Volume 38, No. 3, October 25, 2024

QUARTERLY UPDATE
CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

**CALENDAR OF EVENTS**

**November 28-29, 2024**
Thanksgiving Holiday
CWS Offices Closed

**December 24-25, 2024**
Christmas Day Holiday
CWS Offices Closed

**January 1, 2025**
New Year's Day Holiday
CWS Offices Closed

**January 15, 2025**
4th Quarter 2024
Est. Tax Payment Due

**January 31, 2025**
4th Quarter 2024
Quarterly Reports & Distributions

**March 14, 2025**
Year 2024 K-1
Target Mail-by Date

**April 15, 2025**
2024 Federal/State Tax Filing Deadline
1st Quarter 2025 Est. Payments Due

**April 25, 2025**
1st Quarter 2025
Quarterly Reports & Distributions

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# LIGHT AT THE END OF THE TUNNEL

*By Gary Carmell*

In my quarterly letter from October 2023, I wrote the following:

*With the de-inversion of the 10s and 5s I would say we're now on recession watch. Once the 10s and 2s de-invert then to me it's a clear recession warning. And this will finally get us to the point where the Fed will be officially done raising short-term rates and we can finally be in a position again to get some relief with the prospect of lower rates being much more feasible.*

It turned out that I picked the right indicator to watch to signal when the Fed would be able to start cutting as the 10s and 2s de-inverted quite recently and the Fed cut for the first time in over four years in September.

I have written before how an inverted yield curve is only the first step to being on recession watch, or a much slower growing economy. The most important indicator is when the yield curve de-inverts. This is when the 10-year Treasury yield is higher than the five and two-year yields. This graph shows how recessions (the gray shaded columns) ensue after the curve de-inverts.

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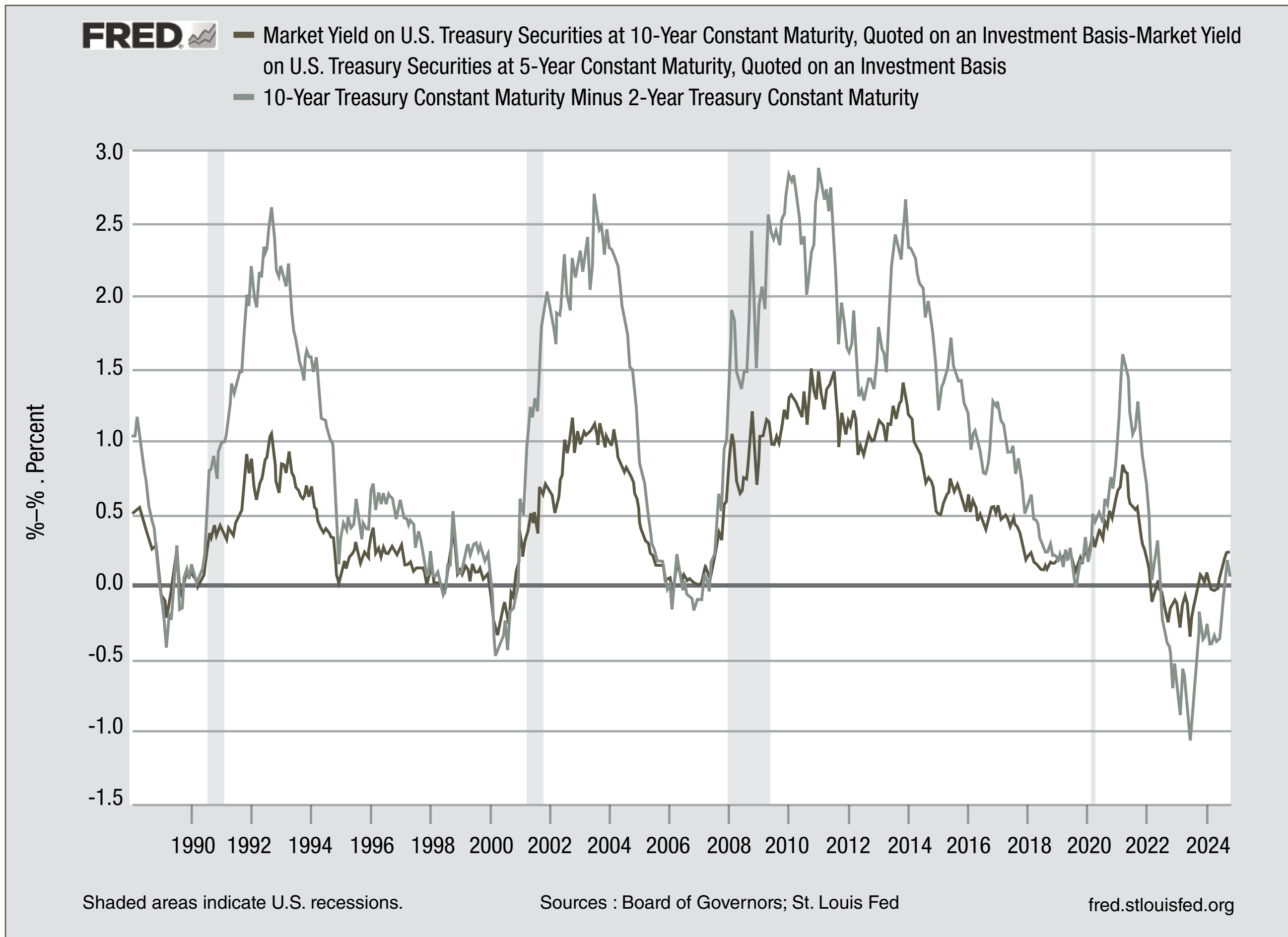


The differential between the 10-year and 5-year Treasuries has been generally positive since when I wrote my article last October. The real confirmation would be when the 10-year and 2-year Treasuries de-inverted which has finally happened so now we are officially on recession watch, although the recent jobs report and reduced unemployment rate call into question the timing.

I would be disingenuous if I said that 2023 and 2024 were just minor bumps in the road for CWS because they weren't. We obviously didn't think rates would go as high as they did. And while we were decently hedged through the end of 2022, we were not sufficiently hedged to spare us the pain of higher rates requiring us to cut or suspend distributions and needing to raise capital for several of our properties. And while everyone who has owned apartments, and virtually all other forms of income producing properties, have seen their values come down by approximately 20%, those that bought in 2021 and 2022 were hit the hardest as these have dropped by more than 50% in many cases. And when factoring in leverage, this may result in paper equity losses of greater than 80%.

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| Green Street CPPI®: Sector-Level Indexes | | | | |
|---|---|---|---|---|
| | Index | Change in Commercial Property Values | | |
| | Value | Past Month | Past 12 Mos | Recent Peak |
| All Property | 125.5 | 0.0% | -3% | -19% |
| Core Sector | 125.9 | 0.0% | -3% | -21% |
| Apartment | 152.3 | 0.0% | 2% | -20% |
| Industrial | 213.7 | 0.0% | -9% | -16% |
| Mall | 85.3 | 0.0% | 5% | -13% |
| Office | 71.6 | 0.0% | -8% | -37% |
| Strip Retail | 114.3 | 0.0% | 3% | -13% |
| Data Center | 108.6 | 0.0% | -4% | -16% |
| Health Care | 123.6 | 0.0% | -5% | -18% |
| Lodging | 103.0 | 0.0% | -4% | -9% |
| Manufactured Home Park | 278.5 | 0.0% | -3% | -14% |
| Net Lease | 94.3 | 0.0% | -3% | 19% |
| Self-Storage | 246.8 | 0.0% | -8% | -21% |

Because apartments require large amounts of capital to purchase, maintain, and build, sponsors and developers need to generate returns sufficient to compete with other investments. And because the rents being obtained by new communities in lease-up are not sufficient to earn a compelling rate of return for investors, this is leading to capital avoiding the funding of apartment developers. Given this, one would expect that new development should drop to allow for rents to rise to a high enough level to incentivize the construction of new units. And, in fact, this is happening as I will discuss later. If one owns good quality properties in desirable and growing areas, then having the financial and emotional staying power is critical as values almost always recover and usually allow for one to recoup most, if not all, of the investor paper losses.

Of course, no one wants to fund into a black hole and throw good money after bad when times get tough. That is why it is important to do one's best to avoid distress by being prudent with one's leverage at the outset of the investment and not rely on very aggressive growth assumptions to justify making an investment. And while at CWS it would have been less challenging had we not purchased properties during those heady days of 2021 and 2022, the fact of the matter is that we did as we were carrying out 1031 tax-deferred exchanges that had fixed timelines in which to complete purchases. Fortunately, we sold properties during that period which allowed investors to generate liquidity if they so desired or exchange their appreciated dollars into new investments. In addition,

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we only purchased nine of our 106 properties in this window so as a percentage of our portfolio it is relatively manageable, although still not a pleasant experience for those of us invested in those properties.

And while there have been some properties that have needed, and may continue to need, additional capital, as well as other ones that will need capital in the year ahead, we are cautiously optimistic that with the Fed now on the path to cutting rates and this spilling over into interest rate cap costs dropping by over 50% in some cases, we may be seeing some light at the end of the tunnel. We will know with more conviction after going through our annual budgeting process how this will translate to distributions and capital needs, but my sense is there should be some increases in the former and less of the latter.

The dramatic run up in interest rates between 2022 and 2023 and staying elevated until the Fed finally cut in September, has led to a roller coaster ride for the cost of interest rate protection. Caps that were essentially free exploded in cost necessitating a huge diversion of our cash flow to not only have the funds to pay for new caps after existing caps expired, but to also make sure we were reserving enough for the purchase of future caps. This necessitated cutting distributions for many of our properties and, in some cases, calling for additional capital from our investors. All was not lost, however, as some of the very cheap caps we purchased paid out enormous sums relative to their cost, helping cushion the blow of having to reserve for the purchase of far more expensive caps.

For example, a cap that we purchased in 2020 for three years at a strike price of 3.50% (we would get paid if the index exceeded 3.50%) cost approximately $50,000 but paid us over $2 million during its three-year life. When it came time to purchase a new cap in 2023, however, we bought a 2-year cap at a strike rate of 4.10% and this cost us approximately $1.7 million! That cap today would cost us approximately $300,000. And while we will lose money on this cap (estimate of $500,000), overall, we will have come out ahead on our cap purchases. Fortunately, almost across the board we now have more than enough money in our lender impound accounts for the purchase of future caps. This will improve our cash flow as we will either no longer have to make monthly payments to the lender into these accounts or they will be dramatically reduced.

We are finally at a point where we can see some sunshine ahead. We're in the camp that the yield curve is going to normalize far more because of short-term rates coming down versus both dropping but short rates dropping more. And because our floating-rate loans are still expected to be at least 0.5% to 1.00% more than fixed-rate loans, even after the Fed cuts by another 1.50%, and the underwriting requirements for floaters today are

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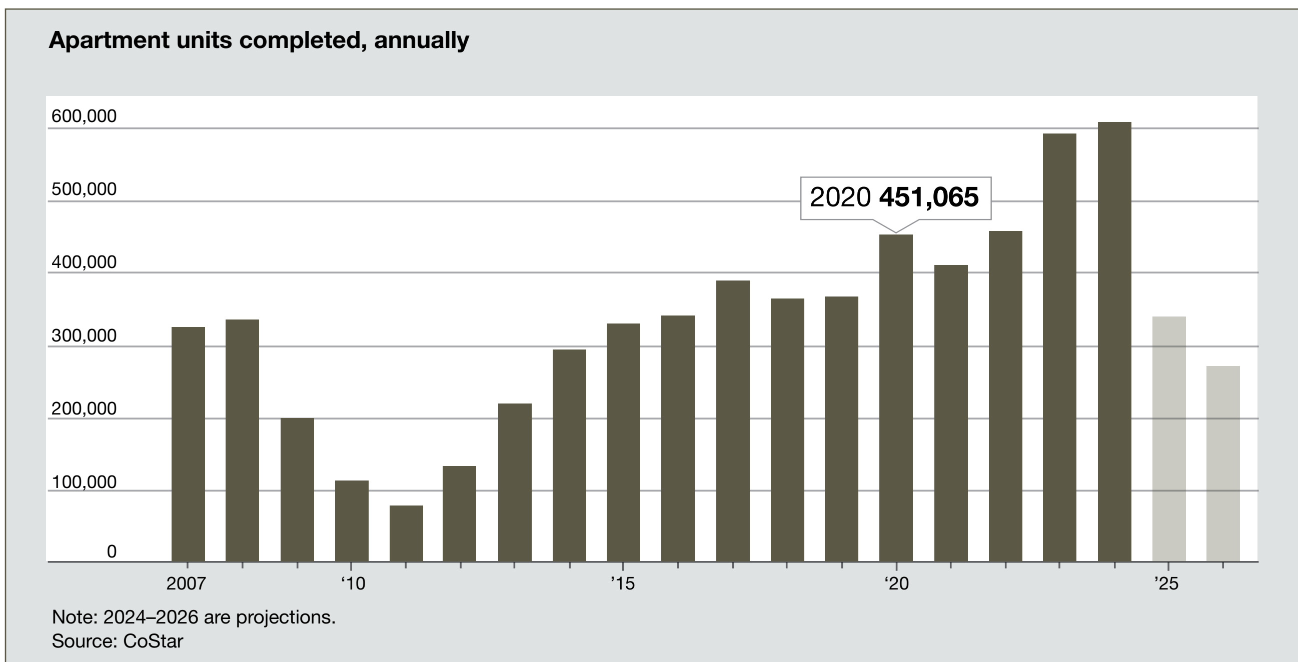
more punitive than fixed, the end result is we can generate more proceeds and lower our debt service while not having any cap requirements if we refinance our floaters into fixed.

We currently have eight properties that are in the process of being refinanced. In addition, we have several others under consideration. We also have a fair number of loans maturing in 2025. We are going to be very active on the refinance front. In some cases, this should allow us to make one-time distributions to our investors from excess refinance proceeds as well as lower our debt service which should allow for recurring quarterly distributions to either recommence or increase.

In addition to lower interest rates and correspondingly much cheaper interest rate caps, apartment owners can see the light at the end of the tunnel as the tremendous amount of supply hitting markets around the country will start to dissipate in 2025. This doesn't mean that pricing power will return immediately, especially in significantly over-supplied markets like Austin, but some will experience their own thawing towards the end of 2025 and start turning the corner in 2026. This graph shows the projected drop in apartment deliveries in 2025 and 2026.




We are in the process of providing liquidity to the majority investor in one of our properties in Austin that we have owned for a few years. I think this property example is a good representation of the significant gap between rents that existing apartment communities are generating versus the much higher rents needed to justify starting a new development project.

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## Discount to Replacement Cost - Austin Property Example

- **Estimated replacement cost in excess of $400,000 per unit based on CWS' internal analysis compared to $252,000 purchase price**
- **$3,400 rents needed to build to a 6.5% yield-on-cost to justify new construction based on CWS' current existing portfolio expense levels**
- **This compares to current in-place rents of $1,912**

And while we don't expect our rents to fully close the gap, even if we end up at a 25% discount, then our rents would have a runway to grow by approximately 33%, which would have a very significant impact on our net cash flow. Add to this the much higher cost of purchasing and owning a home due to continued high mortgage rates, purchase prices, and insurance and property taxes, then apartments offer a very impressive cost advantage for those weighing renting versus buying.

Legendary investor Stanley Druckenmiller discussed some critical lessons he learned very early on in his career that one of his mentors taught him. Here is one of them:

*But before he left, he taught me two things. A, never, ever invest in the present. It doesn't matter what a company's earning, what they have earned. He taught me that you have to visualize the situation 18 months from now, and whatever that is, that's where the price will be, not where it is today. And too many people tend to look at the present, oh this is a great company, they've done this or this central bank is doing all the right things. But you have to look to the future. If you invest in the present, you're going to get run over.*

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Given the lack of distress in the industry despite interest rates having risen by so much in such a short period of time suggests that sponsors and investors are holding on because of Druckenmiller's lesson. For those not cushioned by fixed-rate loans with two plus years of maturity left, there is a strong belief among sponsors and their investors that infusing additional capital represents a good risk-reward as buying another two years or so should result in a materially better financial situation. If one can hang in there and come up with additional capital to support the property until rates drop and/or revenues grow materially or to infuse more capital to pay down maturing debt that can't qualify for enough proceeds to fully repay the loan, there is a strong probability that the new capital will be returned with a sufficient return while the chance of recovering one's original investment should grow materially.

To make a long story short, apartment rents are too low relative to what is needed to justify new construction or to purchase a home. These depressed rents are a result of too much supply being delivered relative to the demand. This makes the economics of development unattractive. As a result, capital is contracting in terms of funding new apartment developments, and this is translating into a significant reduction in new supply in 2025 and 2026. Once markets get back into equilibrium this should restore pricing power to apartment owners and give owners and investors a great incentive to hang on to assets generating negative cash flow or falling short on refinance proceeds. This has led to less financial stress than initially expected, particularly for higher quality properties. And now that the Fed is starting to cut interest rates, values have hit bottom, and they are starting to appreciate again.

Earlier I cited an important lesson that Stanley Druckenmiller learned when he was a fairly new analyst and investor. In the speech he gave he said that he was given two critical pieces of advice from his mentor. Here is the second one:

*The other thing he taught me is earnings don't move the overall market; it's the Federal Reserve Board. And whatever I do, focus on the central banks and focus on the movement of liquidity, that most people in the market are looking for earnings and conventional measures. It's liquidity that moves markets.*

We now can see a better earnings outlook 18 months ahead and a Fed that is far more cooperative. This is laying the groundwork for more interesting investment opportunities in the year ahead.

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