

# SELF-STORAGE FINANCING:



*“Nothing endures but change.”*

*– Heraclitus of Ephesus*



*By Georgia Ragsdale*

Many Americans are indoctrinated at an impressionable age to believe that this is a do-it-yourself nation. As such, we capitulate to the need for the federal government as long as it does not abusively pervade our institutions of commerce; therefore, on principal, we tend to oppose federal bailouts of failed businesses.

Many Americans take to heart the limits upon federal government read in the 10<sup>th</sup> Amendment of the Constitution: “The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.”

The economist, Joseph Schumpeter, also added to the rugged optimism of our beliefs that capitalism is successful when it is allowed to renew itself through “creative destruction” of unsuccessful business and business models—that the old and inefficient die away as innovative, value-added products and services emerge with a better functioning paradigm. This is how our system is supposed to, and many times does, work.

However, in early 2009, we find ourselves embroiled in a confluence of too much creative destruction in the midst of a dynamic situation’s unfolding with many elements still at play. This environment is so dangerous that the constraints we place upon the federal government are interrupted, and a call for the government’s power to restart credit markets and restore stability is needed.

Reliance on Washington to fix the credit markets is extremely disturbing to many. However, it is the only over-arching power that can launch the immense actions needed to hasten the end of the current credit freeze. Meanwhile, the economy’s downward spiral continues as low consumer and business confidence and lack of demand forces yet more lay-offs and less investment.

The extreme liquidity contraction that we are experiencing is influencing the self-storage sector in both positive and negative ways. Full recourse financing through regional and some national banks are the only options left on the table for self-storage properties, with limited participation from life companies at low leverage, tougher terms, and higher interest rates.

While constrained, these lenders do provide viable options. In this economy, we should be glad there are banks out there loaning money at all. The game of getting these loans, however, has changed significantly.

**What Are Lenders Looking For?**

The trends in self-storage mortgages show that to limit risk and mitigate against falling property values, lenders are seeking reduced loan amounts and requiring more personal guarantees with greater liquidity from borrowers. Also, banks are enforcing

greater discipline to the due diligence process and reviewing investment criteria more carefully. Expect to see lenders continue to evaluate based on income in place (T-12), not on projections.

Seller financing and assumed mortgages are now leading the transaction financing

arrangements among single-action transactions. Larger portfolios bought with cash infusions and low-leverage loans 55 percent or less (non-recourse threshold) are expected to become more common.

Many owners who bought during the peak of the pricing cycle with high-leverage, low-cost loans will find themselves unqualified to refinance and in need of recapitalization. As CMBS loans mature, for example, what will happen to these properties? It appears that there will likely be a property specific workout solution applied. Some will qualify for investor equity infusion; some will qualify for mezzanine financing to bridge the gap; some will be sold off at auction for prices yet to be determined. This challenge is looming on the horizon, and undoubtedly many other solutions will be circulated before the bulk of these loans come to the end of term.

Meanwhile, demand for development has dropped considerably. Lenders are uncomfortable with future values of development projects and have a limited appetite to extend credit facilities for construction financing. Federal regulators are requiring banks making construction loans to keep 10 cents on the dollar in a loan loss reserve, making these types of loans counter-productive for lending institutions seeking to survive.

Certain construction loan programs do not include interest reserve, and instead require borrowers to pay out of pocket until the property can support itself. This is a little bit like carrying your child until they are ready to go to high school—a heavy burden given that some lease-up times can stretch to 24 months and developers must begin with 15 to 30 percent cash of total project cost into the development already. There are some construction funds available for strong, experienced sponsors and well conceived projects in metropolitan areas. The bright spot here is that a developer can count on no new competition coming online as most future development remains on hold or can't get started.

The increase in the cost of funds has predictably impacted cap rates. Cap rates for self-storage properties increased 45 basis points over the past six months of 2008 due to the lack of available capital

Underwriting Criteria Comparison		
Underwriting Criteria	2006-2007	Today
LTV	75-80%	65-75%
Debt Cover	1.0-1.15	1.25-1.5
Amortization	I/O-30 year	25 year
Rates	5.75-6.25%	6.5-7.5%
Interest Only Period	5 years	N/A
EXAMPLE		
NOI	\$ 100,000	\$ 100,000
Value	\$1,666,667	\$1,250,000
Max Loan Amount	\$1,333,333	\$ 875,000
Gap		< \$ 458,333 >

Source: Real Capital Analytics

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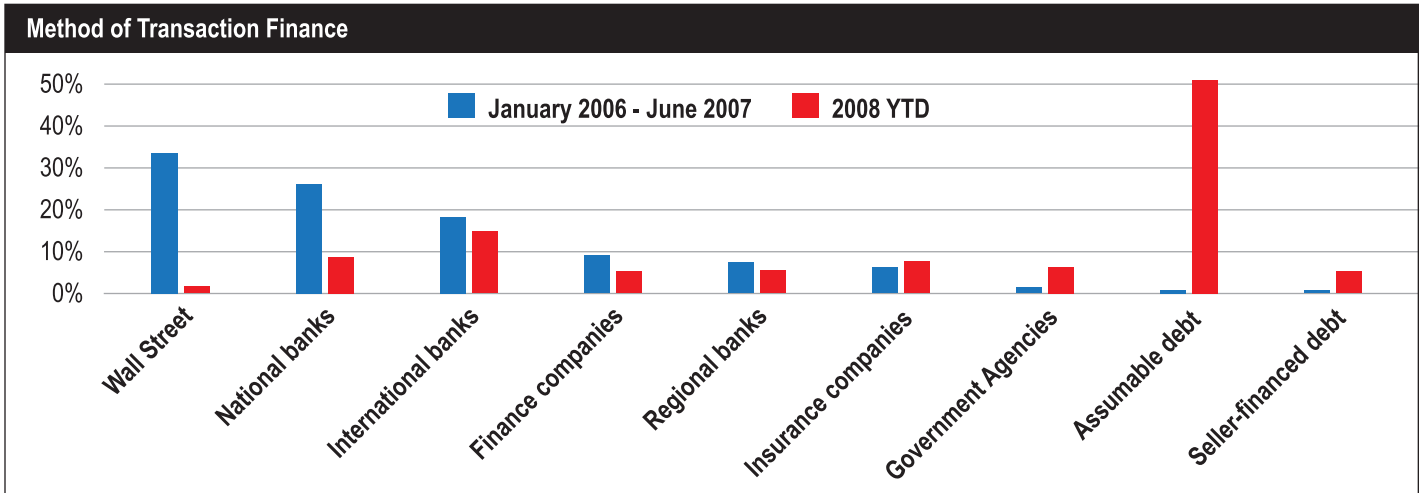
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and its cost. Cap rates raised 200 basis points in some markets in 2008, again as a reflection of the liquidity contraction. Many sophisticated buyers are presently targeting eight percent or nine percent cap rates as their buy sign. The sellers

have yet to come to the realization that this is the new landscape, and are maintaining the gap between parties' expectations which explains the low volume of transactions in 2008—especially in the fourth quarter.

Due to the lack of liquidity and leverage for acquisitions, most expect to see a consolidation among operators with strong cash balance sheets who are poised to take advantage of a raise in cap rates and properties in financial distress, such as



Source: Real Capital Analytics

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over-leveraged properties that do not support refinancing in the new climate or unwilling sellers with newly built, yet unstabilized properties being sent back to the banks.

Positive or negative is in the eye of the beholder. Those possessing strong cash reserves see this as a time to buy or to prepare to buy distressed assets and competitor portfolios at a discount. Those who are less liquid and were hoping to get into the business by building their way into ownership—the way many successful operators have done in the past—may find themselves on the outside looking in.

The many attractive, highly positive features of self-storage remain: the basic fundamentals of the asset class relative to other commercial real estate investment opportunities.

Despite market ups and downs, vacancy rates have remained at an average of 15 percent. Expenses are trending upwards slightly (Expense/Income Ratio: 38.5 percent \$/SF Change from 2007: +7.2 percent), but storage properties reach debt service coverage at a lower threshold (40 to 45 percent) relative to other asset classes. Month-to-month contracts have a benefit over long-term leases because storage owners can adjust to market circumstances almost immediately. Retail property owners with 15-year leases are locked into contracts long term, unable to react quickly to new market conditions.

The impact of disturbances in the housing sector on self-storage is not yet clear. One school of thought anticipates that more households will seek to store belongings and scale down their homes in anticipation of a return. Others suggest that with less economic certainty, the operator's greatest competitor will be the dumpster as families seek to cut discretionary spending, including shedding items typically slated for storage as well as the monthly storage fees. Sorry Grandma, we still love you, but when push came to shove no one wanted your dining room set.

**How Has TARP Affected Lending?**

The government's initial solution to the credit crisis was to provide cash to banks in order to boost much needed lending. Suggested by former Treasury Secretary

Henry Paulson, and passed by Congress in October 2008, the Troubled Asset Relief Program (TARP) is a \$700 billion program. Or, as it's known in euphemism, Tapping Assets Reserved for the Public, the so-called "no strings attached" bank bailout.

Unfortunately, at present, very few of the banks receiving TARP money are using it for loans. Instead, banks are stating that they intend to use the money to build up a fortress balance sheet and insulate themselves from future losses. Others have begun eyeing potential acquisitions.

If Americans thought that the purpose of TARP was to generate loans, that just hasn't happened. The money is going into banks and staying there causing many to question the program's effectiveness. Half of the TARP funds went to the nation's nine largest banks.

The lending capacity may be there, however, in the constrained underwriting environment banks are not finding borrowers creditworthy. Until there is some recovery movement, many experts believe that banks' loan portfolios will remain at or near their current levels. This means the effectiveness of TARP may not be known for months—most say the later part of 2009.

The Treasury has indicated that it would support banks using the money for mergers and acquisitions, although Congress has said it doesn't want the money used this way. That kind of uncertainty has led to another disconnect, this time between public expectations and the reality of the program to date.

In fairness, banks counter that the funds are anything but "no strings attached." The Treasury is charging interest on the TARP loans and has demanded warrants from publicly traded banks as well. The government is receiving five percent plus the value of the warrants, so it's an effectively seven or eight percent yield. In the short run for banks, it's an expense that will be absorbed by their shareholders.

Banks who have declined the money state that the features and costs of the bailout money are not consistent with their goals and that to participate in the program would not be in the best interest of their shareholders. Additionally, the government reserves the right to change

conditions after banks have accepted the funds, most recently observed in the new proposals to limit executive pay.

### Will We See A CMBS Return?

Conduit loans were competitors of the banks and shrunk margins. Now that all the investment banking firms are owned by banks, one would not anticipate a rush to recreate the CMBS market until the major banks have bought up their weaker competitors and consolidated the market.

Many are calling for the end to mark-to-market rules. Mark-to-market is an accounting methodology of assigning a value to a position held in a financial instrument based on the current market price for the instrument or similar instruments. For example, the final value of a futures contract that expires in 18 months will not be known until it expires. If it is marked-to-market, for accounting purposes, it is assigned the value that it would currently fetch in the open market.

Back in the late 80s, the S&Ls were keeping worthless loans on their books at full value when they were essentially insolvent, which is why the mark-to-market rules now exist. It solved that problem, but didn't anticipate a situation like today where the underlying assets may eventually redeem at 80 percent or 90 percent of face value. It could be argued that the mark-to-market rules in this case are causing an unnecessary evaporation of bank capital due to excessive write downs in the 30 percent to 50 percent range. The panic and illiquidity creates the perception that the CMBS pools are riskier than they may be and exacerbates the downward spiral of write-downs and weak bank capital, which then causes illiquidity and further write downs.

Stable pricing for the markets is critical, but the banks have no vested interest in hurrying the return of the CMBS markets. Some are asking, what if the losses in the CMBS pools do not exceed 10 percent of the outstanding balances in the end? The banks will then post record profits in three to five years if those loans pay off at 90 percent of face.

Other solutions include a return to some version of the "good bank, bad bank" alternative. With this solution, the government

would print enormous amounts of money to buy all the bank's "toxic" assets, or just seize them and put them into a massive new financial institution that would operate under federal control and sell them off over time. When all of the bad assets are removed from a troubled bank's balance sheet, the banks are then immediately able to raise new capital and get back into the business of making loans. The federal institution created could then be more patient and efficient in selling off the assets.

It's likely that a hybrid of these possible solutions will help us get back on the right track. The net/net of our present situation is that instability remains when the solution remains variable.

Even as the current challenges continue, the appeal of self-storage compared with other real estate classes remains solid and tangible. Self-storage tends to hold value better, and recover faster than other asset classes, which is why we remain bullish on self-storage.

It's easy to long to go back to the days of high leverage. Yet, while leverage is a wonderful tool to utilize on the upside, leverage on the downside magnifies investor losses. This is what destroyed our investment banks. There's an old saying in Vegas that the more you bet, the more you win when you win. But they always leave out the part about the more you lose when you lose. Leverage does not add value to an investment; it doesn't make a better investment—it only magnifies the outcomes.

It is hard to digest in the midst of a crisis, but consider this a starting point for optimism going forward: The creation of new capital is more important than the loss of old capital. If we look to the past, we observe that every generation surpasses the last with innovation, adaptive progress, and the rapid growth of new technologies. America will emerge with new financing technologies and credit vehicles that surpass those that have recently soured. ■



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