2021 Annual Report Letter

The Surge: Business

By Mike Engels
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CWS feels fortunate to be invested in apartments, an asset class that has had solid performance with continued good prospects. And while others may have undoubtably experienced positive results independent of CWS, there are several things about CWS that are unique and different which can potentially provide a material edge for superior long-term investment outcomes for our investors. Here are a few of them:

We have a long-term time horizon. Warren Buffett instructs all his business managers to adopt a 50-year time horizon when making business decisions. We think the same way. We are proud to say that we have been around for over 50 years, and we are looking forward to the next 50 years.

CWS is one of the very few investment companies that has been and continues to be a true long-term owner of assets. Even some of the most blue-chip institutions are tied into funds with specified lives that create periodic requirements to sell assets or are captive to investment sponsors who require transactions to monetize investment gains. At CWS, we realize that our investors are playing an “infinite game,” and if we sell an asset and return capital, it creates an obligation on the part of our investors to reinvest their capital, often after paying significant transaction costs and potentially taxes, into a new investment with many unknowns. While we occasionally sell assets when we believe our investors’ capital will have a better future in a new location, our bias is to hold assets long term.

We are passionate about our business. Combined with our long-term horizon outlined above, our passion is an indispensable strength for us. Our passion ignites our energy, and our energy enables us to overcome problems and seize opportunities when they present themselves. We are the kind of people who must discipline ourselves to turn off our phones and computers at the end of the day or are happy to talk about apartments at anytime, anywhere. That is our DNA.

We think for ourselves. Whether it is our target markets, our long-term hold orientation, our variable-rate debt strategy, or many other things, we are most comfortable thinking independently. While we observe the world around us, we feel no pressure to follow the latest trends to make ourselves look good or enhance our job security. We have the courage of our convictions. We rigorously and ruthlessly study the important and relevant metrics, using the best information sources available, and discuss these with each other at length to identify the safest long-term opportunities for our investors' capital. We can think very nimbly as new opportunities arise and move very quickly to seize them when they do.

We feel no pressure to make investments to grow our business or enrich ourselves financially. We are blessed to be part of a successful organization. We have the freedom and latitude to do what is smart, when it is smart to do it. We love to say, "We eat when we're hungry and sleep when we're tired."

We are opportunistic investors with safety being the opportunity we seek. "Opportunistic Investor" is sometimes code for "lever up and swing for the fences." The CWS approach is finding an edge that will help us invest capital safely for the long-term. Whether it is assuming a deal with bad debt at a low cost basis, carefully calibrating the incremental cost of additional loan dollars when placing new debt on an asset, assessing new supply risks and current replacement cost in a vibrant job market, or selecting low leverage, long-term variable-rate debt with caps instead of fixed-rate debt, we believe in the maxim that "True wisdom is knowing what to fear." And one of the things we fear is high cost, high loan-to-value leverage with little margin for error.

We are a full-service organization with an exclusive focus on apartments in our target markets. We control all aspects of our organization, from capital raising (equity and debt), to capital deployment (through both acquisitions and development), property management, asset management, investor relations, and all the departments and functions that fall under those major disciplines. When we control each of these functions, we have control over their quality, and we minimize the conflicts of interest and lack of trust that can evolve when varying functions are in different organizations. Our focus on apartments in markets where we have an established presence enables us to have the courage of our convictions and great first-hand knowledge as we make important investment decisions.

We have deep relationships with sources of debt and investment sales professionals. CWS is one of the very few firms in the country that have a preferred relationship with the two largest lenders in our industry, Fannie Mae and Freddie Mac, which provides CWS with lower interest rates and enhanced proceeds for our debt. In addition, we have long-term trusted relationships with brokers in our target markets that provide us with crucial information on investment opportunities, sometimes marketed and sometimes not, as well as an edge in gaining control of opportunities we strongly desire to control.

While tax minimization does not drive our investment philosophy, we sure pay attention to it. CWS has been taking advantage of the 1031 exchange since 1985 and has exchanged over $1 billion in equity since then. The opportunity to reinvest sales proceeds on a pre-tax basis is a great way to preserve net worth over the long haul.

Depreciation expense also is very helpful in lowering taxable income. Our investment structures, as pass-through partnerships, eliminate the double taxation of corporate dividends. Refinances can deliver significant capital events for our investors without triggering tax. And the minority interest discount and step-up in basis inherent in our investments are very helpful tools in estate planning. “Delivering long-term, risk-adjusted, after-tax cash flow and total returns for our investors” is our mantra.

We invest in every CWS project. A very high percentage of the net worth of the CWS Partners and Principals is invested in CWS projects. Our family members and friends are invested with us as well, and many investors over time have become our personal friends. Regardless of whether capital is our own, or from a family member, friend, or someone whom we have not gotten to know yet, we view the precious capital that has been entrusted to us as a sacred responsibility.

We charge fair and appropriate fees to our investors. We transparently disclose our fees. We avoid conflicts of interests with our investors. While the investment management business can be a lucrative business for sponsors like CWS, we know that the vast majority of our net worth generation is a result of participation in the profits of successful investments versus fee income from our investors.

We communicate clearly, openly, and regularly with our investors. Our investors are our business partners in the projects in which we invest together. We strive to communicate timely and relevant information, good and bad, as clearly, openly, and quickly as we can.

We are a purpose driven, values-based organization with a strong company culture. Our company purpose is “Enhancing Lives the CWS Way” Our business enhances very important aspects of people’s lives by taking care of where our residents live, our investors’ money, and the work lives of our fellow CWS employees. The “CWS Way” refers to our long-held company values:

- A demand for excellence with a sense of urgency
- A requirement for profitability and sustainability
- Respect for people
- Honoring our word
- Ethical dealings are paramount

We are blessed with talented team members who care and are great at what they do. CWS is a great place to be, and our team members make it so. Over the years we have grown our team of highly talented, long-term individuals who fit great within our culture and contribute mightily every day. Recently, CWS engaged Qualtrics, which surveys employee experiences for many Fortune 500 companies and leading national real estate companies. CWS scored 84% in employee engagement, well ahead of other Qualtrics customers (US average of 72% and real estate industry average of 74%). Further, our five Partners and Principals, Steve Sherwood, Gary Carmell, Mike Brittingham, Justin Leahy, and I have been with CWS for a combined 126 years, and that's not including our Advisory Board member Bill Williams, who continues to make key contributions, with 53 years of CWS experience.

We have deep, loyal, and long-term investors who value what we do and how we do it. CWS reports to over 1,000 investors. Our investors value and support our investment philosophies and long-term approach. This aligned investor base provides CWS with a high degree of flexibility and capability in seeking and executing upon the best investment opportunities that appear in our markets. We are very fortunate to have each of you as investors, and we will work hard every day to continue to earn your trust. Thank You.

2021 CWS "Same Store" Portfolio Results

Below outlines the financial performance of the "same store" CWS portfolio (85 properties, 25,197 units) over the last three years. Many of the trends in the overall portfolio apply to the individual assets and Strategic Apartment Funds in which you are invested.

Properties: 85 **Unit Count:** 25,197 (in $ millions)	**SAME STORE ROLL UP** **2019**	**2020**	**19 vs 20 % Change**	**2021**	**20 vs 21 % Change**
Market Rent	450.4	439.5	-2.4%	504.5	14.8%
Vacancy	(27.0)	(26.3)	-2.6%	(27.4)	4.2%
Concessions	(1.4)	(3.2)	126.3%	(1.6)	-50.8%
Gain/Loss to Lease	(41.4)	(26.2)	-36.7%	(81.1)	209.3%
Model/Employee Units	(2.0)	(1.9)	-3.6%	(2.2)	13.0%
Bad Debt	(0.8)	(2.4)	193.9%	(2.4)	1.1%
Net Rental Income	377.8	379.5	0.4%	389.9	2.7%
Other Income	41.4	40.4	-2.3%	48.5	20.0%
Total Revenues	419.2	419.9	0.2%	438.4	4.4%
Salaries	36.9	37.6	-1.9%	39.7	-5.5%
Marketing / Advertising	6.5	5.7	12.1%	5.5	2.6%
Turnover	6.2	6.2	0.3%	6.6	-6.2%
Repair and Maintenance	5.3	5.3	-0.4%	5.8	-9.8%
Professional Services	9.3	10.2	-9.7%	10.7	-5.5%
General and Administrative	7.3	5.6	22.9%	5.8	-3.2%
Utilities	25.2	26.0	-3.0%	27.1	-4.1%
Taxes	70.0	73.2	-4.6%	73.7	-0.7%
Insurance	6.0	7.6	-25.3%	8.2	-8.4%
Management Fees	13.1	13.4	-2.0%	14.0	-4.1%

Retail Expenses	1.6	1.5	5.6%	1.4	6.9%
Total Expenses	187.4	192.3	-2.6%	198.5	-3.2%
Net Operating Income	231.8	227.7	-1.8%	239.9	5.4%
Interest Payments	109.1	73.8	32.3%	61.0	17.3%
Principal Payments	9.3	9.1	2.6%	7.5	17.3%
Other Expenses	9.9	12.8	-28.9%	10.7	16.3%
Capital Expenditures	39.2	35.1	10.4%	41.4	-18.0%
Operating Cash Flow	64.3	96.9	50.7%	119.2	23.1%

Revenues: The big line item of "Total Revenues" was up 4.4% in 2021. Rent growth commencing in Q2 of 17.3% for new leases over the prior leases they replaced and 8.6% for renewals led to the revenue increase. If these trends continue as we expect, they will result in strong revenue growth in 2022. The rent increases skewed our "Market Rent" and "Loss to Lease" results, which largely cancelled each other out. The large increase in "Other Income" was the result of accruing in December for lost rent insurance reimbursements due to unit vacancy resulting from the Texas Freeze. We anticipate we will be receiving the actual insurance proceeds for those lost rents in 2022.

Expenses and Net Operating Income: Expenses increased 3.2%, resulting in a year over year Net Operating Income increase of 5.4%.

Loan Interest, Loan Principal, Other Expenses and Capital Expenditures: Annual interest payments continued to decline as our portfolio of largely variable-rate loans experienced a full year of LIBOR averaging under 10 basis points. Principal payments also declined with refinances converting amortizing loans into interest-only payment loans. The combination of higher Net Operating Income and lower debt service resulted in an increase in our 2021 Operating Cash Flow 23.1% over the prior year. Combined with the results in 2020, our 2021 Operating Cash Flow was up 85% from the 2019 results two years ago.

Long Term Distribution Sustainability and Growth: We at CWS focus first on the long-term sustainability of our quarterly distributions, increasing them only when there is a strong likelihood that the increases will be sustainable. A number of our investors will have noticed increases in distributions this past year, though typically not an 85% increase from two years ago. In addition to these distribution increases, CWS has been allocating the additional cash flow to several areas to promote long-term distribution sustainability and growth. These are:

- **Property Working Capital Balances:** We like to maintain healthy working capital balances at our assets such that we can continue paying quarterly distributions should an unanticipated event occur. For example, when an unanticipated event like the Texas Freeze occurs, typically vendors need to get paid prior to receipt of all the insurance proceeds to get the work done in a timely manner. Also, as insurers have experienced substantial losses in multifamily assets over the last several years, deductibles have risen significantly for certain events. For example, the deductible for hailstorm damage on a roof, unfortunately not an uncommon occurrence in Texas, now is approximately the cost of a new roof, which can run in excess of $500,000. So, a portion of the increased cash flow we have received over the past two years has gone toward building up sufficient working capital balances at our assets and is appropriate for the current environment.

- **Capital Expenditures:** As long-term owners, we are committed to keeping our assets in great condition to maximize rents and minimize long-term structural problems that might occur (asset preservation). Our strong operations, asset management, and capital projects teams at CWS are important components of that commitment. Additionally important is having access to capital and a willingness to commit that capital when appropriate needs arise. For 2022, CWS is budgeting over $70 million in capital projects, nearly $2,800 per unit, for this entire 85 property "same store" portfolio. 2022 is an unusually large capex year: some of the capital expenditures which we planned for in 2021 were postponed due to our teams being focused on addressing the damage from the Texas Freeze. Those capital projects are being re-budgeted for 2022, as well as other needs that have arisen. That said, the $70.2 million capital budget for next year underlines our commitment and capability to keep our assets in tip-top shape to produce long-term sustainable and growing cash flows for our investors.