ARGUS
SELF STORAGE SALES NETWORK

Market Monitor

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Winding Down 2011

by Ben Vestal

If you read the last issue of the Market Monitor, it is apparent that the fundamentals of the self-storage business are sound. With all four of the major self-storage REITs posting positive growth numbers over the same quarter last year it is clear that the industry is poised to move forward. Based on our conversations with self-storage owners, there are three main topics that are on their minds as we close out 2011: ***Operations*** - how and what is driving revenues; ***Investor Activity*** - who is buying and how are they valuing properties; and ***Capital Markets*** – what kinds of loans are available. These three topics are influencing the opportunities in today's market whether you are a buyer or seller.

Operations:

Recent industry chatter has been focused on revenue management, SEO (search engine optimization), call center conversion rates and re-branding just to name a few. As the self-storage industry has matured over the last decade we have seen an accelerated sophistication with regards to the operations of self-storage properties. This has led to an increased growth in revenue over the last few years even when the market has struggled. The more sophisticated owners are able to squeeze out 1% to 3% more in revenue growth than the small, less sophisticated operators. We have come to the realization that the Yellow Pages is not slowly going away it is, for all practical purposes, gone and not coming back. The internet is now the focus of all major storage operators with every move-in and click on the internet being tracked to make sure the IRR on each advertizing dollar is maximized. Call center conversion rates are also rising faster than anyone ever expected and it does appear that if you train someone to do a specific job and they do it over and over again you become better at closing the sale, even if they are sitting in Phoenix and the property is in Boston.

I believe third party management is here to stay and we will see several of the small to mid-sized operators joining forces with the larger, more sophisticated operators in the coming years. This will allow the smaller investors to gain access to tools needed to grow their revenues and ultimately their bottom line as this once niche market develops into a tighter and more competitive mainstream market.

Investor Activity:

Investment in the self-storage space has increased over the last 12 months with a few new investors dipping their toes in the water, however the majority of the investment activity has been from mid to large-sized institutions who are looking to buy stabilized properties in major markets with some reaching to second tier markets for an increase in yield of 25 to 75 basis points. Smaller investors looking to purchase assets with a market value of under $2.5M are still struggling to find suitable financing and deals that make financial sense. However we have recently seen a few of the smaller, well-capitalized and experienced operators taking advantage of the tremendous opportunity presented by smaller properties that are not being actively chased by the larger institutions. This has allowed smaller, well-capitalized operators to acquire well-located and under-performing properties with considerable upside.

Many of the owners/operators who are considering selling to the institutional buyers today are struggling with the bigger guy's expense structure. Many of the companies that have the capability and desire to purchase large single assets of $4M+ or portfolios of $10M+ have internal underwriting criteria that increases the operating expense structure which in turn decreases the NOI (net operating income) and therefore also decreases the value that the owner has calculated using his own operating expenses. This has led several of these larger institutions to pitch their third party management services with the assurance that they will increase revenues and therefore the property's value, all while they apply the additional operating cost to the property and the current owner. This also allows them to operate the property and identify the pros and cons before actually purchasing the asset, not to mention it changes the owner's leverage when negotiating the sale. This is apparent as most of the larger operators in the business today are reporting that 25% to 60% of all new acquisitions are coming from their third party management business. I do believe that there are several very well run third party management companies that also own properties and are looking to expand their portfolio. It has been our experience that many of these third party management companies do add value through their revenue management systems, online marketing, and call centers, but we have also learned that they are typically not the highest bidder when the properties go to market for sale.

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So, a word to the wise when considering selling your property, the only proven way to keep everyone honest and maximize your investment's rate of return is to create market competition by listing the property for sale and let the market dictate the value. You owe this to yourself and your partners! Remember you realize 90% of the value of your investment when you sell.

Capital Markts:

With the recent volatility in the market, self-storage financing has been clumped together with the rest of the commercial real estate financing market as banks, CMBS lenders and life insurance companies struggle to pinpoint spreads, i.e. interest rates. This has made pricing self-storage loans very difficult. Much like the investment sales market, "the bigger the better" also holds true in the self-storage financing world today. You will find more aggressive terms and interest rates as you see the loan amounts increase. However, self-storage as an industry has performed very well and if your property has a defendable operating history you should be able to obtain competitive financing with one of the sources mentioned above. We have also seen loan brokers adding value to their client's negotiations. The value of having professional advice in a turbulent market can add a tremendous amount of value when negotiating the terms of your loan. <u>Yes, I said negotiate the terms of your loan</u>. It has recently been brought to my attention that some self-storage owners are not aware that their loan terms (i.e., interest rates, term, amortization, prepayment penalties) are negotiable. Today, the most important aspects to focus on when negotiating your loan is the term of the loan and the prepayment penalties associated with paying off your loan early. First, with interest rates near historical lows you will want to get as much term on your loan as possible, we are seeing loan terms in the 5 to 10 year range and we have also seen some fully amortizing loans with interest rates in the 7% to 8% range. This will allow you to mitigate any unforeseen refinancing risk as we are most likely going to experience interest rate expansion sometime in the future. Second, over the past 10 years we have seen the average cap rates range from 7.5% to 10%+ so when you are negotiating your loan, make sure you will have the ability to sell to capitalize on the current market conditions. You will make more money buying and selling at the right time then you will ever make by renting more units or improving your operating procedures.

Now is a great time to be in the self-storage business, but owners and investors need to keep a close watch on the topics we discussed above to make sure they are maximizing their opportunity. Consulting a qualified real estate broker who specializes in self-storage can help you get on the right track and make the most of your investment.

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