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Quarterly Update

CWS Capital Partners LLC

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CWS

CALENDAR OF EVENTS

May 17, 2021
2020 Federal Tax Filing Deadline

May 24, 2021
Memorial Day
CWS Offices Closed

June 15, 2021
2nd Quarter 2021
Est. Tax Payments Due

July 5, 2021
Independence Day (Observed)
CWS Offices Closed

July 30, 2021
2nd Quarter 2021
Quarterly Reporting Packages Mailed

September 6, 2021
Labor Day Holiday
CWS Offices Closed

September 15, 2021
3rd Quarter 2021
Est. Tax Payments Due

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Enhancing Lives
50 Years

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THE CWS PLATFORM – ADDITION THROUGH THE ELIMINATION OF SUBTRACTION

By Gary Carmell

> *In fact, it is only by cultivating an imagination for tragedy that we can avoid the pitfalls of complacency, confident in the knowledge that history itself is on our side.*
>
> **C. Lee Shea**

When people ask me if I have any advice for them as they contemplate starting a real estate company or have a relatively new one that is trying to gain traction, I tell them that my experience has taught me how lucky I was to start with a company that had an established platform, albeit a much smaller one 34 years ago. It provided us with stability, credibility, and a track record that we could expand upon and grow. We have gone from approximately $250 million in manufactured housing community assets and a smaller investor base to one that is now comprised of over 1,000 individual investors and an asset base of apartments with a value in excess of $6 billion. That shows not only the power of a platform, but OUR platform, which has served our customers well over many decades. I can't overstate how important I think having a deep and capable platform is to long-term investment success.

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We have been fortunate to be invested in an essential business (apartments) in growing markets with a large suburban presence catering to customers who have continued to pay their rent in large numbers in spite of the pandemic. Our properties are financed primarily through very low-cost, variable-rate debt and matched with long-term oriented equity investors who have had the staying power to patiently manage through downturns and setbacks. The combination of these ingredients has produced a set of outcomes that have been very favorable for our investors despite the challenges brought about by the pandemic and the massive disruption that has taken place in our economy and society.

And while we happened to be well positioned for something we had never planned on transpiring (a global pandemic), our ability to weather Covid was not just a fortunate happenstance. It was a byproduct of a pervasive mindset that has been in place from inception which is deeply committed to and intensely focused on preserving our investors' capital.

We do our best to think about what can go wrong and the potential consequences. If the downside is too great relative to the potential upside, then we will pass on that investment. We look for opportunities with a very small probability of a permanent loss of capital and a high probability of a reasonable return through cash flow and appreciation. Framing opportunities in such a way is a byproduct of deep, collaborative thinking, trial and error, lessons learned from mistakes we have made, and better than expected outcomes. We try to understand cause and effect while doing our best to absorb, process, and learn from data and experience so that we can know where to deploy our resources to take advantage of opportunities and lessen our risks. This is not easy as it requires never resting on one's laurels and working hard to stay humble.

We can't win the game without staying in the game and since apartments are a get rich slowly business, we have to always be on the field because there are usually compelling opportunities during the growth phase of the cycle. When a downturn hits, it's imperative to still be on the field as the best opportunities arise when many can no longer play offense or they have to leave the game because of insurmountable financial/investor/lender pressures. Having capital when many others do not is highly advantageous, especially when new supply is minimal and demand is poised to rebound.

This means that not only have we been successful by never losing sight of the downside but also having a bias towards aggressive action when the odds of success have been significantly

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in our favor. To paraphrase a Japanese saying, "We like to think like a man of action and act like a man of thought." We have to be thoughtful and deliberate as well as put the pedal to the metal when the situation calls for it.

This is a long winded way of saying that our platform has been constructed over the years to take advantage of compelling opportunities, avoid uncompensated risks, and to have the strengths, capabilities, and resilience to recover from problems. Or, as former PIMCO Managing Director Paul McCulley brilliantly put it, "Addition by the elimination of subtraction." That was his answer to how the U.S. economy would grow in the wake of the housing market collapse in 2007-9 (how times have changed). He said once housing investment stopped going down it would no longer be a drag on the numbers so that growth could occur if the other areas of the economy expanded. That's how you get addition by the elimination of subtraction. If we can avoid material mistakes then we can capture the inherent growth of being invested in an industry with consistent long-term demand growth and the benefits that a prudently leveraged investment located in growing areas can generate even with modest inflation and appreciation.

My experience derived from many years of investing in apartments has taught me that to make money you have to be prepared to handle unforeseen challenges which can result in losing money if you don't have financial reserves, early warning systems, resources to solve problems, and financial staying power that comes from having access to capital. These result from unforeseen problems or those that may have been more problematic than anticipated. Of course it's great to have nice clean deals that work out of the gate and grow steadily over the years with no major issues. Unfortunately this does not happen very often and should never be assumed. It's important to have a reservoir of resources to provide for a margin of safety to handle these challenges when they do arise. I have found that the biggest line of defense is to have a platform with a lot of capabilities and competence.

The CWS platform keeps us more in control of our own destiny because we make all of the hiring decisions as well as the bulk of how capital is allocated. From a personnel perspective we are responsible for hiring the on-site personnel, their supervisors, and all other facets of the management and investment company. We are not beholden to outside management companies who often have incentives to put their best people at properties that may not be ours. We would rather be the ones managing the pieces on the chessboard than being the pawns.

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Another advantage of how we are structured is our ability to get better information flow by having a company with a strong collaborative culture with healthy interpersonal relationships. If we want to get more information about trends we're seeing in the data, our people can just connect directly with others in our organization and hopefully get their perception of the situation with minimal bias.

So what is the recipe for not losing money in apartments? Of course you don't want to overpay but this may be more of a short-term issue if you need to sell sooner than anticipated, rather than having the time to grow out of it through strong operating performance. This speaks to the importance of investing in economic areas that generate increasing demand through population and job growth, which are typically only interrupted by national recessions versus systemic disadvantages that lead to large numbers of people leaving or not being attractive to those with the capabilities to add great value in our economy and society.

Larger, high demand markets tend to be deeper and more liquid in terms of not only the capital attracted to them but the quantity of investors as well. Both are important because if there are challenges that require a major business plan adjustment, it's easier to sell or potentially refinance since debt capital is usually available given the depth of the market. For those who can manage through the initial stumble out of the gate and are invested in markets in which demand exceeds supply, they should be able to grow out of the misstep because this should allow for revenues to grow faster than costs increasing, thereby bringing more dollars to the bottom line. Unless demand is extraordinary, our experience has taught us to avoid hand-to-hand combat that arises from purchasing or developing new properties which must compete with a lot of supply that is leasing up and offering significant move-in incentives. And while demand should eventually catch up, this can take a long time and lead to disappointed investors.

Even if one has purchased a property that is well located in a market with favorable supply and demand fundamentals, it still needs to be managed effectively. Apartments are a people business as we are dealing with their homes, communities, and families. And since people are fallible, it's inevitable some will underperform for a myriad of reasons. As a result, it's important to have a system that can identify red flags early so action can be taken to correct emerging problems as quickly as possible before they cascade and cause more damage. This requires regular visits to the properties by management's supervisors and a bench to replace people if they leave or underperform so that holes can be filled quickly. It also requires well-

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trained and experienced maintenance and capital projects teams to proactively spot and address physical property problems. Water intrusion must be especially focused on since this can cause extended problems to properties and be very costly. Safety must also always be emphasized because the health and welfare of our associates and residents is paramount.

Another lesson learned over the years is that even with a great platform and talented people we are sometimes faced with unexpected cash needs that can create financial strain for properties. This has taught us how important it is to have sufficient cash reserves to create a financial margin of safety. The importance of this cannot be overestimated. I know finance theory argues against having too much capital in management's hands as it can often be wasted and that investors can do better with the excess cash in their hands than in management's. My experience has taught me that it's better to have a lot more cash on hand than less. For example, we may need to put up a 2% loan commitment fee to refinance a loan, have a big deductible for a wind and hail event that destroyed a roof, be able to absorb the financial blow of a significant revenue drop due to an economic downturn or an event like a hurricane, freeze, environmental issue, etc. In addition, there may be major repairs needed that have to take place immediately due to life/safety risks. We may experiment with expensive upgrades or want to embark upon an upgrade program to generate meaningfully higher revenue. The loan may start to amortize which materially increases debt service and shifts the property into a negative cash flow situation. There could be an insurable loss but the proceeds may not come for a lengthy period of time and it may be necessary to bridge those funds to get started on the work. There may be a much higher than expected property tax bill that must be paid even if you're appealing it. Hopefully by now you get the point. Cash gives you space to handle problems and keep the property in good condition so that it's safe and competitive. It keeps vendors paid and doesn't distract our teams by having them juggle bills and payments. We want them focused on taking care of our current and prospective customers while ensuring the property is well maintained, safe, and has great curb appeal.

The last few years have confirmed, yet again, how vitally important it is to have the right insurance. We found this out during Hurricane Harvey ($30+ million), the Texas freeze ($54+ million) that just took place, and other insurable losses we have experienced, particularly related to hail storms that heavily damaged or destroyed some of our roofs. Insurance for multifamily has become increasingly challenging to get for smaller players so having the scale of a CWS allows us to access the London market as well as domestic carriers at competitive

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Marquis Parkside Austin, TX

premiums and coverages. It's also important to have a risk management team that understands the insurance market and has programs and systems in place to carry out best practices for safety and preventative maintenance. And when there is a loss, how to work with contractors and our internal teams to do the repairs/reconstruction that are done professionally while not treating the money of the insurance carriers like it's our own.

It's very important to have investors who are long term in nature with expectations that are aligned with ours in that they agree that what we think is a win is perceived to be a win for them as well. In addition, they also need to have the financial and emotional staying power to carry investments during tough times. And if they don't, then having access to capital at a reasonable cost is critical. We have said that well-located apartments in growing areas are a forgiving asset class so it's important to be able to not lose properties to lenders or be forced to sell under duress when times get tough. Financial and emotional staying power are the antidotes to these.

Finally, we have prospered greatly from having approximately 83% of our debt being variable rate, particularly during challenging economic times as the Federal Reserve tends to lower short-term interest rates to help cushion the blow to the economy. This tends to result in our debt service dropping more significantly than the revenue deterioration that may result from the weak economy curtailing job growth and household formations. This was particularly the case during the pandemic as the Fed lowered rates quite significantly and rapidly.

The weighted average interest rate for our variable-rate debt is approximately 1.78%. This is about 2% lower than the prevailing fixed rates that were available when we put these

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MARQ 31 Houston, TX

loans in place. With over $2.7 billion in variable-rate debt, this will generate annual savings of approximately $54 million assuming no change in rates as compared to what we estimate we would have been paying had we put fixed-rate loans in place. This does not include savings that have been earned already from having a lower interest rate up until this point. Since these variable-rate loans have fairly cost-effective pre-payment penalties they have also provided us with tremendous optionality which has allowed us to refinance many of these loans to lower our interest rate spread over Libor (interest rate spread + Libor index = all-in interest rate), extend the term, or lengthen the interest-only repayment period. Often times we have been able to capture all three benefits. It's also enabled us to sell properties without requiring buyers to assume our fixed-rate loans or have to pay significant prepayment penalties. Our experience so far has been that our variable-rate loan strategy has not only given us more flexibility than fixed-rate loans, but it has also come at a lower cost. This is the opposite of what economics teaches. There should be no free lunch. Our experience to date has proven this wrong in that the optionality we have had and taken advantage of has come at a lower cost.

We often say internally that the apartment business is simple on the surface but quite complex in many ways behind the scenes. CWS has been able to grow and prosper for over 50 years by marrying strategic thought with a capable and growing and robust platform that helps us manage a myriad of risks to help protect our downside while helping us to aggressively take advantage of opportunities when we believe the odds are significantly to our advantage. It's a powerful platform and one that should help keep us leaning prudently and opportunistically into the future.