

QUARTERLY UPDATE

CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

November 18, 2013
CWS Capital Partners
Semi-Annual Conference Call

**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

Friday, January 31, 2014
4th Quarter 2013
Quarterly Distributions Mailed

February 28, 2014
Year 2013
K-1's Mailed

Friday, April 11, 2014
CWS Annual Partners Meeting
Newport Beach Marriott Hotel and Spa
Newport Beach, CA (Fashion Island)

Tuesday, April 15, 2014
Year 2013 Federal and State Taxes
Filing Deadline

Friday April 25, 2014
1st Quarter 2014
Quarterly Distributions Mailed



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LET THE NUMBERS DO THE TALKING

By Gary Carmell

This article will be shorter than others as I would like the numbers to do the talking as well as Bill Gross from PIMCO. For those of you who have paid even a little bit of attention to our communications, you know that we have had a bias towards variable-rate financing over the last two years or so.



Our use of it goes back to 2003 in terms of when it was more widely deployed by us, but we have really made a quantum leap forward since 2011. Approximately 45% of our outstanding loan balance is variable. I thought it would be interesting to see how variable-rate loans we have put in place since June 2012 and sooner have performed relative to my estimate of what a fixed-rate loan would have been for a similar loan term. This comparison uses Fannie Mae Structured ARM loans (with one exception in which a Freddie Mac loan is used because it is similar to the Fannie loan structure). I generally added 2% to the prevailing 10-year Treasury yield three days before the loan was originated to come up with a fixed-rate equivalent and 2.25% for the 7-year

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Treasury yield for two of the three seven year loans in the data set (Rogers Ranch and Waterview) and 2.50% for Stonegate because of its student concentration. We have 33 variable-rate loans so over time many more properties can be added to the data set as they have more operating history to have financially meaningful results.

The following table shows how much lower our debt costs have been by being variable versus fixed and how this has translated into additional cash flow being generated by the nine properties in the data set:

Property	Months	Avg. Loan Amt.	Est. Fixed Rate	Avg. Interest Rate	Annual Difference	Interest Savings	Savings as % of Loan	Cap Cost	Net Savings
Rogers Ranch	25	\$16.5	3.75%	2.87%	-0.88%	\$296,611	1.80%	\$117,550	\$179,061
Waterview	23	\$36.5	3.74%	2.96%	-0.78%	\$531,466	1.46%	\$0	\$531,466
Carmel Valley	20	\$29.3	3.94%	2.43%	-1.51%	\$747,658	2.55%	\$203,800	\$543,858
Woodlands	19	\$21.3	4.07%	2.46%	-1.61%	\$542,296	2.55%	\$172,913	\$369,383
Shoreline	18	\$17.4	3.75%	2.43%	-1.32%	\$332,635	1.91%	\$117,220	\$215,415
Texas Street	18	\$21.7	3.74%	2.43%	-1.31%	\$410,390	1.89%	\$88,740	\$321,650
Stonegate	17	\$19.6	3.51%	2.61%	-0.90%	\$250,971	1.28%	\$0	\$250,971
Turtle Creek	17	\$7.4	3.63%	1.96%	-1.67%	\$178,503	1.40%	\$51,670	\$126,833
Barton Trail	17	\$10.8	3.61%	2.44%	-1.17%	\$177,782	1.64%	\$60,941	\$116,841
Totals/Avg.		\$20.1	3.78%	2.61%	-1.17%	\$3,468,311	1.91%	\$812,834	\$2,655,477

Prior to factoring in the cost of purchasing an interest rate cap, these nine loans on average have experienced a lower annual interest rate of approximately 1.2% and 1.9% cumulatively as a percentage of the loan amounts¹. This translates into nearly \$3.5 million in higher cash flow. These properties have approximately \$61 million of invested capital, so this translates into approximately 5% additional cumulative cash generation as a percentage of the cumulative investment base. Equally important, the benefit is growing by approximately \$190,000 per month for the nine properties assuming no change in interest rates, which translates into approximately 3.75% in additional cash generated per year relative to the fixed rate alternatives. Assuming that the Fed stays on hold through 2015, then the cumulative benefit should exceed \$7.5 million by the end of 2015 or in excess of 12% of invested capital.

For most of the properties listed above, if we were to convert to a fixed-rate loan today, the rates would be approximately 2.25% higher which would significantly increase our debt

service. On the one hand, perhaps there is frustration that we missed the opportunity to fix our debt at rates that are approximately 1% lower than what is prevailing today. On the other hand, however, we would have given up all of the cash flow benefits that we have earned in the first 17 to 24 months or so. In addition, it is possible that fixed-rate loans may drop in the future so we may not have missed the window entirely. Being variable provides tremendous flexibility because our pre-payment penalties do not lock us into our debt structure like fixed-rate loans do. Thus, we preserve the opportunity to convert to a new fixed-rate loan, refinance into another variable-rate loan with a lower spread over libor or fixed-rate loan, or sell the property.

So what are the prospects for short-term interest rates? Rather than reiterate all of my reasons why I think rates will continue to stay low, I thought it would be most effective (and perhaps credible) to outsource the arguments to Bill Gross, the world famous bond investor from PIMCO, who has a much more impressive track record in this realm. He wrote the following in his recent Investment Outlook (emphasis is his):

In bond parlance, the all clear sign would mean that the Fed believes what it says, and if their guideposts have any credibility, they won't be raising policy rates until 2016 or even beyond. **The critical question to ask in terms of the level and eventual upward guide path of the policy rate is how high a rate can a levered economy stand? How much wood can a woodchuck chuck? How high a rate can a homebuyer handle? No one really knows, but we're beginning to find out. The increase of over 125 basis points in a 30-year mortgage over the past 6–12 months seems to have stopped housing starts and importantly mortgage refinancings in its tracks. It was the primary "financial condition" that Chairman Bernanke cited in his September press conference that shifted the "taper to a tinker to a chance" that maybe they might do something next time.**

If you want to trust one thing and one thing only, trust that once QE is gone and the policy rate becomes the focus, that fed funds will then stay lower than expected for a long, long time. Right now the market (and the Fed forecasts) expects fed funds to be 1% higher by late 2015 and 1% higher still by December 2016. Bet against that.

The reason to place your bet on the “don’t come” 2016 line is what we have just experienced over the past few months. We have seen a 3% Treasury yield and a 4½% 30-year mortgage rate and the economy peeked its head out its hole like a groundhog on its special day and decided to go back inside for another metaphorical six weeks. No spring or summer in sight at those yields. The U.S. (and global economy) may have to get used to financially repressive – and therefore low policy rates – for decades to come... [T]he last time the U.S. economy was this highly levered (early 1940s) it took over 25 years of 10-year Treasury rates averaging 3% less than nominal GDP to accomplish a “beautiful deleveraging.” That would place the 10-year Treasury at close to 1% and the policy rate at 25 basis points until sometime around 2035! I’m not gonna stick my neck out for that – April, May and June of 2013 have taught me a lesson that low yields can become high yields almost overnight. But they should stay abnormally low.

I agree completely with Gross and believe this should translate into staying the course in terms of having a bias towards variable-rate loans and continuing to take advantage of the tremendous cash flow advantage offered by many of these loans relative to the fixed-rate alternatives. It will be interesting to update the table presented at the beginning of this article one year from now not only to see how these loans performed relative to their fixed-rate challengers, but many other ones as well that will have become more seasoned. I think we will all like the results.

¹These are one-time interest rate cap costs that don’t impact cash flow for the first five years typically but an additional cap will need to be purchased again at the end of year five if the loan is still in place. Every month we impound dollars with the lender to reserve for the future purchase of a second cap typically after five years. These reserves are not factored into the calculation because if the loan is paid off prior to the end of five years, then the dollars are returned to the borrower(s).