Volume 28, No. 4, January 30, 2015

Quarterly Update

CWS Capital Partners LLC

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CWS

CALENDAR OF EVENTS

Friday, February 27, 2015
Year 2014 K-1's Mailed

Friday, April 3, 2015
Good Friday
CWS Offices Closed

Wednesday, April 15, 2015
2014 Federal & State Tax Filing Deadline
1st Quarter 2015 Est. Tax Payments Due

Thursday, April 23, 2015
CWS Annual Partners Meeting
Newport Beach Marriott Hotel and Spa
Newport Beach, CA (Fashion Island)

Thursday, April 30, 2015
1st Quarter 2015
Quarterly Packages Mailed

May 2015
CWS Capital Partners
Semi-Annual Conference Call

Monday, May 25, 2015
Memorial Day
CWS Offices Closed

Monday, June 15, 2015
2nd Quarter 2015
Est. Tax Payments Due

Friday, July 3, 2015
Independence Day (Observed)
CWS Offices Closed

Friday, July 31, 2015
2nd Quarter 2015
Quarterly Packages Mailed

www.cwscapital.com

Houston, Do We Have a Problem?

By Gary Carmell

It would be naive and utterly foolish to believe that Houston won't be negatively impacted by the significant drop in oil prices in such a short period of time. The question is how will it affect CWS properties? Although we are generally less concerned about valuation given our longer term orientation, if the stock market is any gauge, it would appear that there is some concern about future Net Operating Income growth and correspondingly equity value has been impacted. What makes me draw that conclusion? Camden Property Trust is a large apartment REIT based in Houston with a meaningful portion of its portfolio in Houston. 24 of its 170 properties are located in Houston as of September 30, 2014. The number of properties and units in Houston represents 14% of its operating portfolio. Here is how its stock has performed between November 28, 2014 and January 2, 2015 compared to some major industry peers.

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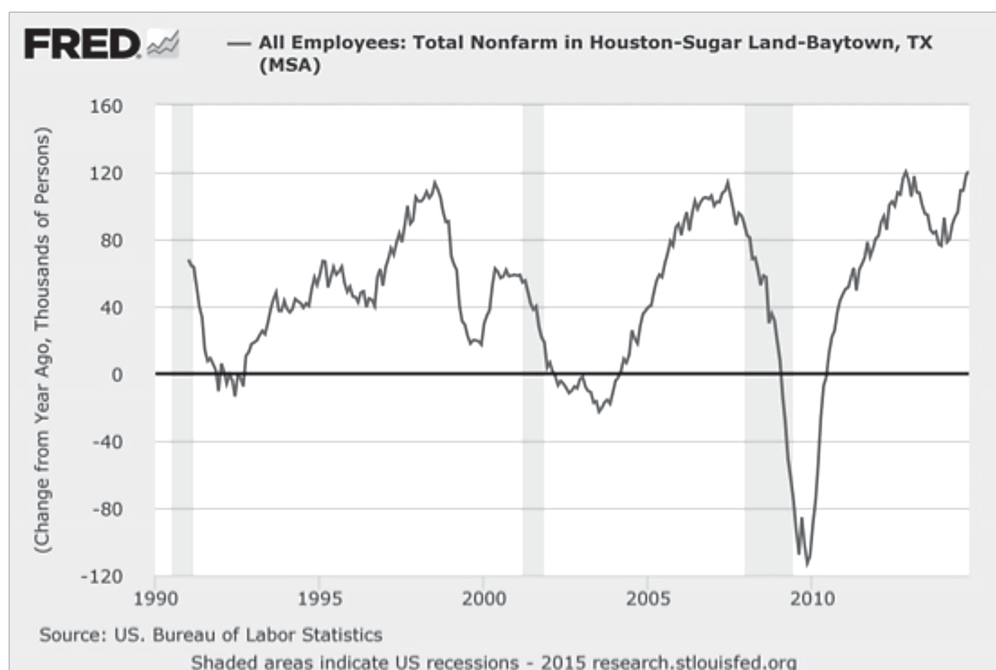
Company	Total Return
Associated Estates	+4.91%
Essex	+3.93%
Equity Residential	+3.63%
Avalon Bay	+3.12%
Post Properties	+1.33%
Camden	-3.86%

Clearly it has underperformed and I would ascribe this to its Houston exposure. Of course the market may be wrong but this is the knee-jerk reaction of apartment REIT investors. Clearly this is a forward-looking concern since Houston job growth has been on fire as the following chart shows:



This has led to apartment demand exceeding supply and a corresponding increase in rents. CWS has 18 properties in Houston totaling 5,181 units representing approximately 24% of our portfolio. Some of these investments are owned with large investors and our traditional limited partner capital via our Strategic Apartment Funds or exchanges. Thus, for the "average" investor our exposure is less. In addition, many of our Houston properties are owned via moderately diversified funds with properties in multiple cities which would obviously help if performance deteriorates.

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We do our own internal supply and demand assessments to get a gauge of when we think markets are under or over-supplied with housing. After the Great Recession we looked at total housing because we believed that single-family demand would have far less market share than in the past due to the much tougher mortgage environment, weak job market, and negative sentiment with regard to homeownership. Conversely, rentals would have a much larger share. We analyze what we think demand should be relative to current job growth, average job growth over a long period of time, and what the average job growth is when it is positive since the average includes both positives and negatives and when we're in an up cycle we want to know what average job growth is during the positive phases. These metrics, combined with valuation, gave us a degree of confidence to grow aggressively in Houston beginning in 2011 and Atlanta in 2012 because we believed there was a large and growing imbalance between supply and demand. Unlike Atlanta, however, Houston is less diversified given its concentration in energy-related employment, so we were always cognizant of whether there was still an imbalance at lower levels of job growth because commodity prices are notoriously volatile and are subject to great speculation both up and down. Here are the most recent numbers for Houston.

	Housing Permits	**Job Growth**	**Housing Permits/Jobs**	**% Multi-Family**
1995 - 11/2014	779,337	1,069,600	0.73	28.9%
12/13 – 11/14	61,702	99,058	0.62	38.8%
	Equilibrium Permits			Excess/(Shortage)
Current	72,176	99,058	0.73	(10,474)
Avg. 2.2% Job Growth	45,718	62,746	0.73	15,984
Avg. 2.9% Job Growth During Up Cycles	62,178	85,336	0.73	(476)

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There are a lot of numbers in the table above but here are some key takeaways. Between 1995 and November 2014 the percentage of housing permits that went to developments of five units or more has been 28.9%. In the last 12 months it's expanded to 38.8%, commensurate with multi-family housing gaining more market share in the aftermath of the Great Recession. Based on current job growth and the historical relationship between housing permits and job growth, there is currently an undersupply of housing in the range of 10,000 units. Our methodology uses a twelve-month rolling average of year-over-year job growth which in this case is approximately 99,000 jobs. The most recent job growth shows over 120,000 jobs being created so at this very moment our estimates are probably a bit conservative in terms of the under-supply of housing.

Recognizing, however, that we may be experiencing peak job growth for a while, then it would be helpful to look at what might happen if job growth reverts to its long-term average growth rate of 2.2%. In this case, we would be facing an oversupply of approximately 16,000 units. Using an estimated base of housing of 3 million units, then this equates to a bit more than 0.5% which seems manageable given that there is not currently an oversupply of housing in the Houston metropolitan area. Of course there are exceptions since all real estate is local and there may be areas much more at risk of over-building but in general it appears that Houston can manage through a pretty significant drop in job growth. We do think apartments competing with new lease-ups, however, will face rent pressure from those properties offering discounted rents to fill up their properties more quickly. While we are not immune to this, we do have a number of properties that have rent levels and locations that are less susceptible than urban properties facing a lot more competition.

Another general advantage we have is a lower cost of debt due to our preponderance of variable-rate loans. This gives us more cash flow to absorb the potential of lower rents and/or higher marketing costs.

So what are prognosticators forecasting for job growth in Houston in 2015? The Greater Houston Partnership is forecasting job growth to be 62,900 comparing December 2015 to December 2014. This is down from over 121,000 jobs from the previous 12-month period. This represents a 2.1% growth rate. Goldman Sachs issued a research report on December 1, 2014 and projected Houston's job growth to be 3.5% in 2015 and 4.1% in 2016 based on $70 per barrel oil. With oil priced at $48 as of this writing, my expectation is that Goldman will revise its job growth downwards. Obviously all roads lead to oil. So how comfortable do we feel with these job growth estimates?

I read an interesting and very in-depth report that analyzed oil production decisions in the

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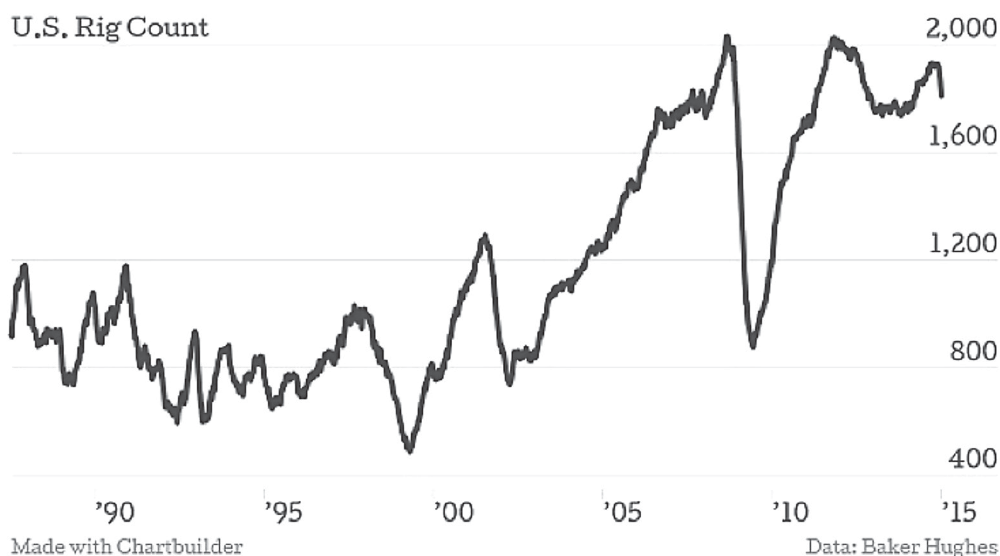
face of changing oil prices. The conclusion after analyzing thousands of wells in Texas over a very long period of time was that it rarely made economic sense to stop drilling in wells that have already been manufactured and to just keep producing regardless of price while it made complete sense to stop drilling new wells. The exception would be if drilling equipment and related costs dropped significantly enough to compensate. Regardless, rental rates for the equipment are highly correlated with spot energy prices. In other words, as prices rise, the demand for their equipment increases as well and they can charge higher rental rates. The opposite occurs when prices drop. With tight oil having high depletion rates we should see continued production growth in Texas through at least the first half of 2015 and then most likely see a precipitous drop. Oil services and equipment prices are already plummeting. I would imagine we will see the early layoffs take place in the drilling areas of West Texas and the Eagle Ford Shale and then move to companies that have to restructure to contend with lower prices or because of mergers.

I will wrap up this article with a few pertinent charts and historical job growth data. The first is the U.S. Rig Count. It is clearly starting to drop and will continue to do so. It dropped dramatically in 2008 and 2009 as oil prices plummeted from nearly $150 per barrel to less than $40 in the wake of the global economic meltdown. Interestingly, during this time the rig count in Texas dropped from 946 to 329 in 10 months. Houston's growth during this 10 month period averaged 0.71% while the United States' (excluding Houston) was -2.12%. As the economy continued to crater over the next 12 months, Houston was not immune to the carnage as its job growth dropped to -3.06%, still better than the national drop of -3.84%. This is a recurring theme for Houston: Consistent outperformance through all cycles, which will be shown shortly in a compelling table of data.



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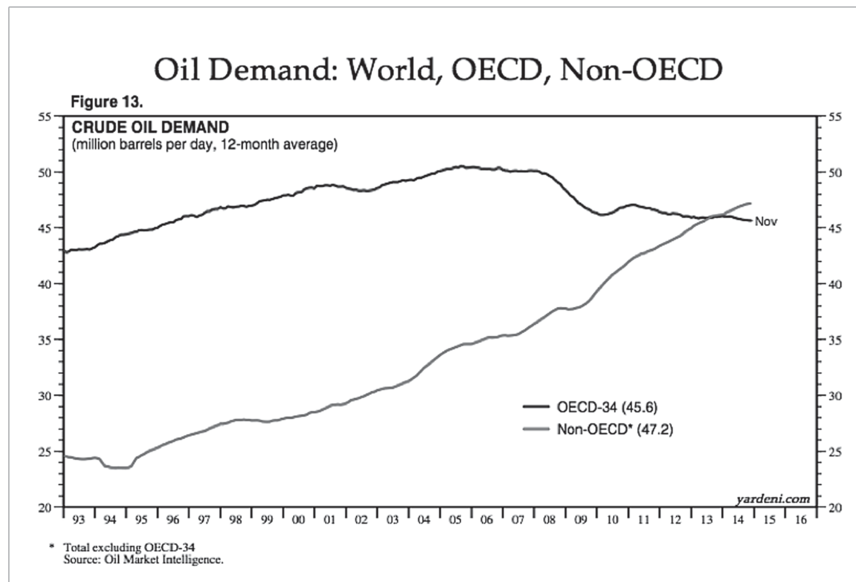
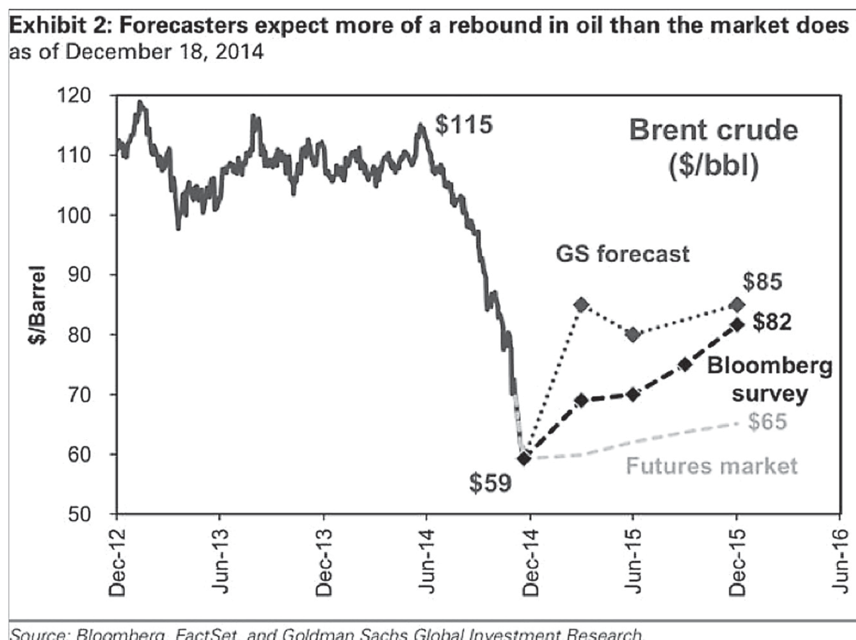
All roads lead to the developing world when it comes to oil demand. Clearly the developed world is using less oil as the following chart shows. This is a result of aging societies and more efficient consumption patterns due to more fuel efficient cars, greater urbanization, and a meaningful percentage of young people not driving. There will be a tug of war between shrinking consumption in the developed world (perhaps mitigated by lower prices) and growth in China and India in particular and the rest of the developing world with a growing middle class.



On a longer term basis private forecasters are projecting crude oil prices to be in the $80 range while the futures market is estimating them to be $65.



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I mentioned earlier that Houston has consistently outperformed the national economy in terms of job growth. I went back and crunched the numbers and here is the key data in the table below.

	Houston MSA	United States (without Houston)
Average Job Growth (1/91-11/14)	2.09%	1.01%
% of the time Positive	82.9%	74.9%
Average when Positive	2.75%	1.82%
Average when Negative	-1.13%	-1.44%

Houston's year-over-year percentage change in jobs since January 1991 has outperformed the United States 74.1% of the time. It typically outperforms during both up and down cycles. In the months that it did under-perform the rest of the country, the average under-performance in job growth was 0.52%.

Even more recently, it has outperformed the rest of the country even more regularly. Since March 2005, the percentage change in Houston job growth was lower than the U.S. w/o Houston for 3 months (out of 117 total), which means it was higher 97.5% of the time.

Warren Buffett likes to say "Don't bet against America." From the table above one can see why with the annual percentage change in jobs since 1991 being positive nearly 75% of the time. I would modify Buffett's statement by saying, "Don't bet against Houston!"