

NUANCES IN SELF-STORAGE

Lessons Learned From The Recent Past

By Peter Ingersoll

One nicety that self-storage investors forgot in the price bubble of 2004 to 2008 (really a debt bubble) was that self storage is not homogenous; neither is debt-financing. During that heady time, Joe Six-Pack could get a property loan at nearly the same rate and terms as a public real estate investment trust, which in part explains the similar cap rate compression across all geographies. Self storage may be the least distressed asset class, but it is also the most debt constrained. It is debt constrained because it is an asset class that does not fit conveniently into a lending box and the deal sizes are smaller, making it difficult for large financial institutions to place capital efficiently. One indicator that this is true is the number of mortgage brokers peddling SBA loans for self storage. No disrespect to mortgage brokers or the Small Business Administration – it is a good program represented admirably by many financing professionals, but the widespread use of this loan program indicates the absence of traditional lending for self storage.

According to Ethan Penner, the president of CBRE Capital Partners, commercial real estate values are more impacted by the flow of capital - both debt and equity - into or out of a sector, than by operating fundamentals. Currently, the tide is out, and commercial real estate transaction volumes and values are down. So are operating fundamentals. Hence, the commercial real estate financing



vessel – the SS Minnow – has been stuck securely in the mud of the harbor. According to Jeff Shouse a self-storage appraiser with Colliers International Valuation & Advisory Services, “The lack of any meaningful transactions makes it very difficult to determine even a range of values. The differences in asset quality, location and market saturation are significant components of price. Investors would be wise to analyze these differences.”

In self storage, the lack of debt capital will define how the market will shape itself in the next several years. As loans mature between now and 2013, established self-storage operators with strong balance sheets will command better pricing and terms than smaller operators. Smaller operators will have to scramble.

Smaller operators are at a disadvantage from two other critical areas that impact net operating income (NOI), namely the ability to create critical revenues to support lower expense ratios and, more importantly, an integrated internet and social media campaign to attract new customers. As many of us are discovering, with internet marketing, one size does not fit all. The mind boggling array of web-sites, tools, tweets, and obscure, yet vocal, on-line social communities is enough to transform an intelligent and risk-tolerant entrepreneur into a mass of neurotic jelly. But mastering this realm is the key to survival. Eroding or flat NOI and occupancy rates are trends that do not make lenders happy, and in this environment everyone wants to keep the lender happy. If you believe that old dogs do not need to learn new tricks, consider this.

At the Extra Space presentation at the fall SSA conference, it was announced that for the first time in its history Extra Space had generated more leads from internet marketing than from drive-by traffic. This was

unprecedented and unanticipated! Small operators dare not ignore this significant trend precisely because this in one area where small operators can actually control and implement e-commerce marketing programs to boost customer traffic and grow NOI. Small operators may not be able to gain economies of scale or bolster their balance sheet in the near term, but internet marketing is within their grasp.

Operating efficiencies and loan terms are not the only differences in today's emerging market – different geographic locations will be evaluated for acquisition differently. This may seem like an obvious truism, but during the froth of the price bubble investors widely believed (or behaved as though they believed) that commercial property risk was minimal and much more uniform than it really was. As a result, cap rates across many property types and geographies were fairly uniform. We can see a dichotomy emerging today in the market through the distinctions in two industry indexes: the Moody's Investors Service Real Commercial Property Price Index and the Commercial Property Price Index prepared by Green Street Advisors. Green Street, a Newport Beach commercial property research firm, tracks a basket of real estate investment trusts that generally have targeted larger trophy properties in dense metro areas. Moody's tracks the market as a whole.

Green Street shows strong price recovery; Moody's does not.

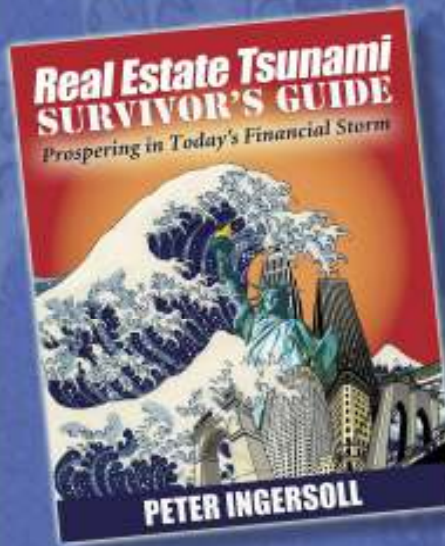
It is no surprise that the institutional and international equity investors reflected in the REIT numbers will pay more for an irreplaceable asset in a core metro market. This asset can be bought at a very good rate on a price-per-square-foot basis, and investors also are buying quality and staying power. Often they pay all cash to get a

5 percent to 6 percent return - considered a superior yield in today's debt markets; plus when buying for cash, there is no interest-rate risk. Not a bad long-term play if one has that kind of patient capital.

For the rest of us, who have to borrow money to acquire investment real estate, there is a completely different set of risks – insufficient loan proceeds and rising interest rates. The core commercial mar-

Real Estate Tsunami Survivor's Guide

by Peter Ingersoll



When the U.S. real estate market collapsed, Peter Ingersoll was on the front lines. With experience in construction, investment banking, real estate development, and other investment-related fields, he assessed the devastation and came out fighting mad.

In his latest book, he offers his blunt perspective on the future of real estate investing and provides tips for investors looking to profit from the market's subsequent price correction.

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Bottoms Up

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The Original Voice of the Self-Storage Industry

ket — transactions valued from \$3 million to perhaps \$13 million — is the realm of the small and medium-sized private investor. The ability to raise additional equity is limited, so loan maturities loom large on the landscape of worry. There will be a lot more pain, particularly in the core market until the banks clear the deadwood off their books — those legacy, life-support loans.

It is a cleansing that banks are loathe to undertake. Just as the residential markets are being artificially propped up by Fannie, Freddie and the FHA, so too is the commercial market. Current levels are not indicative of true pricing. Rather, because there is a limited supply of deals relative to equity capital, premiums are being paid. Banks have no regulatory or accounting urgency to mark their loans to market and, like Japan, are carrying this trash on their books near par. This equation can change quickly if banks are forced to recognize the true losses embedded in their


books, which will lead to severe pressure to reduce their assets and raise capital. When banks get serious about selling their loans, and foreclosing and selling hard assets, the supply of wounded commercial real estate coming to market will likely outpace demand.

Over time—between now and 2013—the weakness of the banking sector will become apparent. Whether it unravels so fast that it brings price levels down further, or whether the Fed and the FDIC can manage an “orderly disposition” remains to be seen. I believe that the core commercial market will be lucky to maintain the current market pricing as reflected in the Moody’s index. For investors today, it seems unwise to announce: “We are at the bottom!” We may be bouncing along the bottom, but that does not mean that rents and occupancy will pick up across the board; it also does not shed light on how fast rents will grow. Expecting cap rate compression for future sales proceeds

is like hoping it will not snow in Michigan. Self-storage owners are in a race to see if they can increase their net operating incomes fast enough to beat the risk of asset depreciation caused by rising interest rates. If we are lucky enough to have interest rates stay low through 2013, then many distressed deals may trade at prices higher than pessimists believe. If growth in NOI can keep up with or outpace the devaluation due to rising interest rates, then the danger of loan default diminishes and investors can sleep soundly at night.

For buyers, a number of economic factors need to be considered to secure a sound investment. Only when one underwrites a specific property, and understands the surrounding market in the context of the enormous stress on bank capital, the unparalleled actions by the Fed to increase liquidity (which cannot continue forever), and the global trade and currency imbalances, can a reasonable decision be made about rents in a particular property and whether they will increase fast enough to offset the risk of rising interest rates.

My own feeling is that the Fed has pushed so much money into the financial system that low-cost money will help offset eroding NOI to support pricing in the core market in the range of 55 percent to 65 percent of 2007 highs, at least for the foreseeable future. This stable pricing will allow banks to sell selective assets and avoid massive losses, but still many more loans will need to be written down and cleared.

If we do experience an “orderly disposition” then perhaps growth in NOI will offset the reduction in value cause by rising interest rates. If not, get ready for a rumble. 

Peter Ingersoll is the author of the *Real Estate Tsunami Survivor's Guide* and a registered investment advisor who works exclusively with buyers and accredited commercial real estate investors. He has over 25 years of experience as a builder, developer, trust officer, investment banker and commercial broker, and serves as the vice chairman of the California Self Storage Association.



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