Volume 24, No. 4, January 28, 2011

QUARTERLY UPDATE

CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

Prior to March 2011
K-1's Mailed

April 13, 2011
CWS Capital Partners
Annual Shareholder's Meeting

April 15, 2011
2010 Tax Filing Deadline

April 15, 2011
1st Quarter 2011 Estimated Tax Payment Due

April 22, 2011
Good Friday
CWS Offices Closed

April 29, 2011
1st Quarter 2011 Quarterly Packages Mailed

May 2011
CWS Capital Partners
Semi-Annual Conference Call

May 30, 2011
Memorial Day
CWS Offices Closed

July 4, 2011
Independence Day
CWS Offices Closed

July 15, 2011
2nd Quarter 2011 Estimated Tax Payment Due

July 29, 2011
2nd Quarter 2011 Quarterly Packages Mailed

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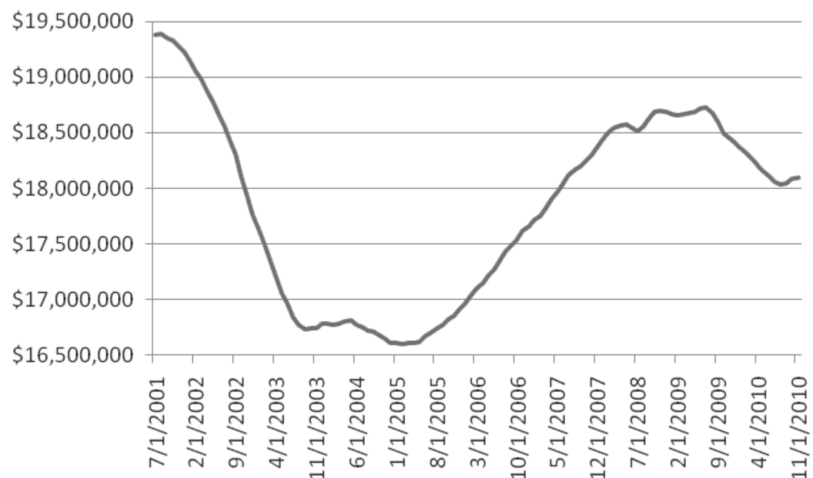
A PICTURE WORTH 1,000 WORDS

By Gary Carmell

Sometimes there is a picture that really is worth 1,000 words, or in my case, closer to 1,400. CWS has owned apartments on an uninterrupted basis since 2000. Seven of the properties we currently own have been in our portfolio since 1998. These seven properties form a mini-portfolio that benefits from geographic diversification as they are in Charlotte, Denver, Austin, Dallas, and San Antonio. The combined performance of these properties has not only been a good barometer of overall apartment trends, but has also provided insight into wider areas of interest such as the economy, financial markets, interest rates, and housing. The following chart is an aggregation of our rolling 12-months Net Rental Income for these seven properties.



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There are a number of takeaways from this chart. They are:

1. Collected rents are still down approximately 8% from their peak in 2001.
2. The 2001-2002 recession was much more devastating to apartment performance than the most recent downturn, despite a much worse economic environment currently.
3. We appear to have hit bottom in August 2010 after declining for 13 months versus a 42-month decline in the last recession.
4. In hindsight, investors were too aggressive in their pricing of apartments in 2007, irrationally pessimistic in 2008 and 2009, and could be appropriately pricing them in today's market.

In the first recession, jobs peaked in November 2000 and hit a trough 26 months later in January 2003 after having lost 5 million jobs. Despite a relatively manageable 4% cumulative job loss, our Net Rental Income dropped by approximately 14%, which was a very significant decline. Fortunately, for apartment owners, long-term interest rates dropped significantly which gave them an incentive to hang on to their properties and put additional capital into them if necessary to get to the point where they could refinance or sell. For example, 10-year Treasury notes averaged 5.83% in August 2001 (our Net Rental Income peak) and 4.17% in February 2005 when our NRI bottomed. If owners were lucky to have debt that could be pre-paid earlier, then they could have caught a refinance window in which the Treasury security was yielding in the 3.33% range (June 2003). Either way, long-term interest rates dropped by nearly 2% which was powerful medicine for a sick patient.

Let's fast forward to the Great Recession from December 2007 through June 2009. This was absolutely brutal from a capital markets standpoint as the credit markets seized up and debt became very difficult to access for a period of time. Fortunately, however, and somewhat ironically, apartment owners could access debt from Fannie Mae and Freddie Mac at a time when they were essentially insolvent because of disastrous decisions made on the single-family side. This debt was not available to other property owners like those of office buildings, industrial space, and retail space. This put much greater pressure on them than apartment owners. In addition, the stimulus that helped propel the economy out of the first recession, single-family housing, was the source of the economic carnage in the latest downturn. We lost 12 million jobs from peak to trough over a 26-month period (Nov. 2007 – Jan. 2010). Yet despite the worst economic contraction since the Great Depression, the downturn in apartments was actually quite muted. Our Net Rental Income for this seven property mini-portfolio only dropped by approximately 4% over a 13-month period (July 2009 – August 2010), which was a much shallower and shorter downturn than the previous recession. Similar to the previous recession, apartment owners also benefitted from a drop in long-term interest rates as 10-year Treasury note yields dropped by 2.5% from peak to trough. Variable-rate borrowers benefitted even more during this time as short-term interest rates (as measured by 30-day Libor) dropped from approximately 5.50% to approximately 0.26% currently. Fortunately, we have a number of loans that have benefited from this drop and some have interest rates less than 1.75%.

We're actually in quite a beautiful spot as apartment owners and investors. We are coming out of a brutal downturn relatively unscathed while there is very little new supply of apartments being built. The following chart shows the cumulative building permits for multi-family projects (5+ units) on a rolling 12-months basis for our major Texas metropolitan areas (Dallas, Fort Worth, Houston, Austin, and San Antonio). As the chart shows, we are back down to the minimal levels we saw in early 1994.

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CWS Texas MSAs Annual
Multi-Family Permits
(1/94 – 10/10)

Source: Texas A&M Real Estate Center and aggregated by CWS

At the same time we're experiencing a meaningful contraction in new supply, we're also starting to see positive job growth in our markets. The following chart shows the aggregate annual change in non-farm employment for our five Texas metropolitan areas.

CWS Texas MSAs Annual
Job Growth
(1/96 – 10/10)

Source: Bureau of Labor Statistics and aggregated by CWS.

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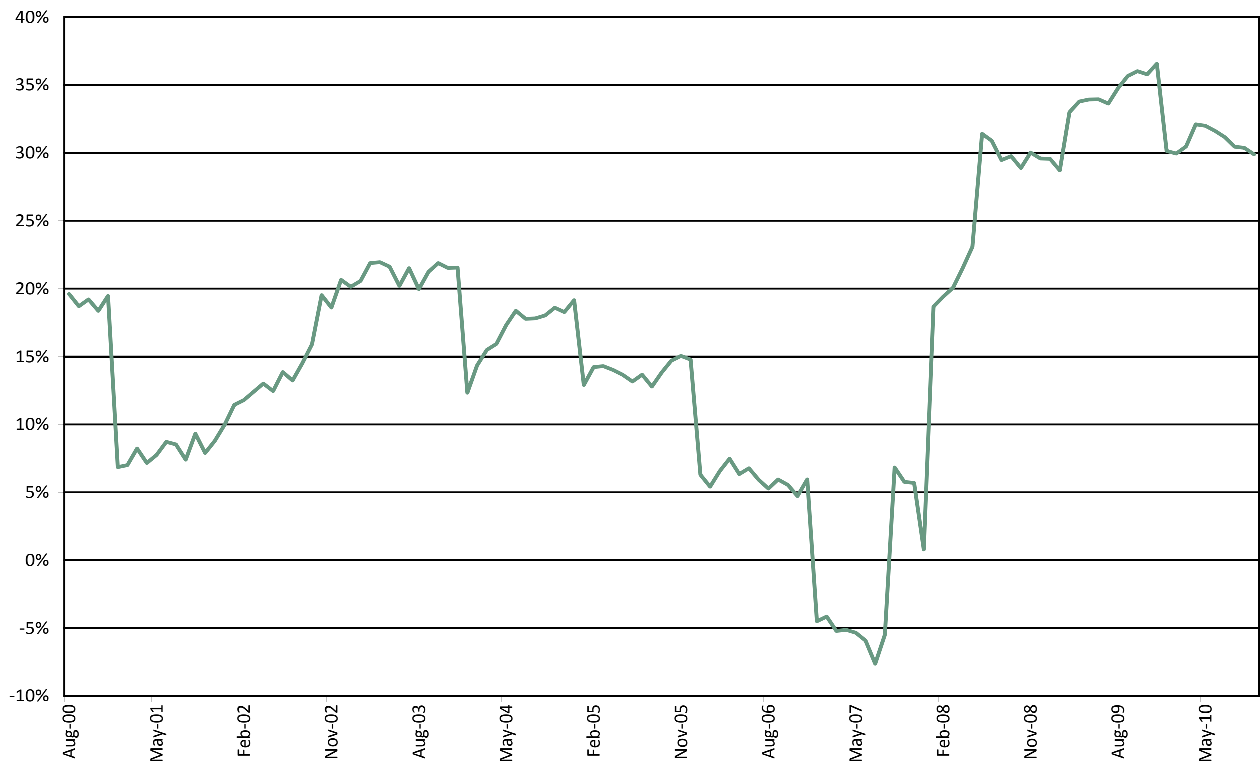
With new supply quite low and jobs increasing, which is leading to new renter household formations, the stage is set for what we project to be relatively consistent rent growth over the next few years as the economy picks up speed. According to REIS, an apartment research firm focused on large, professionally managed apartments, the national vacancy rate has dropped from 8.0% in the 4th quarter of 2009 to 6.6% currently. This is a very healthy vacancy rate which seems poised to drop even more. In addition, we believe that rents still have to rise fairly materially in order to justify meaningful new construction as the following chart shows.

Estimated Gap in
Replacement Cost Rents vs
Actual Rent Collections (8/00 – 10/10)



Based on 7 CWS Property NRI Collections, construction costs, prevailing interest rates, leverage, cost of debt, and cost of equity.

The above chart shows our estimate of how much higher rents should be than those currently being achieved in the marketplace to justify taking the risk of building a new community. Normally we would expect new communities to deserve a rent premium of 10% to 15% more than existing, older communities. With this rule of thumb, we think it is realistic to see rents move 15% to 20% before seeing any meaningful new construction.

Is this a good time to buy apartments? We actually do think so. If you go back to the first chart, we have 20-20 hindsight available to us. Currently apartments trade at valuations similar to what they

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did in 2006-7 while interest rates are a bit lower. It turns out, however, that purchasing at those valuations in 2006-7 was probably too aggressive as cash flows were peaking and interest rates ended up going lower. When the global financial markets imploded in 2008 and 2009, however, the prices buyers were willing to pay turned out to be far too cheap because most believed that the world was coming to an end and rental income could fall off the cliff. People were valuing properties based on not knowing where the bottom was. Apartment owners had a very different view of the future, however, than apartment buyers and they were not interested in selling at those prices unless they had to. For this reason, transaction volume dropped by approximately 90% from the peak as lenders and buyers tightened up. The owners turned out to be right as the downturn was fairly muted, interest rates dropped, and capitalization rates fell back to 2006-7 levels.

Today, however, has a different set of circumstances than 2006-7 as cash flows have bottomed and should turn up materially over the next few years with minimal new supply and an improving economy. In addition, we think interest rates will stay in a similar range as they have whereby most loans will be secured at a rate of between 5% and 6%. Thus, apartment buyers now can purchase assets at similar multiples paid during 2006-7 but with much better prospects for cash flow growth. After many years of apartments being the sacrificial lamb for the "Ownership Society", they should perform very well as our housing imbalance corrects itself by historically low levels of single-family home construction and a much tighter mortgage market, thereby pushing more people into renting. A happy picture is forming.

We are actively looking for new investment opportunities after a relatively dry period of very few acquisitions. If you have someone you have considered introducing to CWS, now would be a good time to do so.