Volume 22, No. 4, January 30, 2009

QUARTERLY UPDATE
CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

Prior to March 1, 2009
2008 K-1's Mailed

April 2, 2009
CWS Annual Partners Meeting

April 10, 2009
Good Friday, CWS Office Closed

April 15, 2009
2008 Tax Filing Deadline

April 15, 2009
1st Quarter 2009 Estimated Tax Payment Due

April 24, 2009
1st Quarter 2009 Quarterlies Mailed

Monday, May 25, 2009
Memorial Day, CWS Office Closed

May 2009
Semi Annual Conference Call

June 15, 2009
2nd Quarter 2009 Estimated Tax Payment Due

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THE ROAD TO 125 (OR 130?)

By Gary Carmell

At the peak of home lending insanity, lenders aggressively sought borrowers to provide them financing of up to 125% of the (inflated) value of their homes. They did this by creating a new first mortgage up to 100% of value and a second mortgage that enabled borrowers to consolidate higher cost, higher risk consumer installment debt like credit cards and auto loans. This was very rational for borrowers to take advantage of because it converted high cost, non-deductible debt into lower cost, tax deductible interest payments. For lenders, however, making such loans required two key assumptions (assuming they expected to be repaid in full and on a timely basis). The first was that home prices would continue to rise every year as they had for more than sixty years and that the default rate on the previous consumer installment debt would be far less than historical statistics had proven. Both turned out to be wrong.

Home prices fell precipitously once lenders were forced to

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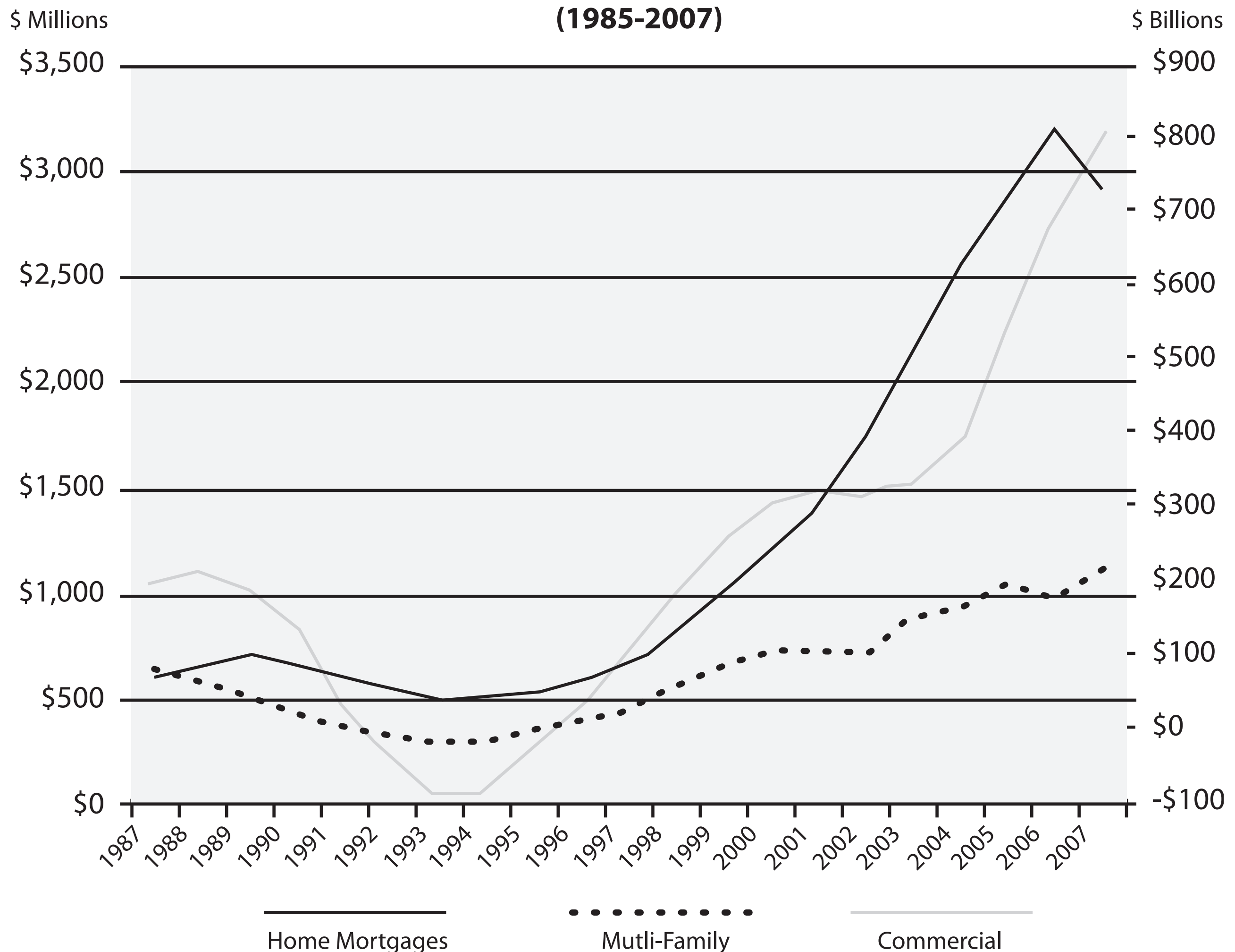
repurchase large quantities of instantaneously defaulting loans and they could no longer keep the balloon inflated with stupid money funded by stupid investors who sheepishly followed the ridiculous AAA ratings from the stupid rating agencies. "Stupid is as stupid does" as so eloquently stated by Forrest Gump. The residential market is in disarray with housing starts at 50+ year lows as lenders have come to believe that down payments and credit history actually do matter if they want to get paid back in full and on time. Rather than focusing on the past, however, I would prefer to follow the wise advice of General Russel L. Honore, who was the commander of the Katrina Joint Task Force. He said, "Don't get stuck on stupid." I liked his recommendation then and today I like it even more. So I won't get stuck on stupid.

What does this have to do with apartments? Apartment borrowers actually have their own 125% challenge, although opposite of the residential lending situation. While residential lenders were attempting to get home owners



Source: Federal Reserve Board, Flow of Funds Statistics.

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to borrow 125% of the value of their homes, apartment borrowers are now faced with the requirement to have their Net Operating Income (NOI which equals revenue minus expenses) be at least 125% of the amount of debt service amount. Sounds prudent? Of course it does, except many borrowers accessed loans during the good old days of 2005 to 2007 when over $220 billion of new multi-family debt was originated at coverage ratios far less than 125%. Before I discuss the challenges and opportunities this may present to apartment owners/investors, let me take a quick detour.

The more aggressive lending environment available to apartment owners from a few years past cannot even compare to what took place in residential and commercial finance. The graph on page 2 shows the cumulative amount of new lending over a rolling three-year period for residential, multi-family (apartments), and commercial (office buildings, retail, industrial, etc.).

Please note that multi-family and commercial lending are on the right scale and residential is on the left. Despite a meaningful increase in apartment lending, it cannot even compare to what the commercial and residential markets experienced. Residential exploded by more than $2.5 trillion on a rolling three-year basis from peak to trough while commercial grew by $900 billion and apartments by "only" $200 billion.

To put this growth in perspective, the table at the bottom of the page shows the outstanding value of all loans for each of the three categories in 1985 and 2007 and the percentage growth rate.

Unlike residential loans, commercial delinquencies are extraordinarily low. For example, according to the Mortgage Bankers Association in its 1/8/09 press release, only 36 loans out of 35,000 mortgages owned by insurance companies have a delinquency rate of 60 days or more. This is impressive. Unfortunately, this is as good as its going to get for awhile. In the same press release, it cites the fact that commercial real estate transaction volume is 67% lower than the first three quarters of 2007 and represents the lowest level of volume since 2003. Interestingly, despite the pressures that are building in

	1985	2007	% Change	Annual Compounded Growth
Residential	$1.526 Trillion	$11.168 Trillion	632%	9.5%
Commercial	$541.7 Billion	$2.492 Trillion	360%	7.2%
Multi-Family	$205.9 Billion	$839.6 Billion	308%	6.6%

Source: Federal Reserve Board, Flow of Funds Statistics.

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commercial real estate resulting from the credit crunch and lower transaction volume, prices have remained relatively sticky as most owners who have financial staying power see very little reason to sell in this environment. Quoting from the press release:

> *"It's important to note that while commercial real estate has been getting a great deal of attention related to the pricing pressure it is experiencing, the price declines seen so far are only a fraction of what's been seen in other investments, including the prices of single-family homes, the Dow Jones Industrial Average or the price of crude oil."*

Although not nearly as egregious as the excesses in home lending, commercial real estate was the beneficiary of the global demand among investors for owning pieces of U.S. real estate loans via the securitization process. In addition, the enormous losses incurred by investors and lending institutions from bad residential loans has spilled over into the commercial real estate loan market via a significant tightening of credit standards for the issuance of new loans.

The byproduct of this huge supply of real estate loan capital was aggressive financing which allowed borrowers to access loans representing a larger percentage of value (80% or more including the use of mezzanine loans) at interest rates of 5% to 6% with full-term interest-only and no repayment of principal required until the loan matured. Some of these loans were underwritten such that when they eventually amortized (begin to repay principal via higher debt service) the debt service would equal the amount of the current Net Operating Income (NOI) of the property. During more normal times, this coverage would equal 125% of the property's NOI in order to give the lender a margin of safety in the event interest rates rose when the loan matured and/or NOI either declined or grew less than projected. By lending at only a 100% coverage (debt service equals NOI), lenders and borrowers would be taking on great risk when these loans come due in large numbers between 2010 and 2017.

The type of road borrowers will be traveling back on to 125% coverage is of extraordinary importance for apartment owners such as CWS. Fortunately almost all of our debt comes due after 2010, and the two loans that do mature in 2010 have interest rates significantly higher than current rates prevailing in the market (8% for Marquis at Barton Creek and Marquis at Town Centre versus approximately 6% for current market rates). This analysis is designed to assess and quantify different paths that our industry may go down and the potential for investment opportunities that may result. If handled somewhat rationally and methodically then the transition should cause

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minimal damage to borrowers and property values (beyond where they have adjusted to already). If not, however, then we could head into a multi-car pile up that could cause great problems for the drivers and insurance companies and tremendous opportunity for the tow truck owners and repair shops.

In order to quantify the challenge facing apartment owners with debt coming due, I have put together the following table based on a five-year loan originated in 2005. The purpose of the table is to quantify how much cash investors will have to come up with to pay down maturing loans based on today's interest rates and 125% coverage ratios (NOI is 125% the amount of debt service) or how far interest rates would have to fall for borrowers to be able to refinance their loans without having to come out of pocket.

There's a fair amount of information in the table below, but here are the important takeaways. Assuming no change in market interest rates in 2010 and a growth rate in NOI of 3% per year for five years, then based on a debt service coverage requirement of 125% of NOI, borrowers will only qualify for loan proceeds of approximately 82% of the outstanding loan balance. Assuming the original loan was 80% of cost, then this set of assumptions would require the borrower to pay down the loan by an amount equal to approximately 70% of the original equity investment in order to access new financing. This is a lot of cash to come up with, especially when this most likely wasn't planned for. It is when cash is needed, unplanned for, and not easily accessible that interesting opportunities can arise for those firms like CWS that can raise such sorely needed money.

If lenders remain steadfast in applying these underwriting standards, then they will take control of a lot of properties because many borrowers will not have the capital to make

	2005	Wide Spreads 2010	Narrower Spreads 2010
Net Operating Income	$2,000,000	$2,300,000	$2,300,000
Interest Rate	5.00%	6.00%	4.28%
Amortization	Interest Only	30 Years	30 Years
Debt Service	$1,552,000	$1,840,000	$1,840,000
Debt Service Coverage – Current (DSC)	130%	125%	125%
DSC - Amortization	100%	125%	125%
Loan Proceeds	$31.0 million	$25.6 million	$31.0 million
5 Yr. Treasury	4.00%	1.50% (current)	1.50% (current)
Spread	1.00%	4.50%	2.78%

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these debt pay downs. So what is the solution? The easiest is to have interest rates drop from approximately 6% today to 4.28% in 2010. Sounds crazy? Not when one sees how much profit lenders are making on new loans. Right now this profitability is required because they have experienced so many losses from previous poor lending decisions. The question is if this will still be the case in 2010. Before the lending spigot was opened it was not unusual for us to be able to borrow at 2% greater than 5-year Treasury notes. When credit opened very widely, that spread dropped to approximately 1% or even lower at times. Today's rates are providing lenders with historically wide gross profit margins. For example, a year ago Wells Fargo's cost of funds were 3.37% and as of 9/30/08 they were 1.78%, although apartment loan rates haven't changed much over the past year on a fixed rate basis.

If spreads returned to a more normal 2% and Treasury yields increase by 0.75%, then it would be possible for 2010 borrowers to access funds at approximately 4.25% and get out of the pay down problem that's on the horizon. At a minimum, I think regulators will ultimately encourage loan extensions for quality borrowers that are maintaining their properties and are clearly the best option for continuing to manage the property. I also think they will try to generate some form of loan pay downs to show a greater commitment to the investment.

Nevertheless, I am cautiously optimistic that the more benign scenario depicted in the table above will come to fruition as the Federal Reserve has targeted reducing the cost of debt for businesses and consumers relative to risk-free Treasury securities as highlighted in the following article from Bloomberg.com on January 6, 2009.

Fed Focuses on Consumer, Corporate Loan Rate Spreads

Jan. 6 (Bloomberg) -- Federal Reserve officials are focused on driving down the spreads between U.S. Treasury yields and consumer and corporate loans, after cutting the main interest rate to almost zero failed to revive lending.

Credit costs for households and businesses haven't followed yields on government debt lower. Fifteen-year fixed-rate mortgages were at 5.06 percent last week, 2.59 percentage points above 10-year Treasury yields; the spread averaged 0.88 point in 2003, when the Fed slashed rates to 1 percent.

Chairman Ben S. Bernanke sees the thawing of frozen credit markets as critical to a recovery, and is determined to try to prevent a second wave of credit distress as the U.S. weathers bad economic news over the next two quarters. The Fed is now looking at ways to revive lending by using its balance sheet to hold loans and bonds that investors don't want.

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Chairman Bernanke reiterated this in a very important speech he delivered to the London School of Economics on January 13, 2009.

> *The Fed's monetary easing has been reflected in significant declines in a number of lending rates, especially shorter-term rates, thus offsetting to some degree the effects of the financial turmoil on financial conditions.*
>
> ***However, that offset has been incomplete, as widening credit spreads, more restrictive lending standards, and credit market dysfunction have worked against the monetary easing and led to tighter financial conditions overall.*** *(my emphasis) In particular, many traditional funding sources for financial institutions and markets have dried up, and banks and other lenders have found their ability to securitize mortgages, auto loans, credit card receivables, student loans, and other forms of credit greatly curtailed. . .*
>
> *In particular, credit spreads are much wider and credit markets more dysfunctional in the United States today than was the case during the Japanese experiment with quantitative easing.* ***To stimulate aggregate demand in the current environment, the Federal Reserve must focus its policies on reducing those spreads and improving the functioning of private credit markets more generally.*** *(my emphasis)*

The Fed was hell bent on reducing LIBOR, the interest rate charged when banks borrow from each other and it was ultimately successful in doing this. The Fed then targeted mortgage rates by purchasing mortgage-backed securities in the open market to create more demand for securities collateralized by home loans. Since this announcement mortgage rates have fallen from about 6.50% to 5.00% in a little more than two months.

With its sights set on lowering borrowing costs for consumers, businesses, and real estate owners, I think the Fed will ultimately win out and the road to 125 will be less dangerous and accident prone then it otherwise would be. Opportunities will undoubtedly be available to firms like CWS who can access capital at a time when having money is highly valuable. Fortunately, however, we are not faced with a lot of debt challenges that others will have to contend with. Warren Buffett said that the best way to avoid an avalanche is to make sure you're not on the mountain when one occurs. Generally speaking, we are keeping safe and warm in the lodge while others are on the mountain skiing. We will definitely be back on the slopes when we think the conditions are much safer and the mountain is less crowded and we hope you'll join us when we do.