Volume 25, No. 3, October 28, 2011

QUARTERLY UPDATE
CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

November 2011
Semi-Annual Conference Call

November 24th and 25th
Thanksgiving Holiday
CWS Office Closed

Monday, December 26, 2011
Christmas Day (Observed), CWS Office Closed

Monday, January 2, 2012
New Year's Day (Observed), CWS Office Closed

January 15, 2012
4th Quarter 2011 Estimated Tax Payment Due

January 27, 2012
4th Quarter 2011 Quarterly Packages Mailed

April 2, 2012
CWS Annual Partners Meeting
Newport Beach Marriott Hotel and Spa

www.cwscapital.com

Collapse Into Now

By Gary Carmell

For many people in my world, the most shocking event of last quarter was the collapse of Treasury yields which led to the 10-year Treasury note yield dropping below 1.80%, last seen well over 50 years ago. For me, however, it was not the collapse in Treasury yields, but the collapse of R.E.M. with the announcement that they were breaking up after more than 30 years together. It's ironic because I was just starting to get back into their music more heavily after downloading their latest album, Collapse into Now. I guess they wanted to go out on top because I really liked the album. On the other hand, I'm still more perplexed as to why they broke up than why Treasury yields collapsed, and a lot more upset as we have a lot to gain from the dramatic drop in interest rates but I'll probably never get to see R.E.M. perform live again. Apparently I was not alone in my dismay as "R.E.M." was one of the most popular Google searches during that week with Prague, Zagreb, and Milan being the cities with the most searches. Atlanta, close to their hometown of Athens, Georgia, was only eighth. Clearly the impact was felt around the world, just like the collapse in Treasury yields.

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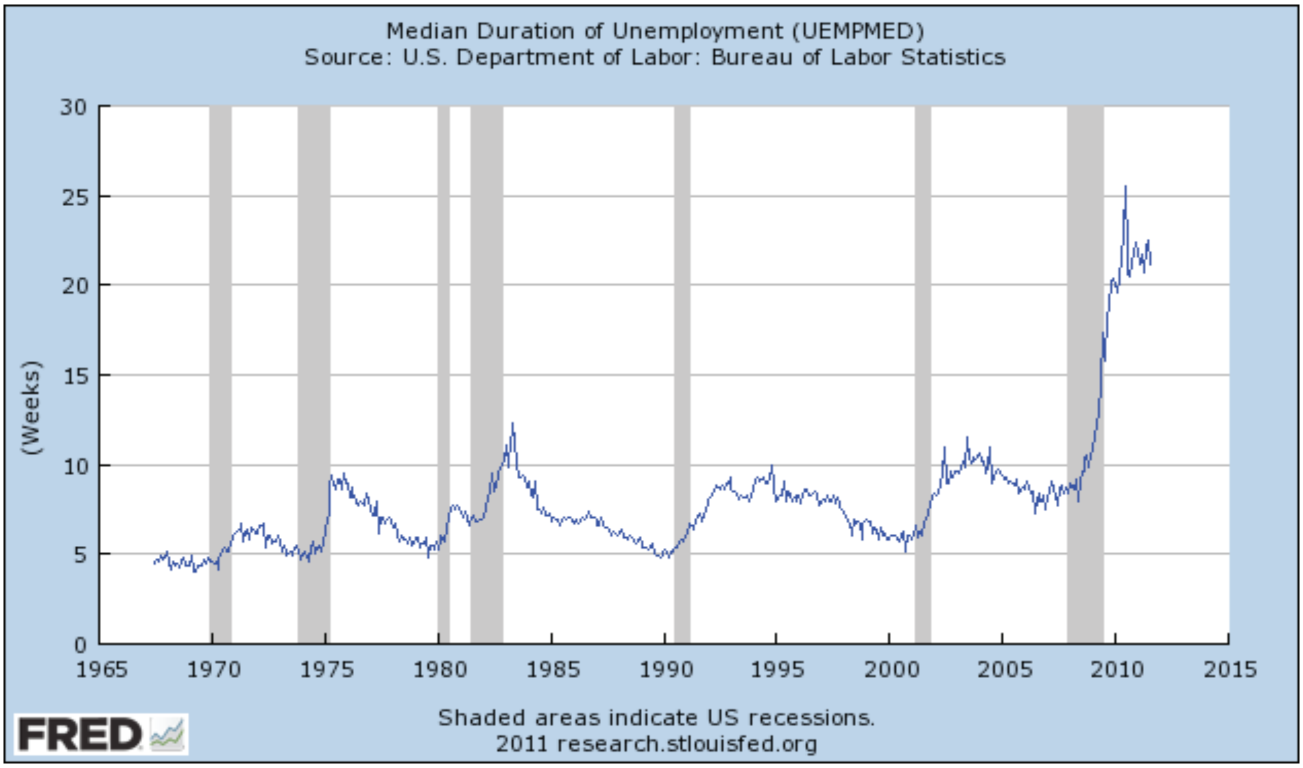
Everybody Hurts

(Well almost everybody)

Why am I not terribly surprised by the drop in rates? One particular chart tells the story pretty clearly. It's the median duration of unemployment and it shows how long people have been out of work with half of the unemployed having been out of work for less time and the other half for more. This chart, combined with the huge level of unemployment shows just how sick the economy really is.

We are having a very difficult time putting people back to work and the more time people spend out of work, the more psychologically damaged they become and less employable. It is a really terrible situation and there are concerns that we'll be creating a lost generation of difficult-to-employ people. Perversely, this situation has beneficial side effects for apartment owners. Not only is credit very difficult to access for people wanting to buy homes, but the desirability of owning a home goes down when people feel less confident about their future.



Source: http://research.stlouisfed.org/fred2/series/UEMPMED

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Public Opinion Strategies released a special report in August 2011 entitled, ***A Pivot Point in American Opinion: The Debt Ceiling Negotiations and its Consequences***. This was a very powerful piece of research that served to convince me that we are in the early stages of becoming much more of a renter nation, especially when combined with the horrific unemployment situation, and the very tenuous state of affairs in Europe. According to the report,

> The debt ceiling negotiation is an extremely significant event that is profoundly and sharply reshaping views of the economy and the federal government. It has led to a scary erosion in confidence in both, at a time when this steep drop in confidence can be least afforded…
>
> The collapse of confidence in government has substantially eroded already weak consumer confidence. Today's consumer confidence rating is the fourth lowest since 1952…
>
> Make no mistake: This collapse of economic confidence is not an independent event driven only by economic reality. This sharp drop in consumer confidence is a direct consequence of the lack of confidence in our political system and its leaders.

There are three pillars to consumer confidence. They are one's income, investments, and home values and currently the confidence in each is at their respective lows for the last four years, which is saying a lot given how bad things were in 2008 and early 2009. According to the report,

> The following numbers tell us Americans' perceptions of each of these three legs of the economic stool are as weak as they have ever been during these last four difficult years.
>
> Fewer than three out of ten working Americans expect a wage increase this year. There has been no change in this measure within the margin of error in the last two and a half years.
>
> A majority of Americans believe it is a "bad time" to invest in the stock market. This is the highest net negative level in four years of tracking for CNBC.
>
> Home values have dropped roughly 25% in the last five years. For most Americans, the equity in their home is their largest investment. But, alarmingly, a new high of three out of ten Americans who own a home are reporting they believe their homes will decrease in value over the next year.

With people having such little confidence, renting becomes the only option for most people. With the collapse in housing values, huge numbers out of work, and very large student loan debt, most people do not have the credit quality to become homeowners. Interestingly, consumers are de-leveraging in every area but student loans as the chart on page 4 shows from a Wall Street Journal article. Our prime renter demographic is 18-29 year olds so this will make it even more difficult for them to buy homes as they leave school with student loans to service and repay.

Besides consumer de-leveraging, weak household balance sheets, and large student loans outstanding, the demand for rentals should continue to grow as renting gives individuals the flexibility to go to where the jobs are and to build and rebuild their credit. With this economic backdrop we believe that renting will continue to get a disproportionate share of newhousehold formations such that the homeownership rate will continue its multi-year drop.

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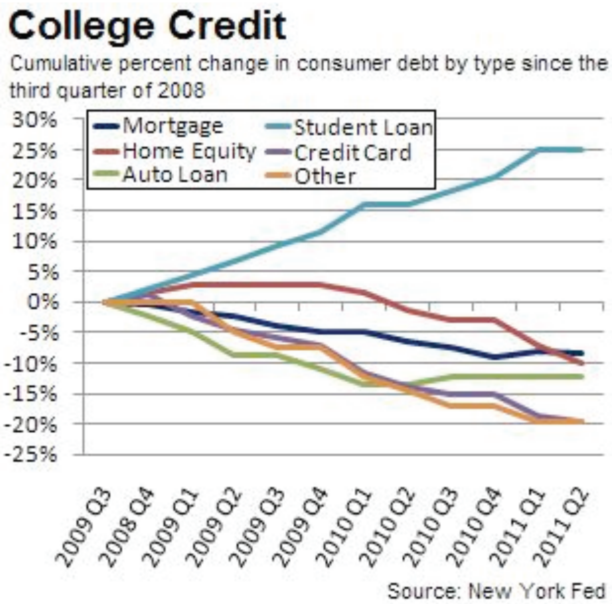

Source http://blogs.wsj.com/economics/2011/08/15/student-loan-debt-climbs

It's the End of the World as We Know it

With the collapse in Treasury yields, we have been the beneficiary of being owners of assets with growing income streams and available sources of capital eager to lend to quality operators like CWS with strong collateral like our apartment assets. In January 2009 I wrote an article entitled "The Road to 125 (or 130?)". In that article I was describing the problem facing apartment owners like CWS with debt maturing in the face of weak operating fundamentals, a much more conservative lending environment, and maturing loans that were originated during a much more aggressive lending cycle. To us, it did feel like "It's the End of the World as We Know it" (R.E.M. song). We had a large number of loans coming due in 2010 but 2011 was (and is) a much bigger year in terms of the properties we own with our individual limited partners. 2010 was much more concentrated with our institutional investors. My theory (perhaps hope) was that with so much real estate debt coming due in the economy and the overall weak economic environment, that the most painless and logical solution to the problem was lower interest rates since it would take a couple of years to begin to see meaningful growth in rents so we couldn't count on growing revenues to get out of the problem. My very precise methodology concluded that if apartment owners could borrow at 4.28% for new loans within two years, then that should be a low enough rate to allow most owners to get out of their debt. Please visit our website to read "The Road to 125 (or 130?)" article for an in-depth explanation at: http://www.cwscapital.com/UserFiles/file/qu/Gary%20Carmell's%20Articles/Jan09_leadstory.pdf

Shiny Happy People

It turned out my timing was pretty good and the forecast relatively on target as we refinanced two loans in 2010 for ten years at rates of 4.45% and 4.50%, and one for seven years at 4.09%. 2011 is even better as we have already refinanced two properties for seven years, one at a rate of 3.85% and one at a rate of 3.66%. We

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have refinanced another loan with a five-year fixed rate of 3.56%, as well as a ten-year loan at a rate of 4.09%. Finally, we just refinanced another loan with a variable interest rate that will have a starting rate of 2.88%. The debt service savings for each of these properties is enormous and will result in either the recommencement of distributions or an increase in distributions for the owners of these properties.

The good news doesn't end there as we have eleven additional properties whose loans either mature in 2012 or have pre-payment penalties that go away as we negotiated large windows (12 to 24 months) in which to allow us to pre-pay without penalty. This turned out to be a big win as we are able to rid ourselves of much higher cost debt (close to 6%) that has 18-24 months left until maturity without incurring a very expensive pre-payment penalty.

Just like the collapse in interest rates only seems to benefit those homeowners who seem to need it the least, those with strong incomes, high levels of home equity, and excellent credit, we are quite fortunate to have some of the most financeable assets in the commercial real estate world. We have growing income streams, very manageable competition over the next couple of years, and a very healthy, long-term demand for our product. It's much more challenging for owners of office buildings, retail properties, and industrial buildings given the very weak employment situation, anemic consumer spending, and corporations and businesses that are very reluctant to spend.

It appears that we are all collapsing into now. R.E.M. is done, all of the forces that conspired to hurt apartments for so many years as all incentives were directed towards homeownership are collapsing into the now of a bloody de-leveraging process for those that hitched their horses to homeownership. Borrowing costs have collapsed as there are few qualified borrowers to soak up the world's excess capital, and apartment owners come out on top. R.E.M. has a song called "Strange Currencies" and it sure is turning out that people don't like the euro, they're not big fans of the dollars, they love gold, and, luckily for us, they are very enamored with apartment income streams.

CWS Apartment Portfolio
Performance Summary
1/1/2011 - 9/30/2011

Number of Properties: 59	*Actual*	*Budget*	*Variance*	%
Total Revenue	$146,861,943	$142,161,010	$4,700,933	3.31%
Total Operating Expenses	$66,363,667	$67,252,358	$888,691	1.32%
Net Operating Income/(Loss)	$80,498,276	$74,908,652	$5,589,624	7.46%

Revenue - when actual is greater than budget result is positive variance
Operating Exp. - when actual is greater than budget result is negative
NOI - when actual is greater than budget result is positive

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