2017 CWS Annual Report

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Excellence into the Headwinds

"Excellence into the Headwinds" is the theme we arrived at during this year's executive planning meeting.

While as investors we are each invested in individual properties, it is instructive to analyze a "same store" rollup for the 64 stabilized assets CWS investors have owned for the entire years of 2015, 2016 and 2017. Here is that rollup:

64 PROPERTY SAME STORE ROLL UP

	2015	2016	15 vs 16 % Change	2017	16 vs 17 % Change
Market Rent	292,800,596	307,310,959	4.96%	314,417,353	2.31%
Vacancy	(18,262,585)	(17,761,610)	2.74%	21,129,040)	-18.96%
Concessions/Loss to Lease	(16,676,378)	(22,722,601)	-36.26%	(24,121,215)	-6.16%
Model/Employee Units	(1,372,977)	(1,399,997)	-1.97%	(1,435,259)	-2.52%
Bad Debt	(554,595)	(448,685)	19.10%	(577,090)	-28.62%
Net Rental Income	255,934,061	264,978,066	3.53%	267,154,749	0.82%
Other Income	24,154,671	25,363,893	5.01%	26,338,303	3.84%
Total Revenues	280,088,732	290,341,959	3.66%	293,493,052	1.09%
Salaries	22,909,976	24,327,876	-6.19%	24,996,773	-2.75%
Marketing/Advertising	4,464,721	5,023,088	-12.51%	5,770,571	-14.88%
Turnover	4,736,616	5,019,766	-5.98%	5,277,308	-5.13%
Repair & Maintenance	4,136,069	4,420,127	-6.87%	4,572,437	-3.45%
Professional Services	5,840,748	6,352,057	-8.75%	6,512,523	-2.53%
General & Administration	4,988,634	5,051,662	-1.26%	5,001,307	1.00%
Utilities	16,954,003	17,290,497	-1.98%	17,970,940	-3.94%
Taxes	48,331,326	51,521,077	-6.60%	51,399,085	0.24%
Insurance	3,932,910	3,365,678	14.42%	3,453,511	-2.61%
Management Fees	9,120,308	9,352,030	-2.54%	9,443,079	-0.97%
Total Expenses	125,415,312	131,723,858	-5.03%	134,397,534	-2.03%
Net Operating Income	154,673,420	158,618,101	2.55%	159,095,518	0.30%
Interest Expense	52,477,528	54,762,626	-4.35%	60,860,456	-11.14%

Other Expense	6,108,656	6,117,168	-0.14%	6,292,371	-2.86%
Net Income, before Depreciation/Amortization	96,087,236	97,738,308	1.72%	91,942,691	-5.93%

Analyzing the rollup brings to light some of the headwinds we are facing.

On the revenue side, Total Revenue growth slowed from 3.66% in 2016 to 1.09% in 2017, largely due to higher Vacancy and Concessions this past year. Houston's negative revenue performance weighed on the portfolio last year. Without Houston, portfolio rent growth would have been 2.45% last year. On a brighter note, we predict the revenue growth of this same portfolio to grow 3-4% next year, due in part to an expectation of a rebound in Houston.

On the expense side, Total Operating Expenses are up 7.06% cumulatively over the last two years combined, which is higher than inflation and exceeds our combined revenue growth of 4.75% over that same two year period. Chief culprits are higher Marketing and Advertising expenses, mostly in the form of increased locator expenses as we have struggled to keep our properties fully occupied. And as we budget for 2018, we are expecting another year of expense growth above inflation, primarily due to Salaries, Property Taxes, and Insurance expense growth.

Furthermore, we have had significant interest expense growth, due largely to increases in LIBOR. While our use of floating rate debt remains beneficial in the form of lower than fixed rate interest payments and high flexibility to refinance or sell assets at the most opportune times, there is no doubt that the movements in LIBOR have had a material effect on Net Income before Depreciation and Amortization, resulting in that metric declining 5.93% in 2017. Furthermore, we are expecting LIBOR to move even higher in 2018, resulting in a further increase in our portfolio interest expense and another decline in Net Income before Depreciation and Amortization in the neighborhood of half this year's decline, or about 3%.

While individual asset performance varies across the portfolio, the portfolio rollup is instructive to spot trends that generally flow through to many of our assets.

How does CWS respond?

First, we take a clear-eyed look at the performance of each asset in our portfolio. We realize that many of the tail winds that we have been experiencing in the early part of the cycle (in the form of strong rent growth and declining financing costs through refinance opportunities) are no longer present for the most part, and we need to adjust our approach accordingly.

Second, we are intensely focused on execution. To support this we have created meaningful and measurable objectives for our operating team in the current environment. Our company objectives in 2018 include:

--Hitting budgeted controllable expenses at a minimum of 75% of our properties, with 100% of major category expenses falling within 5% of budget.

--Reducing the marketing and advertising acquisition costs of new leases below $225 per lease, from its current level of $325.

--Achieving online ratings averaging four stars or higher at 75% of our properties based on the average score of the four most important rating websites: Google, Yelp, Facebook, and Apartment Ratings.

--Reducing the onsite turnover of our community directors and maintenance directors to under 10% each for our entire portfolio.

These nuts and bolts objectives are key steps in keeping expenses under control and driving prospective resident traffic to our properties. We have strengthened our property support team considerably over the last several years to include adding new corporate resources in the form of Asset Managers, Regional Maintenance Directors, and Regional Marketing Personnel. We have action plans in place for each of the above objectives, and we look forward to reporting our results.

One obvious question when analyzing the above is, should we transition our debt from floating to fixed interest rates? This question is one we discuss rigorously at each quarterly board meeting. It is important to note that overall interest payments are not higher now than they would have been had we had fixed rate debt, we are only giving back the “free lunch” we have been enjoying with the lower rates of variable relative to fixed. On balance, we are still attracted to the flexibility of variable-rate loans in what is generally a slow growth, low inflation environment. That said, with the starting rates of variable and fixed rate loans closer together than they have been in some time, and also in an environment of rising LIBOR, the decision is more difficult than it has been in the recent past, and we will continue to examine our strategy closely.

We are highly committed to bringing excellence to everything we do at CWS and one of the most important ways of doing so is to have a ruthless focus on execution during these more challenging times. We have always relished a challenge at CWS and we are excited and highly motivated to position ourselves to continue to produce compelling results during this more competitive point in the cycle.