CWS CAPITAL PARTNERS LLC

2021 Annual Report Letter

Momentum: Financing

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The theme of this annual report is the *Perfect Storm*. It's to be expected that one would have a negative connotation regarding the perfect storm, particularly after seeing the movie with the same title, since it ended in disaster. In addition, most people also think of storms as very destructive and harmful events unleashed by Mother Nature. In this context, however, it's the complete opposite in terms of how it is being used as a metaphor to describe the impact of COVID on CWS' apartment business.

The conditions that came together unleashed a chaotic fury that had terrible outcomes for people, businesses, and society in terms of economic, social, and health effects. Those areas of the economy dependent upon large numbers of people congregating together were impacted terribly by COVID. These include airlines, hotel, leisure, cruise lines, entertainment, the office economy, and retail, just to name the most impacted ones. From an apartment industry perspective, and for CWS in particular, however, there were countervailing forces that came into play that were extremely beneficial for our business.

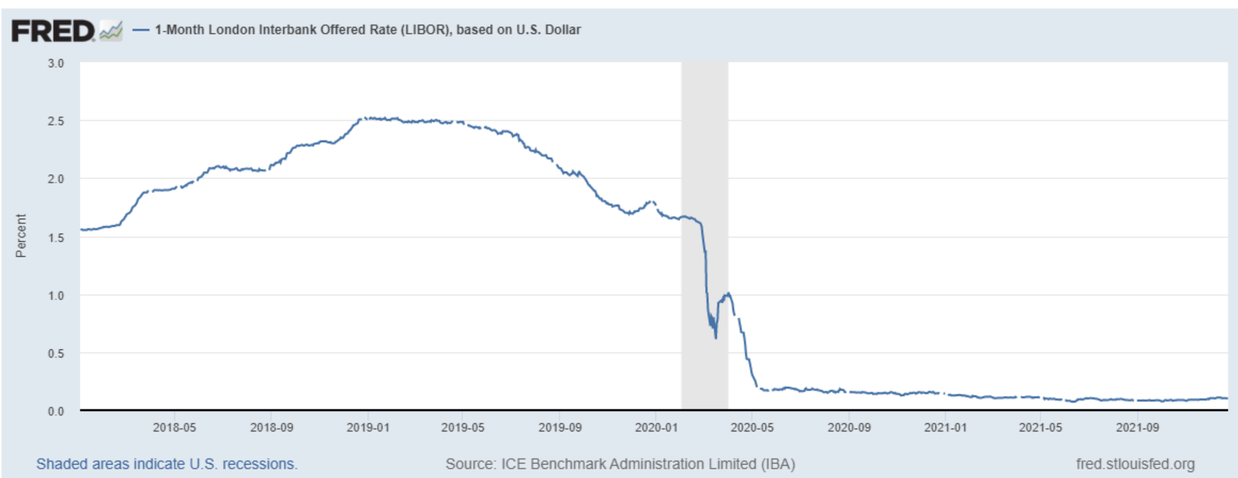
We have talked about how being in the right business in the right locations with the right customers with the right investment partners and financed with the right debt has been a winning formula for us over the years. My focus will be on the right financing as this produced the greatest financial benefit for us in the aftermath of COVID. This set of circumstances is the perfect example as to why we have such conviction in terms of aggressively utilizing variable-rate loans to finance the purchase and development of properties in our portfolio or will be after they are constructed. We have always felt that it is a great hedge against economic problems that may impact our occupancy and/or rents. With our average lease term being 11 months, our units can get repriced quickly. When times are good, this can be quite beneficial, but when they're not then we can find ourselves with less demand which can negatively impact our pricing power. And if our weakening financial performance coincides with overall economic weakness, which is often the case, then the Federal Reserve will typically lower interest rates to help revive economic growth. Lower rates then flow through to our debt service which can make up for some or all the revenue decline we might experience.

This scenario took place during the recession of 2001-02 which hit apartments quite hard. We experienced declining demand in the wake of the Tech Wreck and the increasingly easy mortgage lending standards that enticed people to purchase homes.

Unfortunately, virtually our entire portfolio was financed with fixed-rate loans which prevented us from taking advantage of lower rates because the cost of pre-paying our fixed-rate loans was too prohibitive due to the large penalties triggered by early repayment. Thus, we were not able to hedge our revenue decline with interest savings because so few of our loans were floating rate.

We learned a very painful lesson 20+ years ago which left deep scars and long memories. From that point forward we placed a greater emphasis on attracting capital from investors that understood and accepted our floating-rate strategy and to utilize this type of debt on virtually every new loan we put in place. This helped us during the Great Recession with the dramatic drop in short-term interest rates that took place and for the long period of time they stayed quite low. At the same time, we still had some large investors who preferred fixed-rate loans, so a still meaningful percentage of our portfolio could not benefit from the lower rates until those loans came due.

When COVID hit we were never better positioned from a debt perspective. We had dramatically increased our exposure to variable-rate loans such that approximately 83% of our debt was floating when the COVID contraction began, and this is when the Federal Reserve started lowering interest rates. As the following chart shows, 30-day Libor peaked at approximately 2.50% in early 2019 and hit a low of approximately 0.08% in late 2021.



From CWS' viewpoint, this meant that we went from an average interest rate for our floating-rate loans of approximately 4.20% at the peak to about 1.80% at the bottom, which is very close to what they're at today. It doesn't take a math whiz to figure out that when your interest rate drops by approximately 2.40% and this is applied to approximately $2.3 billion of debt, that this results in significant interest savings—$55.2 million to be more precise. As a result, we were able to raise distributions despite our operating income dropping by approximately 5% from peak to trough as well as build up working capital to continue to reinvest in our properties and to be able to compete very effectively.

So where do we go from here? It's as good as it gets from an interest rate perspective since the two indices our floating-rate loans are tied to, 30-day LIBOR and SOFR, are close to zero percent, and if they were to go negative, our loan agreements do not allow us to capture that benefit. With the Fed fixated on fighting inflation there is virtually no chance these indices will go negative any time soon. We are also expecting the Fed to raise rates, so we have budgeted LIBOR and SOFR to average 0.75% in 2022, which we think is a conservative but realistic assumption. We see 2022 as passing the baton from interest rate savings propelling our cash flow higher to much improved operating performance doing the heavy lifting going forward. We are seeing impressive demand across much of our portfolio and rent increases none of us have experienced during our time at CWS. We have not only weathered the Perfect Storm, but the energies unleashed turned into a powerful wave that we have been trying to ride and navigate for the last two years to the benefit of our investors.