Volume 29, No. 1, April 30, 2015

Quarterly Update

CWS Capital Partners LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

May 2015
CWS Capital Partners
Semi-Annual Conference Call

Monday, May 25, 2015
Memorial Day
CWS Offices Closed

Monday, June 15, 2015
2nd Quarter 2015
Est. Tax Payments Due

Friday, July 3, 2015
Independence Day (observed)
CWS Offices Closed

Friday, July 31, 2015
2nd Quarter 2015
Quarterly Packages Mailed

Monday, September 7, 2015
Labor Day
CWS Offices Closed

Tuesday, September 15, 2015
3rd Quarter 2015
Est. Tax Payments Due

Thursday, October 15, 2015
2014 Tax Return Extensions Due

Friday, October 30, 2015
3rd Quarter 2015
Quarterly Packages Mailed

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Positive Optionality

By Gary Carmell

One of the most important pieces of advice that I could give for not only positioning oneself for success in the world of investing, but probably in life more generally is to do all you can do to preserve positive optionality.

Optionality is a pretty dry and technical term, but powerful nonetheless. It's a concept that I've been aware of for a while, but not necessarily by this name. I've always thought of it more like keeping one's options open. It was only after I started reading the 25iq.com blog that I became more familiar with the concept and the power of it.

The author of 25iq.com is a very bright executive at Microsoft who has a strong interest in gathering information from multiple sources about very successful investors and coming up with 12 things that he has learned from them.

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He does this each week and I highly recommend his blog. He will often times discuss very successful venture capitalists.

Venture capital is a world where positive optionality is hugely important. This is because the maximum one can lose is 100% of one's investment but there's also the possibility of earning 1,000 times one's investment as well.

This is an extreme example of positive optionality in the world of investing. The challenge, however, is that it is much more common to lose all of one's money than finding a 1,000 bagger. Yet, it only takes one or two of those to make a life changing difference.

Positive optionality doesn't always have to be restricted to the world of investing. One of the most famous examples of this is Pascal's Wager. Blaise Pascal was a French philosopher, mathematician, physicist, and overall brilliant man. He truly made a dent in the universe as Steve Jobs famously said was his goal in life (more of Steve at the end). He only lived 39 years (1623-62) but made enormous contributions to the aforementioned disciplines. Pascal's Wager centered on the existence of God and was groundbreaking in terms of charting a new course for probability theory by introducing decision theory.

It is more complicated than my summary but the essence of the wager is that if one has to bet that either God exists or He does not exist then it is a bet with unlimited upside and no downside. Why is this? Because if I bet that God exists and I'm wrong, I've lost nothing. If, however, I bet that God exists and I'm right, then I have gained everything. This is known as a very asymmetrical payoff with essentially no downside and unlimited upside and that's exactly where one should try to position oneself in life whenever possible.

Realistically, it's very rare that anything will have such an extreme dichotomy in payoffs as this is truly a binary outcome. Although there are those very rare times in life when the odds are overwhelmingly in one's favor, I have found that we can influence those odds by setting ourselves up for success by some of the key choices we make in life. In that way, we can be on the field when the opportunities arise, recognize they are indeed opportunities, and then muster the courage and resources to capitalize on them.

So, what are some of the ways that we can create positive optionality? We first have to be in the game, which means first avoid doing something very self-destructive. Stay out of trouble! Conversely, one should try to stay in good health mentally, physically, and spiritually so that one can manage through the challenging times and be there when lightning strikes.

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We tend to improve our odds when we are in an environment that offers great opportunities for learning, meaningful and rewarding relationships, a cluster of businesses that are involved in important industries (think of the Silicon Valley with its venture capital firms, technical talent, weather, entrepreneurs, etc.), tremendous connections, etc. These almost always take place in urban areas where there is a density of people and businesses that offer a wide variety of opportunity for the curious, intelligent, and ambitious.

There's a lot of controversy over whether paying for private universities is worth the money but one could argue that it is still a good return on investment if one goes to an elite university. It's almost akin to Manhattan real estate in that it is limited in supply, has tremendous barriers, and one has access to huge opportunities.

The quality of peers and professors that one is exposed to is tremendous as one is truly surrounded by the best and the brightest. The unlimited upside that can come from meeting such people and being involved in an enriching and stimulating environment can potentially far outweigh the costs for someone who can truly absorb the experiences and cultivate relationships that can lead to immense opportunities in the future.

Another way of gaining tremendous positive optionality is to find great partners in life and business. When we do, we find people who can complement our skills and shore up our weaknesses thereby improving the odds of success. Plus it makes life that much more enjoyable.

CWS and Positive Optionality

From a financial standpoint, having cash reserves and manageable liabilities that don't cause problems when times get tough can offer tremendous positive optionality.

One of CWS' goals is to always have access to capital when others are bogged down with financial challenges and become pressured sellers. We have found that this is where the best opportunities have been over the years. This requires us to be on the playing field with capital so we can take advantage of the opportunities.

Another important source of positive optionality is being in a business that is focused on an industry with excellent, long-term demand characteristics and having a deep organization that can take advantage of different aspects of such a good business. We find this is the

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case with apartments as they should continue to benefit from positive demographics, the expanding appeal of urban areas, efficient resource utilization, a more regulated, challenging lending market which makes it more difficult for younger renters to become homeowners, especially since they are burdened with student loans, and social trends such as delayed marriages which tend to keep people renting longer.

We can build and reposition assets by improving and upgrading them, hold properties for the long term to extract maximum value from them, build and manage student housing properties, and we can be effective in urban and suburban areas in diverse locations.

By having an outstanding reputation, tremendous capital relationships, and the deep, diverse skill sets that we do in an industry with strong demand fundamentals, CWS has created significant positive optionality.

So, why am I pointing all of this out? Well, I have talked for years about our variable-rate loan strategy and the reasons we have so aggressively pursued financing our properties in this manner. One of the most important elements of this has been related to the optionality that it created given the relatively minor cost of repaying these loans early relative to fixed-rate financing. By having very affordable pre-payment penalties, this has created the option for us to sell properties when the time is right or take advantage of much better financing when lenders become quite aggressive. Fixed-rate loans do not offer these options cost effectively because they are usually burdened with very expensive pre-payment penalties.

Internally we always love knowing we can do what's smart with a property without being burdened by costly pre-payment penalties. It's even more fun, however, to actually take advantage of that optionality! And boy did we do so recently by refinancing 18 loans within a 30-day period. We saw a window opening up among apartment lenders that was putting a premium on high-quality borrowers with strong management capabilities, excellent quality assets, and a large portfolio of loans that could be taken to the marketplace. CWS possessed all of these characteristics, which made us a very desirable borrower, particularly with Fannie Mae, the incumbent lender.

Fannie Mae had most of the debt that was being refinanced and they wanted to do all they could to retain the business because they did not want to lose such quality loans to another lender. As a result, they came forward with very compelling loan options. They even waived the 1% pre-payment penalties to induce us to refinance with them.

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This is another example of optionality that was positive and quite unexpected. The cost to us to refinance and pay the pre-payment penalty was manageable for us and conversely, the benefit of retaining the business for Fannie Mae far outweighed them collecting the 1% penalty.

While we not only reduced the interest rate on most of our loans by approximately 0.75% per year as compared to the previous loans, we were also able to lower debt service by extending our interest-only periods or converting amortizing loans to interest-only for either the entire term or a portion of the new loan term. We were also able to extend the loan terms as each new loan has a 10-year maturity. The new loans are variable as well and also preserve similar cost-effective pre-payment penalties of 1% of the outstanding loan balance after the first year.

Overall we will have refinanced over $350 million in debt, returned $58 million to our investors on an investment base of $152 million (nearly 40% returned, although each property refinanced will have a different percentage since these numbers are in aggregate), and will save $4.2 million per year in debt service based on current interest rates. We view this unequivocally as a very favorable outcome.

One could argue that maybe the risk that we exposed ourselves to was unacceptable or was very high in terms of interest rate exposure. I would argue we were very well compensated for the risk. We had interest rate caps in place and our deep (almost obsessive) analysis of the factors that influence interest rates and our borrowing costs led us to believe that we were being well compensated for this as we not only had a lower borrowing cost and a cheaper prepayment structure compared to fixed rate loans, but tremendous optionality. We viewed the risk of rates rising as minimal and because most of our loans had starting rates 1.50% to 2.00% lower than the comparable fixed rate loans, we could benefit in the early years quite significantly from a benign rate environment. That advantage added up as our interest costs were cumulatively 3% to 4% less for loans that were in place for a minimum of two years.

We ended up with higher cash flow, which not only allowed us to maintain satisfactory distributions but also provided us with the capital to upgrade many of our communities without having to take on more debt or reduce the distributions. This is unusual in that most owners are not capitalized so that they can plow many dollars back into the property because the needs of their investors often trump biting the bullet and cutting the distributions. As a result, they often have to let the property suffer somewhat until they can refinance when

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their loan comes due or sell it at that time rather than plow a bunch of capital back into the asset.

Either way, we believe they are operating with one hand tied behind their back and end up producing financial results that are less than someone that has had the resources and flexibility to keep their assets in a strong competitive position.

I think this is a great example of not only how CWS sought to retain positive optionality in our business but how we actually took advantage of it.

I mentioned earlier I would reference Steve Jobs at another point in this article. The time is now. I wanted to leave you with something he said about the power of the best software engineers and how they create positive optionality. This is from 25iq.com:

"The difference between the best worker on computer hardware and the average may be 2 to 1, if you're lucky. With automobiles, maybe 2 to 1. But in software, it's at least 25 to 1. The difference between the average programmer and a great one is at least that. The secret of my success is that we have gone to exceptional lengths to hire the best people in the world. And when you're in a field where the dynamic range is 25 to 1, boy, does it pay off." [1995]

"The problem is, in hardware you can't build a computer that's twice as good as anyone else's anymore. Too many people know how to do it. You're lucky if you can do one that's one and a third times better, or one and a half times better… Then it's only six months before everybody else catches up. But you can do it in software. As a matter of fact, I think that the leap that we've made is at least five years ahead of anybody."

While we may not be in software, we do believe that we can gain a great advantage by hiring the best people as well. By hiring and retaining people who are ethical, have a long-term perspective, are team oriented, have a great work ethic, and don't need much external validation, and marry them and the resulting CWS culture and organization with like-minded, long-term oriented investors deploying capital in a growth industry like professionally managed apartments, we believe we have created tremendous positive optionality for years to come.