

2018 CWS Annual Report Letter

By Michael Engels
Partner

Platform and Processes

Many attributes guide a company through fifty years of economic cycles, in good times and bad, to produce the solid, long-term results that CWS has provided to its investors. Our platform combined with our processes provides CWS with an edge, especially when times are tough.

Update: Same Store Portfolio Performance

One process that has been a key element of our success is regular financial reporting and analysis of it. As an update to last year's annual report, the following is a look at the "same store" rollup for the 63 stabilized properties CWS investors have owned for the entire years of 2016, 2017, and 2018. While investors are invested in individual assets, not the portfolio as a whole, this analysis highlights general trends that are relevant for many of our individual assets.

Unit Count: 18,038	SAME STORE ROLL UP				
	2016	2017	2016 vs 2017 %	2018	2017 vs 2018 %
Market Rent	295,161,325	301,730,087	2.23%	308,377,628	2.20%
Vacancy	(18,456,709)	(20,111,678)	-8.97%	(21,561,256)	-7.21%
Concessions/Loss-to-Lease	(2,842,605)	(1,472,498)	48.20%	(1,199,728)	18.52%
Gain/Loss	(18,104,323)	(21,058,817)	-16.32%	(22,065,603)	-4.78%
Model/EE Units	(1,469,026)	(1,449,308)	1.34%	(1,450,035)	-0.05%
Bad Debt	(527,023)	(534,086)	-1.34%	(474,515)	11.15%
NRI	253,761,638	257,103,700	1.32%	261,626,491	1.76%
Other Income	25,449,459	26,761,935	5.16%	30,739,694	14.86%
Total Revenues	279,211,097	283,865,635	1.67%	292,366,185	2.99%
Salaries	23,275,422	23,853,025	-2.48%	25,783,961	-8.10%

Marketing	5,218,188	5,734,342	-9.89%	5,397,712	5.87%
Turnover	4,780,728	4,975,280	-4.07%	4,800,261	3.52%
R&M	4,123,436	4,262,828	-3.38%	4,044,008	5.13%
Prof Services	5,905,201	6,098,320	-3.27%	6,493,055	-6.47%
G&A	4,914,640	4,856,726	1.18%	4,717,507	2.87%
Utilities	16,489,777	17,170,294	-4.13%	17,428,273	-1.50%
Taxes	49,597,359	49,303,518	0.59%	53,358,565	-8.22%
Insurance	3,216,653	3,305,650	-2.77%	4,285,766	-29.65%
Mgmt. Fees	9,041,405	9,154,523	-1.25%	9,456,823	-3.30%
Retail Expenses	149,793	477,772	218.96%	507,786	-6.28%
Total Expenses	126,712,602	129,192,279	-1.96%	136,273,718	-5.48%
NOI	152,498,495	154,673,356	1.43%	156,092,467	0.92%
Interest Expense	53,670,643	58,414,133	-8.84%	71,315,694	-22.09%
Other Expenses	6,770,301	6,638,829	1.94%	7,655,051	-15.31%
Net Income Before Depreciation / Amortization	92,057,551	89,620,394	-2.65%	77,121,722	-13.95%

The numbers show improved revenue growth in 2018 over 2017, led largely by a rebound in Houston and also at select assets in Charlotte and Atlanta. However, above inflation expense growth, especially in salaries, property taxes, and insurance resulted in overall Net Operating Income growing just under 1.0%. The big story has been the rising interest rates on our variable-rate loans that have resulted in Net Income (before depreciation) for the portfolio declining 16% over the last two years. Furthermore, interest rates in 2019 will likely be higher again than the previous year as short-term interest rates appear to have reached a cyclical peak with LIBOR starting 2019 at 2.50%, compared to the average LIBOR rate for 2018 at 2.02%. These higher rates are resulting in distribution reductions for a number of assets in our portfolio. The “free lunch” of hyper-low variable rates has, for the time being, evaporated. That said, our variable strategy allows us complete flexibility (witness our recent 12 property refinances, which resulted in lower interest rate spreads on the loans and allowed for a number of one-time distributions to investors)

and a solid hedge in the case of an economic slowdown, which could possibly result in LIBOR decreases and lower interest payments in the future.

The CWS Platform

The CWS platform has numerous strengths that help provide solid results for investors over the long term. These platform strengths include:

--CWS is a purpose-driven, values-based organization. Our purpose statement is, “Enhancing Lives the CWS Way,” and each of our employees is well aware of the critical role our company plays in people’s lives, including taking care of where our residents live, our investors’ capital, and our fellow associates, all within a values-based organization where respect for each individual is paramount. *Fortune* magazine partnering with *Great Places to Work* ranked CWS in 2018 as one of the “100 Best Medium-Sized Workplaces” in the country. *Fortune / Great Places to Work* defines a “Great Place to Work” as one where employees trust the people they work for, have pride in the work they do, and enjoy the people they work with. CWS’s devotion to its purpose and values makes those things possible. Additionally, *Entrepreneur* magazine ranked CWS as having one of the top 10 company cultures in the country. A key contributor to our culture is our BRIDGE program, where CWS supports the individual initiatives of our employees in the area of community service. CWS strives to be a great place to work to enable us to attract and retain great employees, who in turn deliver great service to our resident and investor customers. And our employees tend to stay for the long term. The average tenure of the 139 corporate level employees is 9.1 years.

--CWS has a solid recurring revenue base from its existing portfolio of 100 properties that enables us to field a strong team to support our portfolio and seize new investment opportunities as they arise. Importantly, this financial strength enables us to not be pressured to execute deals to generate fee income when the odds are not in the investor’s favor.

--Lastly, CWS is a fully-integrated company. We own, manage, acquire, and develop apartments. Each separate discipline is enhanced by knowledge learned in other company disciplines. For example, we can be better acquirers of apartments when we have informed views on when we have an opportunity to operate a property more efficiently or effectively. Our development group’s intimate understanding of replacement cost helps us better discern acquisition opportunities and to find the right price to pay for an asset. Likewise, we can have the confidence to go forward with a new development project by receiving input from our operations team regarding the rents we are likely to achieve and the amenities our customers value.

CWS Processes

Over the years, CWS has developed numerous processes that we believe provide us an edge. These processes include:

--Corporate Planning Process: each of our corporate departments annually goes through a “pre-planning” process where departmental goals are derived. At the end of the year, the department heads come together at our annual planning meeting to review each department’s objectives and set our corporate objectives for the coming year.

--Budgeting Process: the annual budget process commences in June of each year with the “Cap Ex walks” where a team of CWS associates walks each asset and categorizes capital needs for the coming year. Then in September, we commence week long budget camps in each region, as team members crunch numbers and provide projections for the coming year to draft preliminary budgets. Lastly, the process is finalized by the partner budget reviews and approvals in November.

--Due Diligence Process: When a new investment is proposed which appears to have merit, Rich Fagan and the due diligence team spring into action. The team thoroughly evaluates the asset, including walking each unit, fully inspecting the physical asset, examining the rent roll and financials, conducting a file audit, checking resident incomes and qualifications, examining title and survey, and examining the environmental condition of the asset, to name a few. The process culminates with the drafting of a “Go Hard Memo” wherein all the information is outlined and presented to CWS leadership for sign-off before earnest money is committed.

--Quarterly Advisory Board: Each quarter, the CWS executives meet with members of our Advisory Board that include Steve Mulvany, Bill Williams, and Mike Voss. Each of these individuals has a long and deep history with CWS, and is hugely committed to the lasting success of our organization. We have the added benefit of each one being highly intelligent and insightful. I can speak from personal experience to say how valuable this process is to address problems and hash out potential solutions, to point out risks and opportunities, to celebrate successes, and to air our disappointments and help put them behind us.

--Investor Communication Process: Includes quarterly written financial information and property specific updates, the Annual Investor Report and the PAIR, the Annual Investor Meeting, bi-annual investor conference calls, and annual distribution of K-1's by mid-March.

While we have a solid platform and numerous internal processes that give us an edge, we continue to work hard at improving them so that we can provide even better long-term results for our residents and investors.