



2011 Financial Which Way

By David Lucas

Following a bitter credit freeze and the drying up of capital sources available to self-storage operators, many in the industry are anxiously awaiting better prospects from the financial markets in 2011. This anticipation may be likened to a blushing bride whose wardrobe on her wedding day includes something old, something new, something borrowed, and something blue. Like the bride wearing her hopes for good luck and a happy marriage, many self-storage owners, operators, and investors wish for well-capitalized partners who will help them prosper in the year ahead.

They look forward to both old and new sources of funding to refinance borrowed money acquired in more optimistic times. Owners and operators are hopeful for remedies that will overcome the blue pall hanging over an industry trying to cope with overbuilding and over-extending.

There is evidence that lenders are loosening their purse strings as the credit freeze thaws. As 2010 came to a close, some observers saw signs that the spigots may be opening. "It's more than a thaw; the water is flowing again," says Christian Sonne, managing director of the Cushman & Wakefield Self Storage Industry Group.

Georgia Ragsdale, CEO of Best American Financial Services in Los Angeles, characterizes the climate this way: "It's not a mass rush back into the market; it's more like a slow drip."

The *Emerging Trends in Real Estate® 2011* report, released in October by PwC US and the Urban Land Institute indicates debt markets will thaw further in 2011 as banks continue to strengthen balance sheets, take their losses, and step up lending. Borrowers are expected to have improved chances to obtain refinancing if they own relatively well-leased properties with good cash flow. But over-leveraged owners dealing with high vacancies and declining rental rates may face uncertain prospects in the credit markets, including the increasing likelihood of foreclosure.

"There are options out there for financing in the capital markets and it does seem to be loosening up," reports Wayne Johnson, senior vice president of acquisitions for Strategic Storage Trust, Inc. (SSTI). "Terms are tighter where there's greater equity required and tougher standards as far as how lenders underwrite the value of the loan. Once you get past those hurdles, terms are pretty compelling as far as life companies and even some conduit type financing coming around."

Something Old: CMBS

The self-storage acquisition market has been relatively quiet in recent years as REITs and other large operators kept their powder dry and waited for the prices of properties to settle more to their liking. Acquisitions picked up steam in 2010 and some large portfolios were traded. Meanwhile, the industry witnessed the re-emergence of a trusty financial vehicle that was forgotten for several years: commercial mortgage-backed securities (CMBS).

CMBS began its comeback in 2009 when the Federal Reserve Bank of New York allowed self-storage properties to be leveraged in CMBS transactions with backing by the Term Asset-Backed Securities Loan Facility (TALF). Later that year, several investment banks announced that they were firing up their conduit lending programs and beginning to originate loans for a new round of CMBS offerings.

"The CMBS markets are again active in self-storage finance. I've already been involved

in two portfolio CMBS deals that are in excess of \$30 million each," Sonne says. He classifies the rates as very favorable: 10-year money at 5.25 to 5.5 percent interest.

While Ragsdale agrees that CMBS is making a comeback, she does not view rates as nearly as favorable. "Their funds are simply not attractively priced now," she says. "The cost of funds is too high compared to what's available on the commercial market. In terms of CMBS making a large impact (in 2011), I would be very surprised if that happens."

CMBS funding this year likely will be limited to large operators. "You may start to see larger operators putting together portfolios to access CMBS executions," says Shawn Hill, principal of The BSC Group, based in Chicago. "If you have the ability to put together a \$15 million or greater package of loans in a major metro market, the CMBS markets are open for business and those lenders are willing to talk about aggressive rates and terms."

Some financial professionals worry about an estimated \$12 billion in outstanding self-storage CMBS debt. While delinquency rates for commercial mortgages continue to increase, self-storage represents the lowest of any property type. This has attracted the attention of many investors.

"Wall Street investors are very intrigued with self-storage," Johnson says. "They know the story that the self-storage category continues to be the lowest default rate of loans compared to other real estate categories."

Something New: SBA Loans

In October, the federal government in combination with the Small Business Administration (SBA) changed the rules that previously prohibited self-storage for SBA lending. Traditionally, the SBA has viewed self-storage as investment property and not as a business. The new rules are going to help smaller operators, according to Hill.

"They have opened up SBA lending to self-storage owners/operators, which is going to add available credit to those borrowers and should help to bring some loan dollars into our industry," Hill says. "That's going to be a good source of capital for the smaller operators that are not overly capitalized—those whose net worth is primarily wrapped up in their business. Those individuals have really struggled in this market because banks have lofty expectations about what they want in terms of credit quality, net worth, and liquidity in order to make loans."

The new SBA guidelines were scheduled to be released in December, so details have yet to be worked out. "There are still a lot of unknowns about it so it's hard to say what type of impact that will have," Ragsdale says. "Nobody's sure how it's going to work or what banks are going to be interested in participating."

Nevertheless, SBA funds open a world of possibilities for the smaller operator. "Potentially, this could revolutionize finance options for the mom-and-pop operation," Ragsdale says. "It's set up to help people with between one and four properties. If you own 10 properties or more, you probably won't qualify for an SBA loan."

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Something Borrowed: Debt Availability

The debt burden carried by many self-storage operators during the recession has led to distressed sales and foreclosures. Properties that were developed during the boom years will need refinancing in the next few years, and it is critical for operators to have sources of affordable financing going forward.

"There are huge amounts of loans that are coming due in the next three and a half years," Sonne says. "The markets will have to lend because these notes are due."

Everyone's wish list contains a variety of funding sources to choose from; however, it's the usual suspects who likely will lend in the year ahead. "I'm not sure on the debt side you're seeing new players in the market—really more of the same old players coming back in," Hill says. "Some of those players may structure transactions on distressed deals to find a way to achieve higher returns or potentially even take a piece of ownership."

Financing is coming from large national banks as well as regional and commu-

nity banks. Life insurance companies also make up a growing share of self-storage lending. To take advantage of these sources, operators must have strong balance sheets and good relationships with the lending institutions.

Loan rates are typically at 5.5 percent on 10-year term loans with 30-year amortization, and 65 percent loan-to-value (LTV), according to Sonne. Lenders will look carefully at the trailing 12 months of income, and net operating income (NOI) benchmarked to the trailing three years. "Your credit history and balance sheet have to be strong," Sonne says. "For some single property owners, it can be challenging."

To illustrate, a facility owner refinancing a \$4 million loan may have to come up with more than \$1.3 million on 65 percent LTV. "I'm not sure there are many of those folks that have \$1.3 million lying around," Sonne says. "That's caused some people to have to sell just to retire the debt."

Choices of lending instruments may be limited as well. "There's been very little movement on the retail side in terms of new products coming online," says Ragsdale. "We are seeing some lenders getting back to commercial lending in certain regions. Products that are being offered are moderate leverage, but interest rates are very low."

Something Blue: Distressed Properties

The recession had many self-storage owners singing the blues, no more so than those who are under water with distressed properties. Facing a loan coming due, low occupancies, and lagging income, these owners may be looking at a shotgun wedding to help resolve their financial problems.

There are interested takers standing by to buy, but only under the right circumstances. "The debt that's available to distressed property is more 'dequity'—it's hybrid debt and an equity product," Hill says. "They are

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going to capitalize a distressed deal where there is a lot of risk in one of two ways: either they're going to take a deal in which the former owner is out, or they're going to provide debt, keep the existing owner in, which is going to be structured with equity returns whereby they will give the owner a period to work things out."

Many industry experts predict a rise in distressed sales or foreclosures in the year ahead as many more loans mature. "Given the level of loans coming due in the next three and a half years, it's possible that by the sheer volume of loans we'll see more foreclosures," Sonne says. "On the other hand, with all this activity and portfolio buyers, it's possible we'll see more brokers looking for workout deals."

Lenders will likely be more aggressive about resolving these troubled assets. "The tolerance level among lenders to continue to work with properties that have been moving sideways is going to be very limited," Hill says. "The capital providers are going to move aggressively to get the remaining problem loans off their books. Owners who have been able to recapitalize themselves and put themselves on solid footing will be in better shape than those who have continued to struggle."

Hill explains that if the property is recovering, the lender may work with the existing owner. However, if the property is not showing significant signs of recovery and the owner has not found some creative financing to bring to the table, the lender will take swift action to dispose of the property.

As lenders move to resolve problem loans this year, more money should be available for borrowers. "I think banks are starting to get a handle on their bad debt situation and have been able to move some of the bad debt off their books, and that is going to allow them do more lending going forward as that trend continues," Hill says.

The bulk of the problem loans can be resolved through various means. New owners will take over some properties, more debt will be repaid, and lenders will have more funds available in the future. "As lenders clear their books of their problem loans or extended loans, eventually they will run out of problem loans," Johnson says. "Since they're not really making

new construction loans, they're not creating new loans to have to deal with in the future, so eventually their problem loans work out one way or the other."

Investors In Waiting

Wall Street investors, institutional lenders, and even wealthy individuals have been biding their time, waiting for opportunities in self-storage. This may be the year they come off the sidelines to make plays for properties. "Hedge funds and other opportunistic real estate owners that have been

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chasing the four primary institutional property types—multifamily, retail, industrial, and office—are now starting to look at the performance of self-storage through the down cycle and possibly consider some of the opportunities that are available," Hill says.

New players are emerging along with the deep-pocket REITs. Sonne identifies SSTI as the most active buyer in the country. W.P. Carey has created a non-publicly traded REIT and Equity Based Services of San Diego has raised money for possible self-storage buys. Also, one Texas group launched a \$100 million self-storage fund and used the money to purchase two dozen properties in 2010.

"Then you have all the new players like crossover investors, high net-worth individuals that had apartment properties and built up substantial portfolios," Sonne notes. "They're very interested because self-storage has higher rates of return than apartments and yet capital expenditures for renovating an apartment when a tenant leaves is so much lower for self-storage."

REITs also may investigate more joint ventures and perhaps even walk down the aisle with owners of distressed properties. "Coming out of this cycle, it seems obvious that we're heading toward a period of consolidation," Hill observes. That's being driven by two things: REITs getting into the management game and Internet marketing. REITs have a lot of value they can offer clients, and it helps them increase

the size and scale of their portfolio. That is a natural parlay into being able to talk with that owner about acquiring the asset. That provides the owner with a disposition strategy and it provides the REIT with an acquisition strategy."

In addition to the typical joint venture structure in which a REIT or another large operator partners with a large institutional equity partner, future JVs may sport a new makeup. "Going forward, you may see some joint ventures going a different direction where the REIT is the capital provider using the capital they have available to partner with an owner/operator to recapitalize distressed transactions," Hill says. "This structure gives them a lot of flexibility; they can partner with either a financial institution or the current owner, or both, to bring their management and operating expertise to the table and simultaneously take an ownership position in a deal that may need to be restructured."

The self-storage REITs have accumulated funds to invest and they are in the acquisition mode. That activity is only going to increase this year. "Our outlook is very positive for 2011," says SSTI's Johnson. "We are going to be highly active acquiring assets on a cash basis along with a loan assumption basis. We're going to continue to focus on performing assets, not necessarily proforma."

While many expect the capital markets to open up for self-storage this year, there is a consensus that funding for new construction projects will not be available. Developers with big plans but few resources may be left at the altar. Owners and operators who focus on remodeling or expanding their facilities might be a better bet for financing, but they will need attractive balance sheets to get a look from lenders.

The face of self-storage may be changing as new players enter the market, form partnerships, and invest their capital in one of the most promising commercial real estate categories coming out of the recession. ■



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