Insight

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Over the years compelling insights have played a major role in CWS' investment success. To generate powerful insights requires an active and curious mind, keen observation, and close attention to what is transpiring in our business. A prepared organization must also be a patient one. And while many think of patience as a passive state, it's actually one of heightened awareness because one is waiting for a set of conditions to materialize before taking action.

Some of the key insights we've had at CWS include the recognition that in the wake of the Great Financial Crisis single family housing construction would greatly diminish because access to mortgage credit would be extremely limited due to the tremendous losses banks and investors took during the subprime debacle. As a result, newly formed households would rent at a much greater percentage as compared to historical averages and, once the economy started to recover, there would be a significant imbalance between supply and demand due to apartment construction having come to a screeching halt due to construction debt and equity having dried up. This would lead to strong rent growth and a great opportunity to generate strong cash flow and appreciation. It's one thing to recognize an opportunity and another to be prepared to take advantage of it. To do this we believed that it was important for us to have a loaded gun so that we could quickly take advantage of opportunities. This led to the formation of CWS' first Strategic Apartment Fund in 2010 and has been a great vehicle for us to deploy capital and provide diversification for our investors. We are now on our 14th fund which represents one of our insights that has had great longevity and success.

Another insight was recognizing that certain previously underperforming markets may offer compelling investment opportunities. This is especially the case when sellers are fatigued and frustrated by poor investment returns and they just want out. Two examples of these markets were Atlanta and Phoenix. Once we had the clarity and conviction that these two markets offered great value, we mobilized our resources and went into action to grow our portfolio in these two cities with a lot of success.

Our most powerful insight starting in 2003, but gaining much more traction since 2011, was the benefits of utilizing variable-rate financing. This worked quite well up until early 2022 in that it has resulted in significant interest savings on a cumulative basis for the properties financed with variable-rate loans as well as prepayment flexibility that has allowed us to pay off loans in excess of $2 billion early by either refinancing them or by selling the underlying properties. We were able to take advantage of the optionality that the very low prepayment penalties these loans have to optimize our financing or selling properties without being encumbered by loans that cannot be prepaid without enormous financial penalty.

That was then and this is now, so what are our current insights? The apartment industry is now contending with the reversal of the Covid trends that were so beneficial for us. We had far greater than anticipated household formations due to remote work and people working from home needing to have more space. The Covid disruption and mobility of our population served to pull future demand forward. At the same time supply was insufficient to meet this accelerated demand because of the supply chain issues and labor shortages that created delivery delays. This supply and demand imbalance led to significant rent increases which benefited all apartment landlords. CWS had the added benefit of seeing a tremendous drop in our interest expense as the underlying rates tied to our variable-rate loans fell precipitously as the Federal Reserve brought short-term interest rates down close to 0%. We were in the very beneficial position of being able to materially increase our distributions given the much higher cash flow.

Now we are paying the piper in that many of these trends are now reversing. Demand is softening, the previously delayed apartments under construction are now hitting the market in very large numbers, the industry is facing much higher insurance rates, and labor quality, reliability, access, and compensation continue to be a challenge. And for CWS, higher interest rates are really starting to bite now that our very cheap and lucrative interest rate cap expired in December 2022.

And while it has been painful for CWS from a cash flow perspective, it has been far more challenging for many other owners that utilized much higher leverage, higher cost variable-rate loans to purchase or refinance properties at very aggressive values. We believe that our prudent management of our portfolio should enable us to avoid being bogged down with a lot of financial challenges in our portfolio such that we can remain on offense and be prepared to purchase properties at what should be more compelling valuations from organizations facing far more financial difficulties.

The Federal Reserve has been quite explicit in its goal of engineering an economic slowdown and reduced hiring to wring inflation out of the system. Based on the level of interest rates and the structure of the yield curve and projected forward rates, the market believes the Fed is at the tail end of its interest rate hikes. The question is how long it stays at peak levels. The market is now convinced the Fed is close to overtightening and it will have to cut rates in later 2023. If this does occur, then we are well-positioned to benefit from this as this will start to lower our interest costs which should more than compensate for any rent reduction or slower growth that we might experience in our rental income. This should particularly be the case in 2024 when more aggressive interest rate reductions are projected to take place. And if the economy does stay strong then household formations should remain elevated, which should allow us to grow our rents more than we would expect.

Our intention is to remain patient and not act just to stay busy. We think we could see some very interesting opportunities in the year ahead and we are positioning ourselves to act quickly, if necessary. We believe that market conditions are adjusting such that deploying capital in 2023 could provide some compelling opportunities for those organizations with the patience, capabilities, and access to capital to take advantage of them.