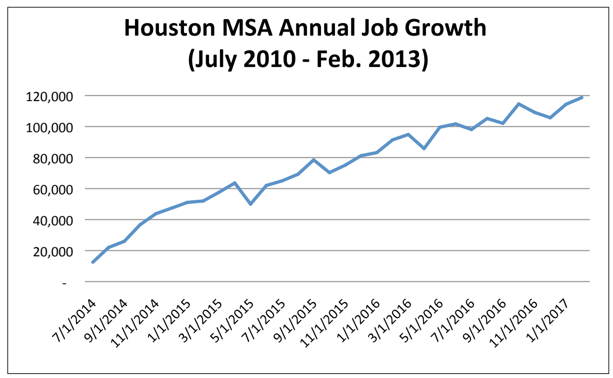
This should continue to be a positive sign for apartment owners, particularly in Texas, as Texas is prospering significantly from the explosion in oil and gas exploration and production related to hydraulic fracking in the Permean Basin, Eagle Ford Shale, and the Cline Shale which has resulted in billions of dollars of investment with much more to go. According to the University of Texas-San Antonio, the economic activity associated with the Eagle Ford Shale alone added $28.4 billion to the state's economic output in 2012.

Oil production is up significantly as the following chart shows.



This has led to very strong job growth for the state in general and Houston in particular as the next two charts show.





Source: Bureau of Labor Statistics

Single-family housing markets are strengthening which is needed and not the cause for concern for apartment owners as it was during the bubble period of 2003-7 when they were siphoning off quality renters via imprudent underwriting standards for people who should never have been homeowners.

The improving single-family market is good for the economy and should help job growth and household formations which will benefit apartment owners. Despite the renaissance of single-family, there are still some powerful demographic drivers for apartments. The prime renter demographic of 18 to 30 year

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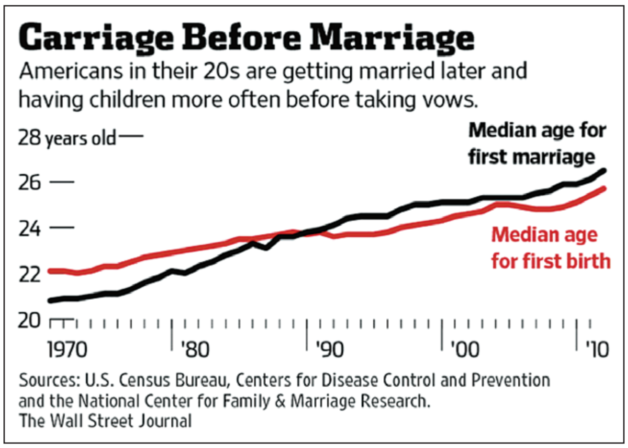
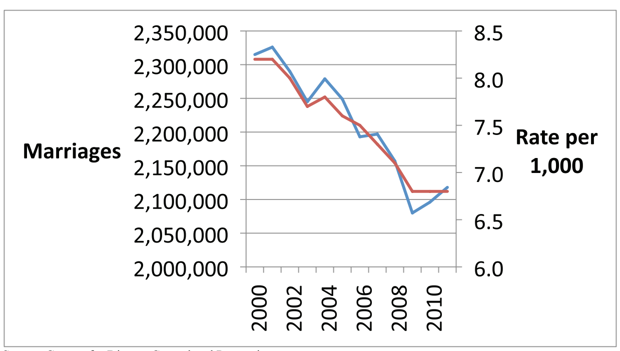
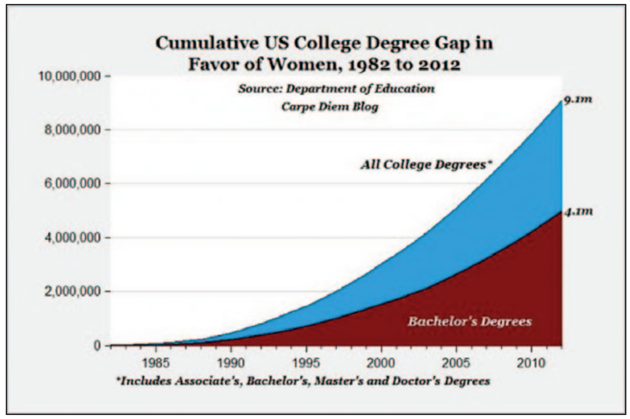
olds is projected to continue to exhibit strong growth for the next 20 years. Another important trend is the delay in marriage, the mis-match in male/female educational attainment, and the resulting number of births to single mothers or in co-habitation households. Marriage and starting a family is one of the best predictors of home buying but as the following charts shows, people are getting married later and the number of marriages has been dropping as well as the marriage rate.





Source: Centers for Disease Control and Prevention

Approximately 41% of children are born to single mothers and the odds of getting married lessen as educational level drops. Only 12% of those women with college educations have first births out of wedlock while it is 83% for high school dropouts. This looks to pose a looming challenge as there are currently 9.1 million more degreed women than men and 3.1 million more in college now as the following charts show.



NATIONAL ENROLLMENT

Total fall enrollment in degree-granting institutions

1970

Men: 5 million

Women: 3.5 million

2000

Men: 6.7 million

Women: 8.6 million

2010

Men: 9.1 million

Women: 12.1 million

Source: U.S. Department of Education

There is some question as to whether this will result in even educated women remaining single more than they have in the past due to a lack of perceived suitable mates. All of these trends are seemingly beneficial to apartment owners over the long run as it should result in a fairly large segment of the population that may not have the credit and financial resources to be home owners for a relatively long period of time.

Supply and demand imbalance, favorable demographic trends, and interest rates that should remain quite tame for awhile (see last quarter's article "Silver Linings Playbook"),

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offer favorable yield generating potential for selective investments, including more of a focus on developing high quality, long-term ownership assets, due to higher prices for existing properties and a strong customer demand for new product.

On a Personal Note – Book & Blog

I started off the article with the quotation from Charlie Munger. Our results have shown that we were able to do what he described. How were we able to do this? That is the benefit of having over 40 years of history with a tremendous amount of experience navigating the turbulent waters of economic cycles.

By this time next year I am hoping to have written a book. The working title is called Investing with Socrates (and a few rock and roll poets). Socrates said that courage is knowing what not to fear while wisdom is knowing what to fear. The book is intended to show how the trials, tribulations, and triumphs over the last 40 years or so have helped us deepen our wisdom to avoid calamity and strengthen our courage to take advantage of opportunity, culminating in capitalizing on this very powerful investment wave we started riding in 2010 and into the future. Since it will lean heavily on much of what I have written over the years in these articles, it will at times feel like a real time diary weaved into a narrative about what we were thinking, fearing, looking forward to, etc. as events were unfolding. It's an ambitious endeavor, but one well worth taking because CWS is a special company with extraordinary people, and an amazing history whose trails were blazed by three very special individuals. It is a story well worth conveying.

Finally, self-promotion is not my natural instinct but I have come to learn that it is extraordinarily helpful to have an online presence to a wider audience by the time the book is published. I will be launching a blog for people to have a more real time insight into my current thinking (psychiatrists and psychologists are encouraged to stay away). As I have been writing entries I have found it helpful to crystallize my thinking with regard to our strategy and direction, although you will find some of the postings quite tangential to apartment investing. Nevertheless, I hope followers will find it interesting, thought provoking, educational, and entertaining. While the blog address will be:

www.garycarmell.com

the title of it is going to be Same As It Ever Was because I believe that with rare exception, there is very little new under the sun and I hope to convey this time and again. In fact, by looking into the past and finding parallels (particularly from the 1930s) we were able to widen our knowledge base beyond just what we had experienced in order to capitalize on the extraordinary opportunities that have unfolded as we transition to more of a Renter Nation. I hope you will visit the blog periodically and find it to be a source of education and enjoyment.

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