UNDERSTANDING POTENTIAL UNSTABLE FORCES

By Steve Sherwood
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Over our 56-year history, CWS has endeavored to become not only resilient but increasingly Antifragile. It has also been the case that when there is widespread fragility, we have been able to make some of our best investments. I want to do a deeper dive into some of the fragility that is present, which will probably continue to become more widespread, among some apartment owners. This is particularly the case in the opportunity set that has the most appeal to us, which are newer, higher quality communities that are delivering units into a much more competitive environment with record supply at a time when interest rates are much higher than when developers first broke ground on their new communities.

The spike in rents in the wake of Covid and the very low interest rates made building apartments quite lucrative, at least on paper. This led to a huge increase in supply of apartments and now many of those have come online at a time when rates are much higher, rents have pulled back, and the yields required by purchasers of apartments have gone up significantly in conjunction with interest rates.

Many of these newly built communities are only generating a 5% yield on cost that is not only lower than projected, but too low given the much higher interest rate environment to exit with a profit via a sale or, in the event of a refinance, to repay their construction loans without having to come up with additional cash unless the initial leverage was relatively modest. The alternative is to access higher leverage, more costly debt.

Because of the mismatch between long-term income streams that apartments are capable of producing and the short-term construction loans developers use to finance their projects, developers are highly incentivized to fill up their vacant units as quickly as possible via move-in incentives such as free rent that burns off after a few months, so their rent rolls are eventually populated with residents paying close to full market rent. These incentives make it very difficult for owners to obtain rents high enough to justify building new apartments. Renters have too many choices now for owners to have any material pricing power, particularly when leasing vacant units.

Many apartment developers find themselves in a fragile state delivering new properties in highly saturated markets with construction loans maturing. In a number of cases, they will either have to bring in additional capital to repay their construction loans, access high-cost bridge loans, or sell at a loss or with very little profit. This fragility creates the potential for some compelling investment opportunities for firms with more stability and particularly for those that are antifragile.

The opportunity set isn’t just restricted to newly developed properties or older, lesser quality B and C apartments (which hold very little appeal to us). Higher quality existing properties may provide some compelling investment opportunities as well. The problems developers are having in some cases spill over to existing communities as there are instances when developers need to sell older, stabilized properties to enable them to access capital to cover their development capital needs. The opportunity set for purchasing existing communities is further expanded by owners who are facing loan maturities that may also require additional capital to fully repay their maturing loans.

In general, since 2022 we have been very quiet on the capital raising front for new opportunities as we did not think that deploying capital into a much more competitive operating environment while also facing significant cost pressures (e.g. insurance), and rising interest rates was prudent given that values were declining and there was risk that cash flows could contract as well. It now appears the Fed is done raising interest rates, although apartment rents are too low relative to what is needed to justify building new communities and when compared to purchasing a home. In addition, when it comes to higher end apartments, they are still quite affordable as renters are paying on average only 23% of their income to rent.

Our north star is to have CWS be an antifragile organization. We have been in business since 1969 and navigated so many downturns that we have been doing something right to have not only survived but prospered over the last 56 years. I would ascribe this to tenacity, agility, having skin in the game, never betting the company, a deep commitment to communicating openly and honestly with our investors, having operational control of our properties, and having had access to capital when capital was in short supply. This has helped us not only have staying power when difficult times came upon us but also allowed us to take advantage of some very lucrative opportunities because we could purchase properties at deep discounts.

Given the improving operating environment with an undercurrent of fragility among apartment owners with loans maturing such that the opportunity set is material and growing, we are very excited to be actively raising capital again. We believe that rents need to rise quite significantly to justify building new apartments and to make home ownership more competitive. This large gap between current rents and replacement cost rents, combined with the building up of stress among borrowers with maturing loans, has us feeling quite confident that this is an optimal time to be raising and deploying capital.

***Disclosures:** *Past performance is not necessarily indicative of future results. There can be no assurance that any investment opportunity with CWS will be able to implement its investment strategy, achieve its investment objectives, or avoid substantial losses. All investments carry some degree of risk.*