

QUARTERLY UPDATE

CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

September 4, 2023

Labor Day Holiday

CWS Offices Closed

September 15, 2023

3rd Quarter 2023

Estimated Tax Payments Due

October 16, 2023

2022 Tax Return Extensions Due

October 27, 2023

3rd Quarter 2023

Quarterly Reporting Packages Mailed

November 23-24, 2023

Thanksgiving Holiday

CWS Offices Closed

December 25, 2023

Christmas Holiday

CWS Offices Closed

January 1, 2024

New Year's Day Holiday

CWS Offices Closed

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GETTING TO '25:

A BUMPY RIDE AND THE OPPORTUNITY TO THRIVE

By Gary Carmell



In May we had our first in person Annual Investor Meeting since 2019. It was so nice to be together again despite not communicating the rosier of messages. We showed how higher interest rates have negatively impacted our cash flows given our reliance on variable-rate debt. I spent the bulk of my presentation discussing why we have emphasized variable-rate loans since 2011 and our rationale for not converting to fixed-rate financing when rates were lower. The presentation was too lengthy and detailed to cover all of it here, but it was recorded and is on our website for those who would like to watch it.

For this article I wanted to focus on one aspect of the presentation and how unusual, and painful, today's situation is. And while I don't think the situation will change until the second half of 2024, I do think that the continued squeeze the Federal Reserve is putting on variable-rate borrowers and those needing to access new credit should generate some compelling investment opportunities. These should be most prevalent from borrowers who utilized very high leverage variable-rate loans with correspondingly high spreads over LIBOR/SOFR to purchase properties between mid-2021 and mid-2022 at record low yields.

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For these investments to be profitable it necessitated interest rates staying low and rent growth remaining robust. Conversely, it would only take modestly lower than projected rent growth and higher than projected expense increases, along with interest rates rising only 1% or more to put these borrowers in a precarious financial position. Unfortunately, this is what happened and now many of these properties are producing significant negative cash flows and these owners will be very challenged to refinance these loans when many of them come due between 2024 and 2025 as they will not qualify for enough debt to replace their maturing loans. This will necessitate sales or potentially highly dilutive capital infusions. And if neither of these materialize, then foreclosures will result.

Absent a rapid and significant reversal by the Fed to shift to lowering interest rates and loosening monetary policy, it looks like the stage is set for those apartment investment firms with patience, access to capital, and a solid track record with lenders to deploy capital over the next couple of years in ways that should provide compelling returns relative to the risk being borne. Since I started at CWS in 1987 we have been well positioned to take advantage of opportunities that materialized during other downturns, and I don't see why we won't be for this one as well. And while we are not immune to facing our own set of challenges, fortunately the combination of reasonable leverage levels and almost all our debt maturing in 2025 and beyond should make working through the challenges we do face fairly manageable. With that being said, we expect somewhat of a bumpy ride through 2024. By 2025, however, we should start turning the corner as I expect interest rates to be lower and industry fundamentals to have improved. Our goal is to make sure each investment is on solid financial footing to get us over the hump until the Fed reverses course and apartment demand once again exceeds new supply.

The Math Behind Variable Rate Loans

The underlying premise behind our variable-rate focus has been that for the economy to function optimally banks must be healthy and profitable so they can continue to provide credit prudently and continuously to help support the economy's needs so that it can grow and innovate. For this to occur the yield curve should be positive for a large percentage of the time. Said differently, long-term interest rates need to be higher than short-term rates since banks pay depositors and holders of certificates of deposit based on short-term rates and they then in turn lend out money to make longer-term loans based on long-term interest rates. This spread helps banks remain profitable. When the curve is inverted, however, the profitability of the bank sector comes under pressure.

I went back and looked at some interest rate statistics to see if this theory had validity. I used two time frames. The first was from 1990 to 2002 when rates were quite a bit higher and then from 2003 to the present when rates continued lower until they reversed course starting in late 2022 through now. I looked at daily closing yields for the 10-year Treasury Note and 3-month Treasury Bill for these time frames as proxies for testing whether the slope of the yield curve is positive more than it is negative (inverted).

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I used the 10-year as a proxy for the cost of 10-year fixed-rate loans and the 3-month for the cost of floating-rate loans. The assumption is that the spreads over the two indices were the same. It's not a perfect assumption, particularly since our floating-rate loans have been pegged to 30-day LIBOR and now SOFR, but for testing my hypothesis it works just fine. The point is that if a positive yield curve is the most common situation versus an inverted yield curve, then being a floating rate borrower should result in a lower cost of funds over the long-term. So what does the data say? Here is the first table with the key data.

	1990 - 2002	
	Positive	Inverted
# of Days	3,136	116
Percentage	96.4%	3.6%
Avg. 10-Year Yield	6.36%	5.62%
Avg. 3-Month Yield	<u>4.51%</u>	<u>5.96%</u>
Differential	1.85%	-0.34%
Current 10-Year Yield		3.98%
Current 3-Month Yield		<u>5.42%</u>
Differential		-1.44%

When it comes to this dataset, the results are overwhelmingly supportive of the hypothesis that a positive sloping yield curve is the default state for the economy as it was positive 96% of the time with an average spread between the 10-year and 3-month of 1.85%. In addition, during those rare times when the yield curve was inverted (approximately 4% of the time) it was only inverted by an average differential of -0.34%. This

provided a very asymmetric risk-reward relationship for floating rate borrowers in that when it was positive, it was positive for the vast majority of the time and with a much higher spread (1.85%) as compared to when it was inverted (-0.34%).

The second dataset has very similar results, although in the first one the 10-year yield was higher when the curve was positive while in the second one the 10-year yield was lower when the curve was positive versus when it was inverted.

	2003 - 5/5/23	
	Positive	Inverted
# of Days	4,669	410
Percentage	91.9%	8.1%
Avg. 10-Year Yield	2.86%	3.72%
Avg. 3-Month Yield	<u>1.01%</u>	<u>4.16%</u>
Differential	1.85%	-0.44%
Current 10-Year Yield		3.98%
Current 3-Month Yield		<u>5.42%</u>
Differential		-1.44%

Once again, the curve was overwhelmingly positive with this being the case 92% of the time versus 8% when it was inverted. What's fascinating to me is that despite the 10-year yield being much lower when the curve was positive (2.86% average) versus in the first dataset (6.36% average), the spread was still 1.85% between the 10-year and 3-month.

A couple of takeaways. This dataset also had a very positive risk-reward relationship if you were a floating rate borrower. The 1.85% average spread has been in place approximately 92% of the time while for the other 8% it was only -0.44%.

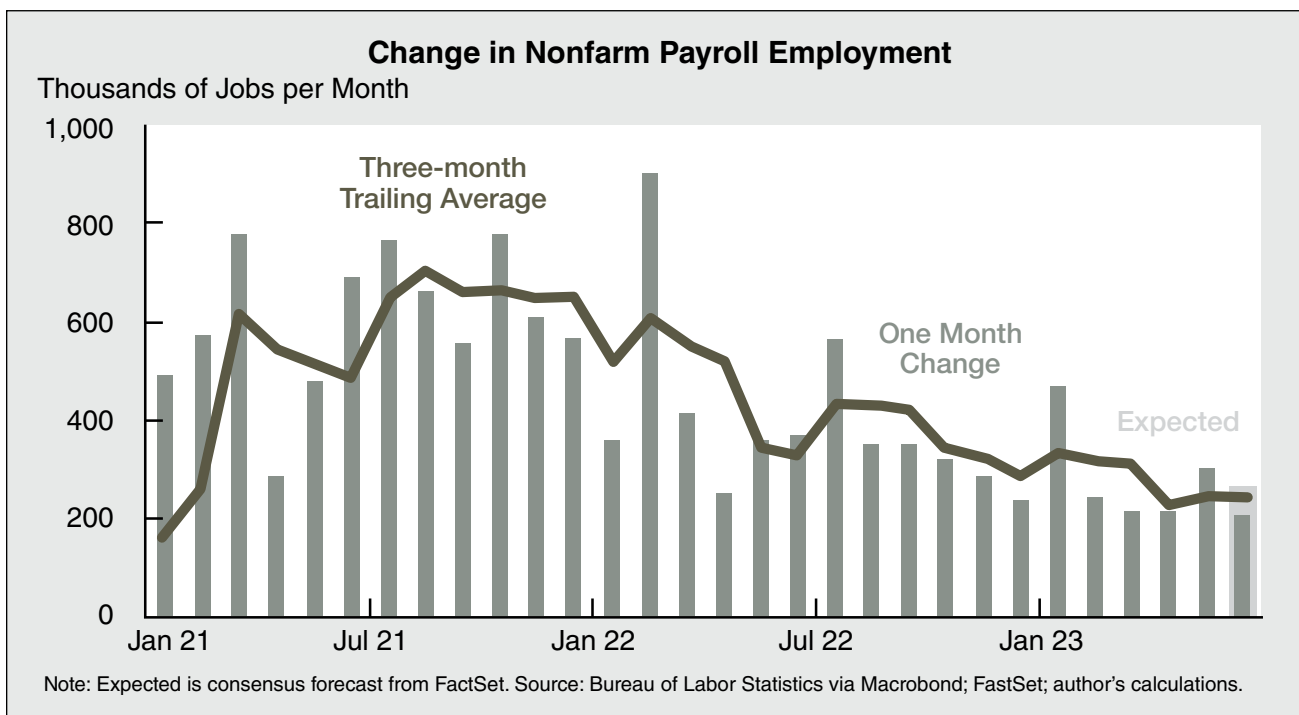
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In addition, one can see what an incredible anomaly today's inverted yield curve is and how it has to be a temporary phenomenon as this is not the natural state of affairs as it has not only caused a lot of pain for the banking system with two high profile bank failures and deposit outflows to much higher yielding money market funds, but will continue to do so as banking pressures continue to build as profitability is eroded. In addition, there is more pain on the horizon with office building loans defaulting adding to profitability pressures for banks. All of this is conspiring to make credit much harder to access. This is especially true for apartment construction loans. It's virtually impossible to get a bank to originate a new loan to build an apartment community. This is a good thing for the industry, however, as there are currently a lot of units being completed and in lease-up that need to be absorbed. This will probably take through 2024 for the industry to get more into equilibrium and with the prospect of supply being curtailed going forward, 2025 should start to provide more daylight for apartment investors.

If the typical 1.85% gap between long and short rates rematerializes, and the 10-year Treasury yield stays at around 4.00%, then this would imply a future 3-month T-Bill yield of 2.15%. If this happens, then we are very well positioned to benefit from this more than 3% drop in short-term rates. On the hand, this is a big if and the reality of the here and now is that the rate we're paying is closer to 7%, not factoring in any benefits we're receiving from interest rate caps we have purchased.

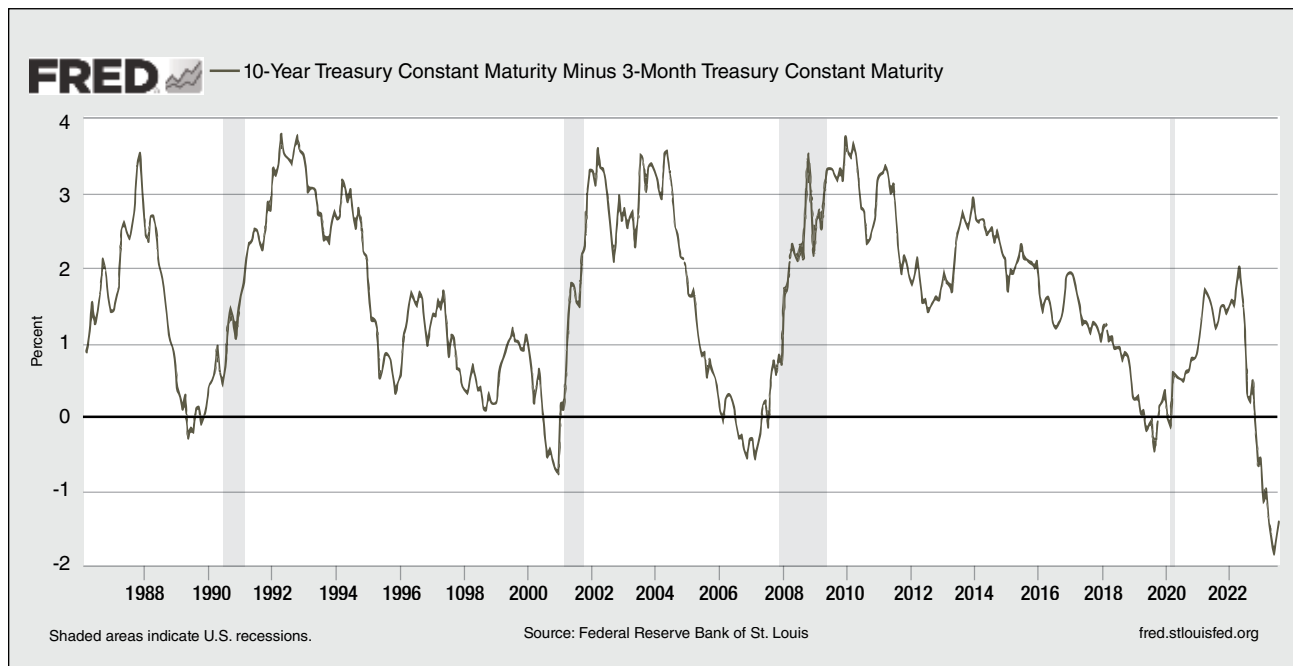
And while this chart shows a fairly consistent and methodical slowdown in the rate of job creation, it's still running hotter than the Federal Reserve would like, especially given that wages are growing by over 4%.



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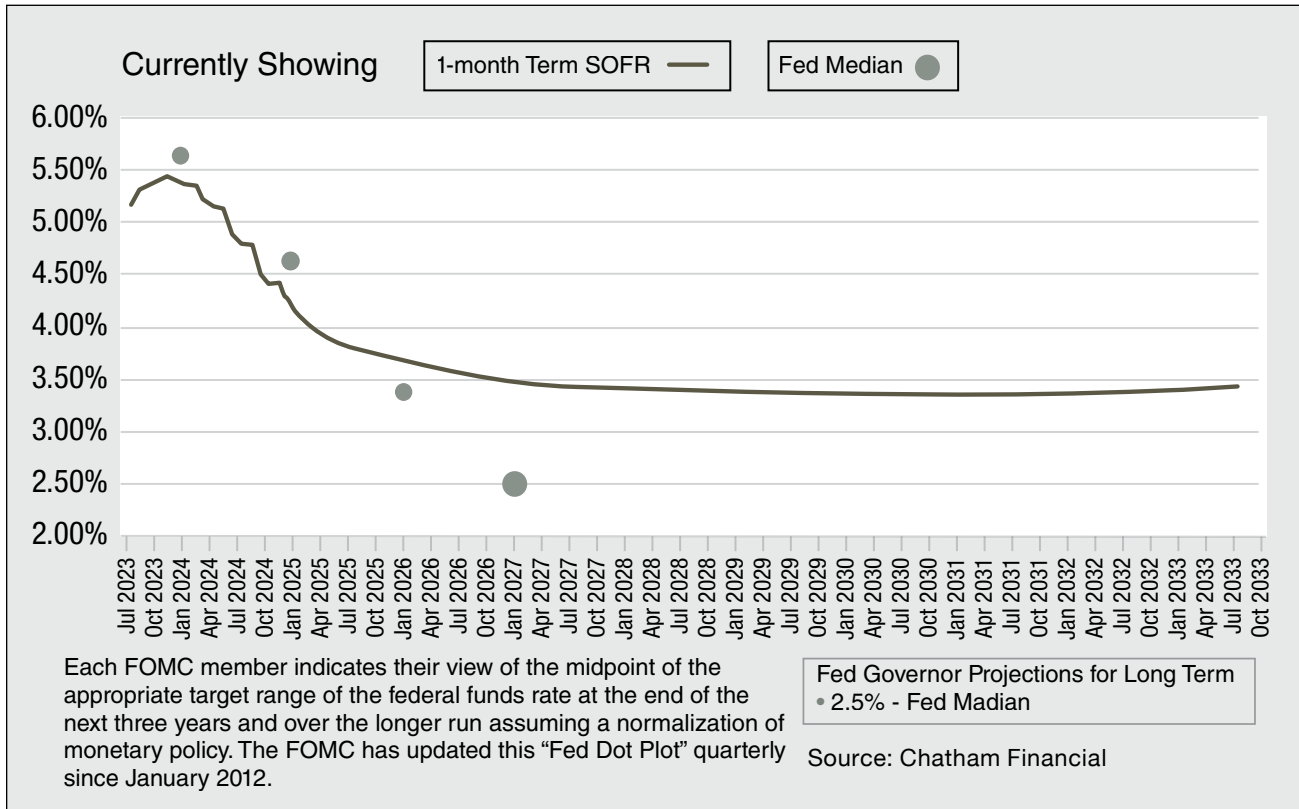
Admittedly I have been surprised that the economy and job growth have held up as well as they have given how inverted the yield curve has been. On the other hand, as this chart shows, the economy has not entered into recessions until the yield curve has become positive again. The grey bars denote recessions.



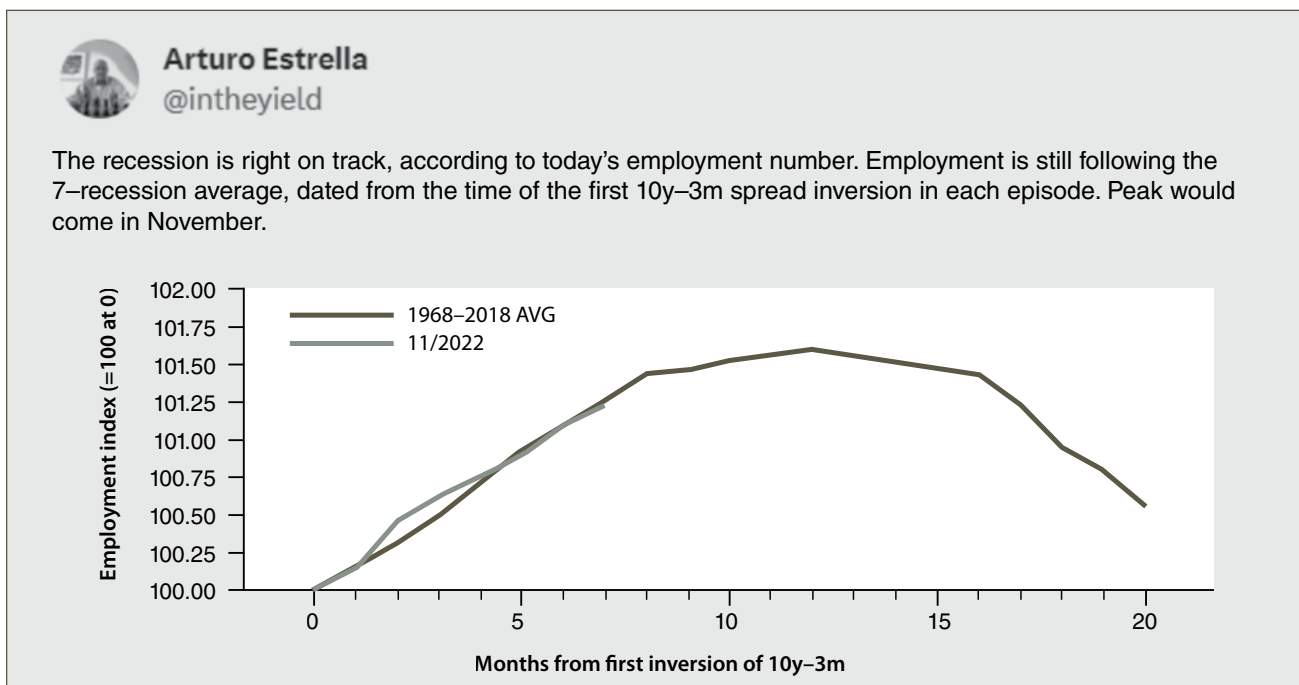
What has typically happened is that the economy's momentum clearly shifts to slowing and then contraction and the Fed starts to cut short-term rates which ultimately results in long rates becoming higher than short rates. These initial cuts are not enough to slow the economy's descent, however, and the Fed keeps reducing rates until a bottom is finally reached and it starts growing again. By this time, however, the yield curve is typically strongly positively sloped. Given this pattern, it's not as surprising that the economy has held up the way it has. The market seems to be pricing in the Fed squeezing the economy such that something will either break or there will be a material slowdown or contraction such that they will have to cut rates and the yield curve will become positive again.

The chart on the next page shows the forward curve for future short-term interest rates as compared to the Fed's median dot plot which is based on FOMC members individual projections. One can see that the market is pricing in lower rates in the near term as compared to the Fed but the Fed's projections over the longer-term are substantially lower than that of the market. And yet, as I mentioned earlier, despite some compelling reasons for rates to come down in the second half of 2024, where we are at this very moment is still quite painful as a substantial portion of our cash flow is being consumed by our interest costs and reserving for the purchase of future interest rate caps. And while, the future trajectory of rates looks favorable for us, there is by no means a guarantee that this will materialize as quickly as investors are pricing in.

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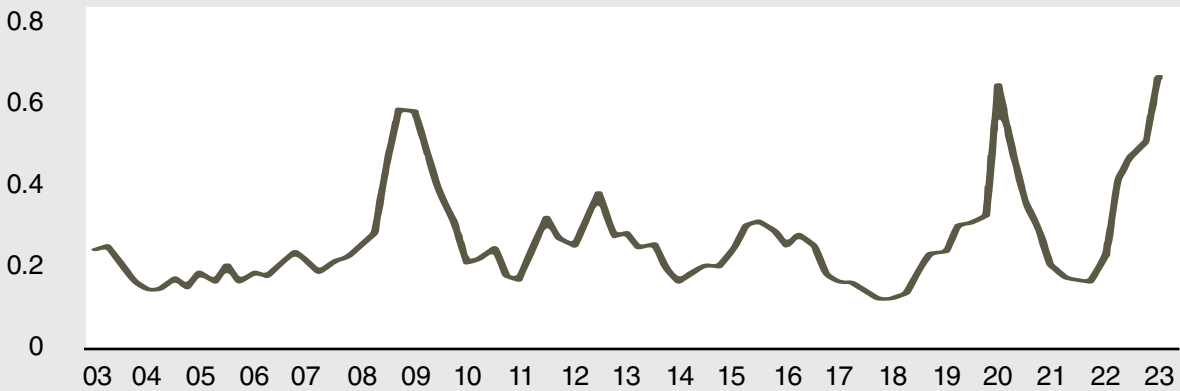
This next chart is further corroboration that the commencement of an inverted yield curve tends to represent the final stage of each cycle’s economic growth, as measured by employment growth, and peaks approximately 13 months later, which would be in November for this cycle since the curve first inverted in October 2022.



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Despite a soft manufacturing sector, credit sensitive sectors of the economy feeling pain from higher interest rates, and inflation on the decline, there are other parts of the economy that are growing and strong enough to keep the Fed ready to raise rates up to two more times. There is no talk of cutting them at this point. Despite a chart like this showing softening demand among the customers of S&P 500 companies, there are other areas holding up or gaining momentum.

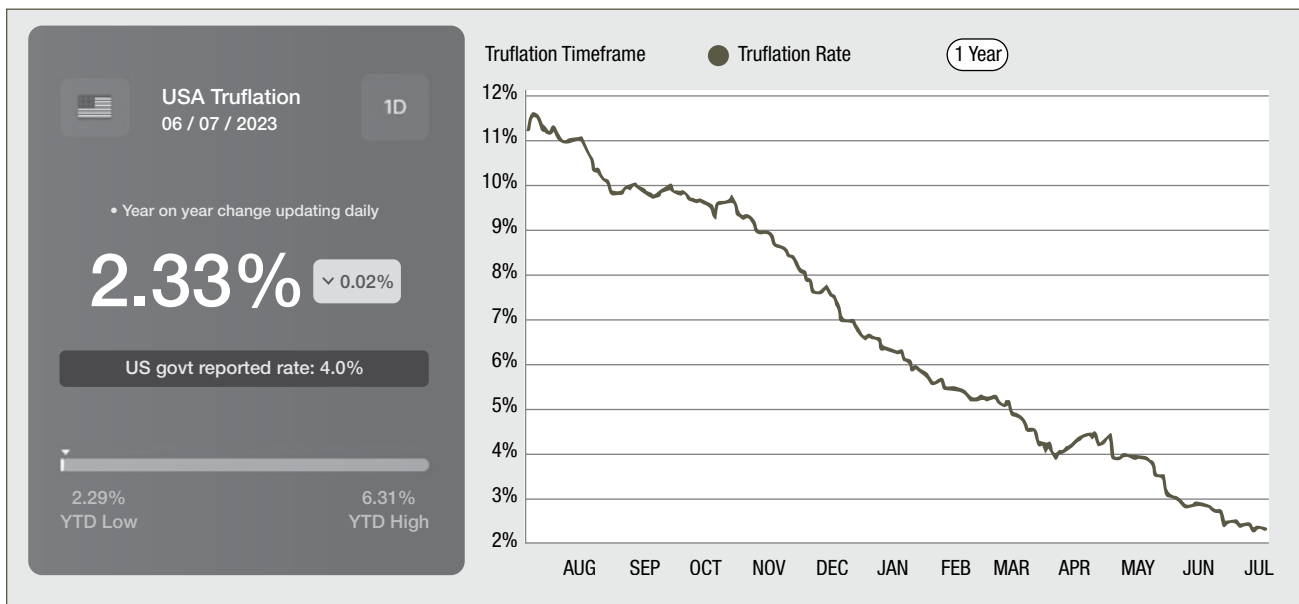
Exhibit 33: Mentions of weak demand soared to a record level
Average mention of weak demand per S&P 500 company (2003–4/23)



Source: BofA Global Research
Note: Mentions include "lower," "softer," "moderateing," "weaker"

BofA GLOBAL RESEARCH

Here is an alternative measurement of inflation that shows how rapidly inflation has been coming down. As future CPI reports are released, this trend should be reflected in those reports as well and will result in real rates, that is interest rates after subtracting the inflation rate, being restrictively positive.

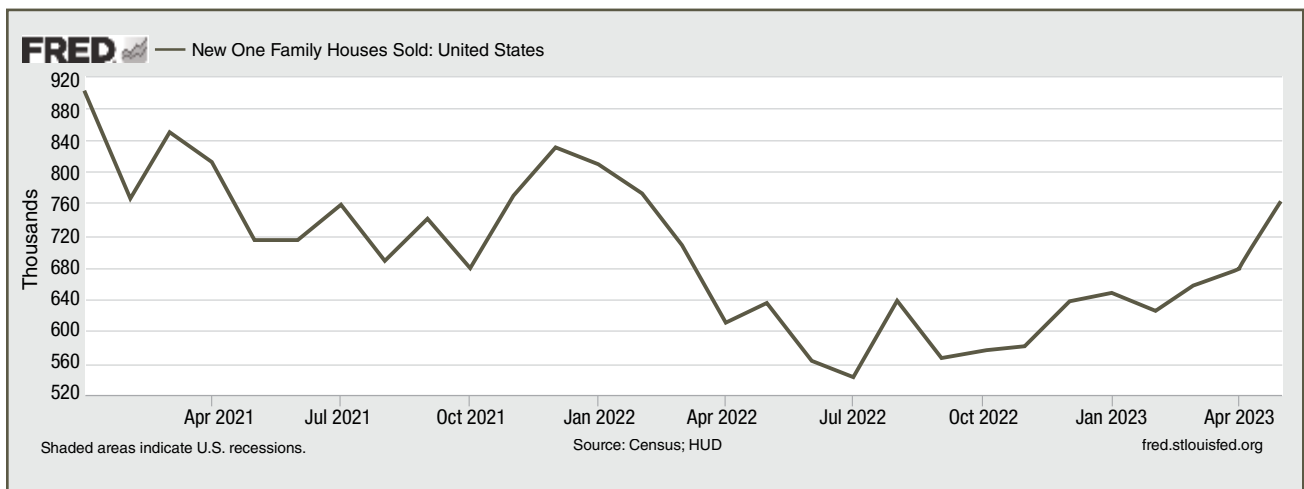


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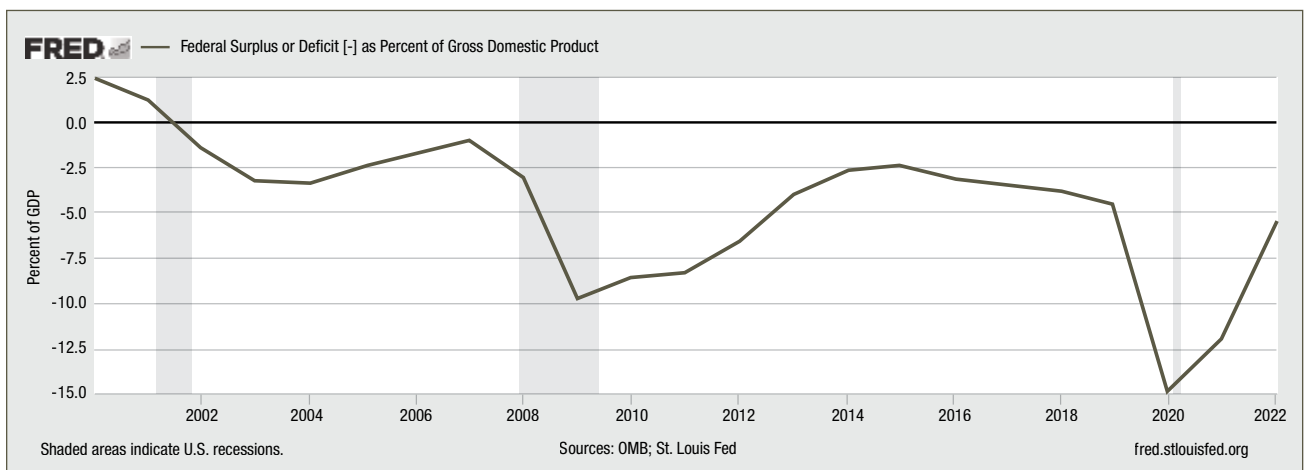
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Housing is one sector that has gone from contraction and now back to expansion as the lack of existing inventory due to a limited number of sellers has resulted in new homes being the only meaningful supply of housing for sale. This is because so many homeowners are locked into far below market mortgage rates and they do not want to sell as they would have to buy their next home utilizing much higher cost debt. This has been a boon to homebuilders who are able to provide a supply of homes as they are in the business of creating home inventory and selling them and doing what it takes to clear the market. This can include mortgage buydowns, which most individual sellers cannot or will not do for prospective purchasers.

One can see how new home sales have increased quite substantially after hitting a bottom approximately one year ago and momentum is gaining strength.



Another source of economic stimulus is the federal budget deficit, while less than it was during Covid, is still a very strong 5% of GDP. This is about 2.5% higher than is typical.

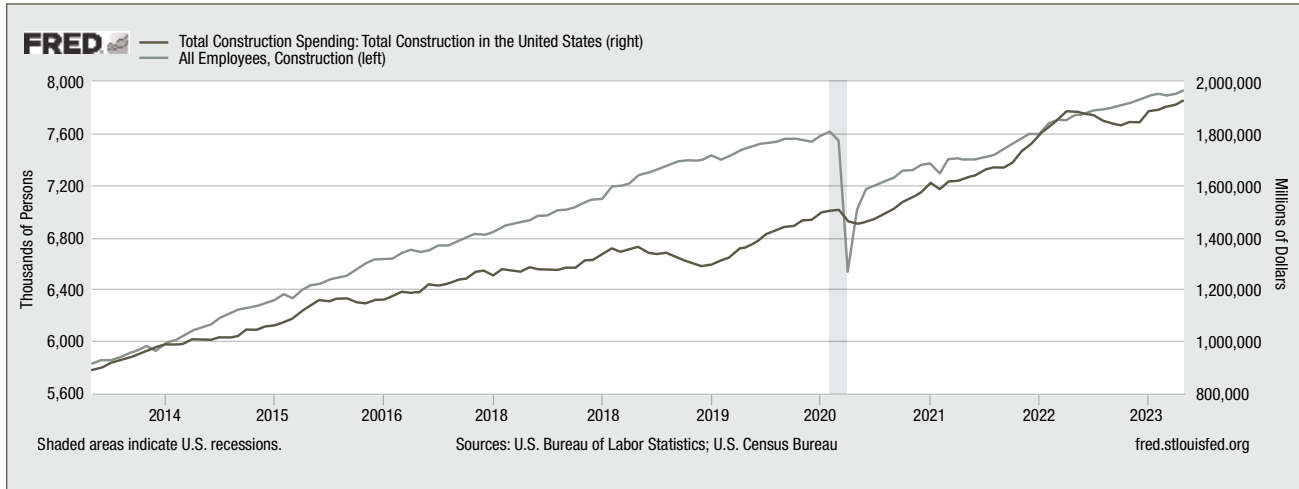


The budget deficit and strengthening new home market have led to construction spending and employment holding up quite well as the following chart shows. A lot of new dollars

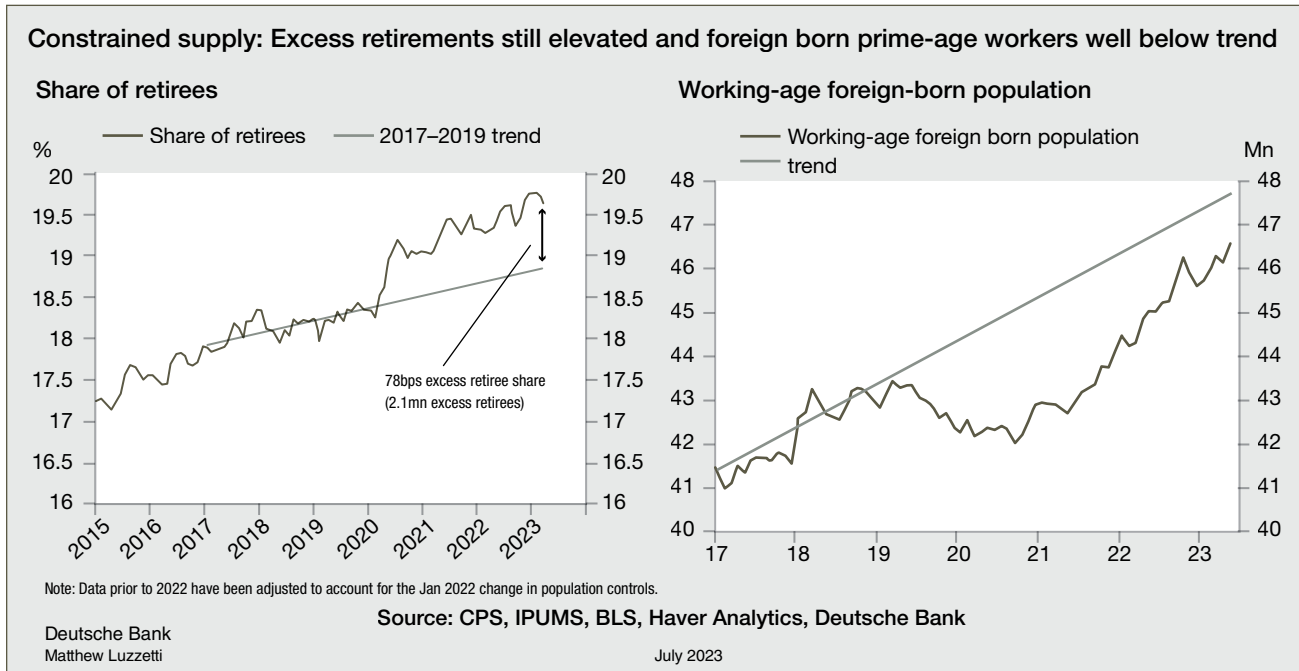
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are going to be allocated to infrastructure, clean energy, and chip plant construction which should keep construction employment higher than it otherwise would be. It's not unusual during a downturn to see 15% of construction jobs shed (equivalent to one million jobs) and this has not happened, nor does it appear that this will transpire. That is not to say a construction downturn won't occur but the slowdown in immigration and large future government expenditures make this highly unlikely as labor should remain in high demand.



One can see that labor force growth has been challenged by a much greater number of retirees in the wake of Covid as well as less immigration. We will need both trends to reverse to help grow the supply of labor more rapidly which would bring the labor market more into balance.



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Although we are feeling the squeeze from higher rates consuming more of our cash flow and having to reserve for the purchase of interest rate caps when our individual ones mature, fortunately we have very few loans coming due through 2024. The year of 2025 is when we have a large number of maturities, but those loans do not appear to have any material issues that would hinder us from replacing the debt given the cash flow being generated is healthy relative to the debt levels at each property.

To put some numbers to this assertion, over the past five years our same store portfolio has generated annual growth in Net Operating Income of approximately 5%. My rough calculations show that in total the loan proceeds we would qualify for today would be approximately 10% higher than the aggregate loan balance for these properties. Of course on an individual basis the results may not have the same level of margin of safety but in aggregate we feel good about our leverage levels, particularly for those loans maturing in 2025.

I bring this up because I think it's somewhat reflective of a fairly healthy apartment industry for loans coming due over the next few years that were originated five or more years ago. I don't anticipate there being widespread issues with refinancing unless rents drop significantly and/or interest rates rise quite a bit more.

The real stress in the system lies with those very aggressive loans that were made during part of 2021 and 2022 to finance the purchase of very high-priced apartment acquisitions using a great deal of leverage and high-cost debt. Many of these loans were originated at 70% to 80% of the purchase price at cap rates that were around 3.50% (I'm being generous as many were purchased at lower yields). The expectations were that rents would continue to grow rapidly, interest rates would stay low, and borrowers could sell these properties within three years (before their loans came due) into a still frothy apartment market with a tremendous amount of capital on the sidelines eager to purchase what they had to sell. And if a sale didn't materialize then they could always be refinanced since operating income would have grown significantly and rates would not have risen too much such that new debt could be put in place to replace these maturing loans. Unfortunately things did not turn out the way these investment sponsors had hoped and needed to unfold. Yes, rents did rise, but they have not risen anywhere near where they needed to in order to offset the interest rate increase. These owners are really feeling the squeeze as they are now contending with negative cash flow, values having dropped, interest rates having risen dramatically, and lenders having become much more conservative. And this doesn't even include having to purchase interest rate caps which have become exponentially more expensive than they were in 2021 and early 2022.

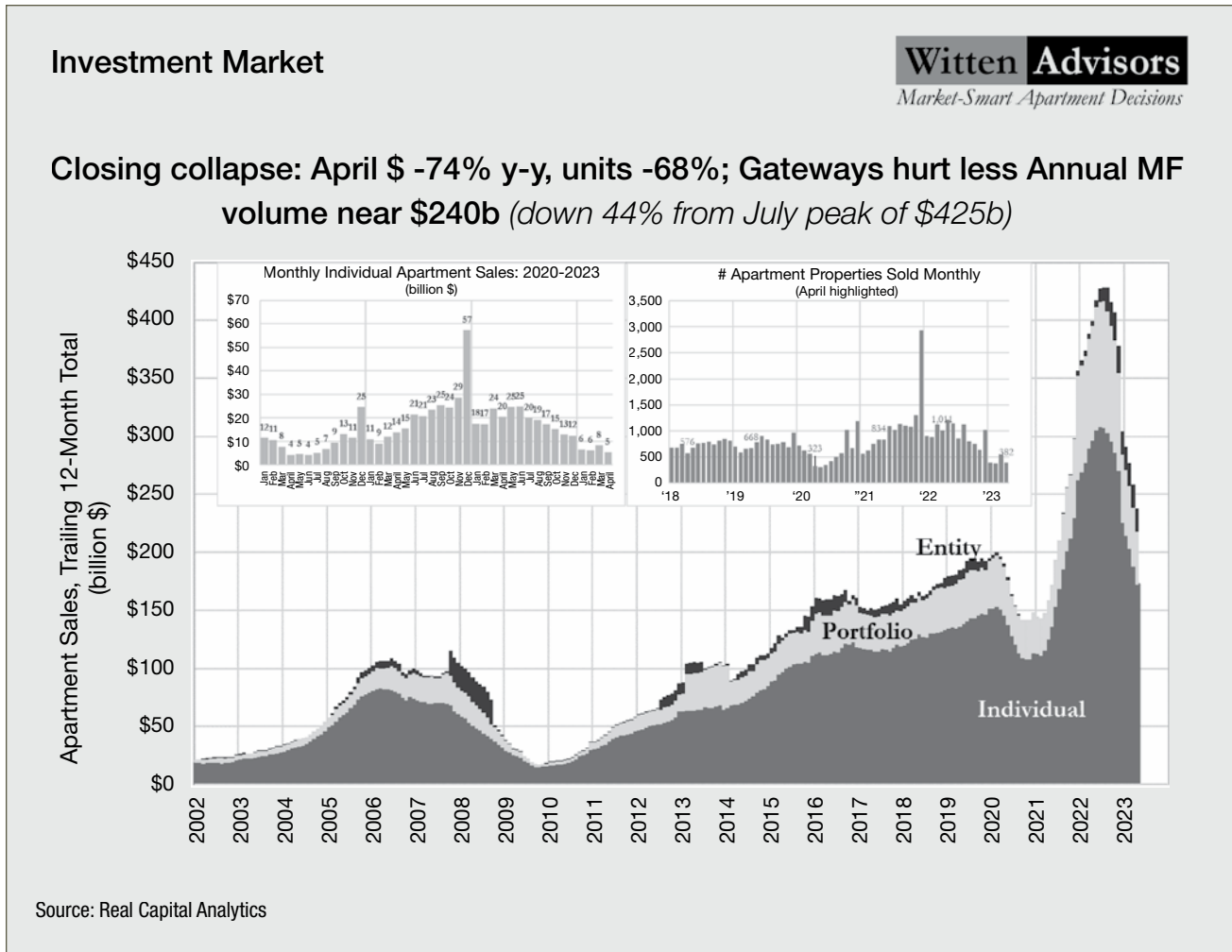
The math is quite daunting for these borrowers to get out of their loans when they come due in three years. Let's assume that these acquisitions are now yielding 4% on the total investment and the original loan was 70%. Based on today's underwriting from Fannie Mae and Freddie Mac, my calculations show that a borrower would qualify for new loan proceeds that would

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only equal 44% of their cost, resulting in a large shortfall that can only be closed by selling (most likely at a loss), accessing very high-cost debt from other sources, bringing in additional cash, or losing the property to the lender. None of these are very compelling options.

This chart from Witten Advisors shows how apartment transactions from both individual and institutional buyers exploded during this one-year period when so much aggressive debt capital was available. Transaction volume has collapsed as there is a big gap between what buyers are willing to pay and what sellers are willing to sell for, or need to, in order to avoid booking a loss. It's only a matter of time but the Pied Piper will need to be paid.



I don't think interest rates will come down enough over the next couple of years to generate enough proceeds to refinance these loans without needing additional capital. I would also not bank on operating income growing enough to earn out of the problem as the combination of a Fed that is trying to engineer a soft landing, and even a mild recession, and a large amount of supply that has to be absorbed, will make sustaining rent levels challenging. Add to this higher

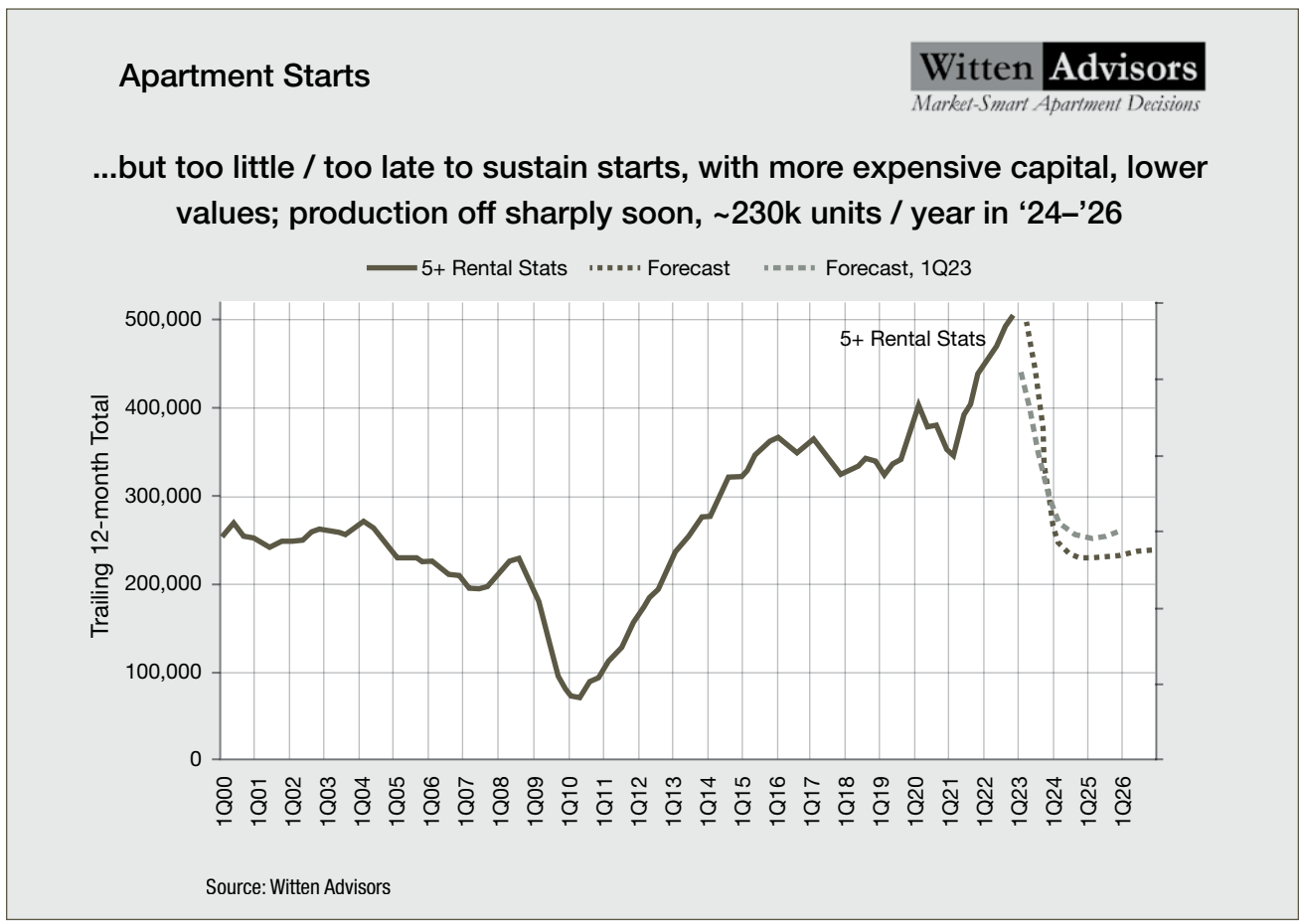
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insurance costs, very costly interest rate caps, aggressive county assessors putting pressure on property taxes, and a still tight labor market, growing Net Operating Income through 2024 will be challenging.

Our focus at CWS is to do a deep dive for each of our properties to determine which properties may face challenges getting through 2024 in terms of cash needs and being very judicious in terms of managing our capital expenditures given these are often our largest annual outlays after property taxes. We will never compromise the care and safety of our community, residents, and employees, but we also know that discretionary projects can often wait another year or two without impacting the marketability and satisfaction of our residents.

And while we know we will have to spend some of our time on defense to ensure our properties can manage through this turbulence, we also know there are many others who are facing far more challenging circumstances than we are, and this should result in some very interesting and compelling investment opportunities over the next couple of years. The credit crunch that I alluded to earlier should result in new apartment supply dropping dramatically as this chart from Witten Advisors shows.



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I remember the downturn we experienced between 2001–2004. The mantra for the industry then was to “Stay Alive Until 2005.” Ours was “Stay Alive Until We Can Refi in ‘05” since our challenge then was the numerous, high-cost fixed-rate loans we had that we couldn’t refinance due to large prepayment penalties resulting from interest rates having dropped materially. We knew that it would be a game changer for us if we could replace our 7% to 8% debt with market rate financing of 5% when many of these loans were coming due in 2005. Fortunately, we were able to work through all our challenges and come out the other side no worse for the wear.

Today we are in the opposite situation in that we are now paying a premium for having floating-rate debt due to the inverted yield curve. Although the circumstances are different, our goal today is the same as it was 20 years ago, as well as during the Great Recession: To skillfully drive the winding and slippery roads we’re on, and will continue to be on, to get us safely to the other side in 2025. At that point we should be in a stronger apartment market as demand should be exceeding supply combined with a very high probability that short-term rates will be lower than where they are today.

To manage through the squeeze will require patience, perseverance, and strong communication on our part to keep our investors fully informed so that surprises are kept to a minimum. We feel very good about the properties we own, the metropolitan areas in which they are located, the length of our debt maturities, and the compelling long-term demand for apartments along with the prospect of diminishing supply. And while we will have our set of challenges with which to contend, we are firmly convinced that many others will have their backs to the wall and be forced to sell properties because of severe financial pressure, require additional capital to keep them from being foreclosed, or have no other option but to let their lenders take over their properties. This will undoubtedly offer some very compelling investment opportunities and CWS intends to not only be well positioned to capitalize on this, but to thrive in this environment as well.

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