



Broker Roundtable: The Northeast States

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by Michael L. McCune

*Our Roundtable of experts gathered this month to discuss the Northeast United States. Let's hear what our local experts have to say about their respective cities and regions. Our Northeast Brokers: **Linda Cinelli, CCIM** (LC Realty) in North Branch, NJ; **Joe Mendola** (NAI Norwood Group) in Bedford, NH; **Chuck Shields** (Beacon Commercial Real Estate) in Conshohocken, PA; and **Guy Blake, CCIM** (Upstate Commercial Group) in Kingston, NY join us in this survey. **Michael McCune's** comments are in italics. These are interesting times, so we wanted to ask our local brokers some straightforward questions that every self storage owner – and potential buyer – will find pertinent.*

1. How are the local lenders for self storage reacting to the so-called “credit crunch”?

Mendola: The local lenders here in New England are being accommodative to our lending needs. They do not have the same loan portfolio challenges that the larger national lenders got themselves into. The whole sub-prime event has made everyone cautious, but good borrowers with strong signatures and well-thought out projects have no problem locally.

Shields: Locally, our lenders seem to be following the patterns of most of the country in that interest rates still seem to be reasonable but the lenders have tightened their underwriting standards. Lenders have become more selective, require more detailed financials and look for more conservative pro formas. In many cases they look for more equity in the deal.

Blake: We are seeing much tighter underwriting standards from the local lenders in Upstate New York and higher cap rates on the properties that are for sale.

Cinelli: Lenders are re-looking at many deals. Unless the facility is in a prime location with high occupancy, the lenders look at the trailing twelve months income and not the pro forma financials.

McCune: The “credit crunch” is quite real and still has a long way to play out. While the residential loans have been clobbered, the commercial loans appear to be holding up well. However, a recession could negatively impact rents and occupancies. Given the loose underwriting of many recent commercial loans there is certainly a possibility for the infection to spread. Luckily, self storage has the lowest default rate of any real estate class and most of the facilities we see are moderately leveraged.

2. The CMBS lenders are becoming more picky about the locations and the total amounts of loans, how is this affecting potential buyers?

Shields: As the CMBS lenders change their attitudes, philosophies and standards about lending, the attitudes of buyers also change. A lot of buyers are now looking to more class A locations and facilities because they give them the best opportunity to get funding. On the other hand, there are a number of buyers who are eliminated. These buyers would look to acquire class B and C facilities but now can't meet the lenders standards or they don't have the cash for deals that require additional equity.

Cinelli: Buyers are not as willing to accept a story about potential increases in rates and occupancy at the facilities they are looking at. The rates on the loans are higher and the buyers are looking at a minimum of 8% on their return before debt.

Mendola: Yes, CMBS lenders have the Wall Street affect to deal with. Even though the 1-year T-bill is a full 100 basis points lower than it was 6 months ago, the credit spreads have widened to the point that the rate for leveraged deals are 75-100 basis points higher than they were last summer. Under-leveraged deals of 60%-70% seem to fare better than the 75%-8-% deals. These lenders do not seem to be in a real hurry to get their money back out on the street.

McCune: *You can be sure that any deal that is made by a CMBS lender today is getting big time scrutiny. As Joe Mendola says, the days of unlimited leverage are gone! Thus loan to value ratios are probably the most important thing that lenders look at when underwriting today.*

3. Given the unsettled investment markets, how are buyers and sellers reacting?

Blake: Buyers have reacted immediately and are looking for lower risk and higher cap rates than they were a year ago. Sellers, not surprisingly, seem hesitant to admit that the days of doing "8 cap on pro forma" deals are over. At the moment, there seems to be a wider gap between buyers and sellers because buyers have adjusted to the changing market, but many sellers have not.

Mendola: In this unsettled market, sellers and buyers seem to be acting in a usual way when the market begins to turn. Sellers want the valuations of 6-9 months ago and buyers want to buy at a value that is reflective of these uncertain financing markets.

Cinelli: There are still many buyers out there looking for self storage projects to purchase, but the frenzy is over. The properties need to meet higher expectations than ever before. We have found that sellers who have been in the business for a while are becoming disillusioned and are looking to get out of self storage, finding that the business now is not exactly what they bargained for.

Shields: Both buyers and sellers look at the economy and the financing market a little differently. The buyer sees the economy, especially the housing market which self storage is so dependent upon, and wonder if they were to buy or develop a facility could they stabilize it, how long would it take and could they keep it stabilized. The conditions for financing are a whole other set of concerns. Sellers find themselves with devalued

properties from only a couple of years ago, fewer buyers in the marketplace and buyers with difficulty financing.

McCune: Buyer's potential profits have been reduced by higher loan rates and low leverage so they need more return from the property they are buying. Buyers are also figuring in more risk in the cap rates than in the past.

4. What impact have the credit problems had on cap rates in your area?

Mendola: Cap rates are a function of mortgage constants and the relative competitive nature in each market. Overall, the cap rates are following the credit spreads of about 75 to 100 basis points higher than 6 months ago.

Cinelli: In past years, buyers were more inclined to buy at rates comparable to the lending rates because they were anticipating higher income based on the pro formas of the properties. Now, buyers want a 1-3% return over the lenders rates, depending on the performance of the facility and the expectations of increased cash flow.

Shields: I was told by a major lender that in general he is seeing cap rates between 7 ¾ - 9 ½, and in self storage he is seeing increases of about 50-75 basis points. This can be attributed to the higher cost of capital, the overall availability of funds or lack there of and the tightening of underwriting standards. The question is to what extent these conditions will continue and how much will it affect cap rates going forward.

Blake: Cap rates are up easily 100 basis points except, perhaps, on large class A facilities.

*McCune: These comments from the Northeast about increasing cap rates are consistent with what we hear across the country. Just to show how much this means in terms of value (sales price); a one point increase the cap rate from, say 7% to 8%, **REDUCES** the value by **14.3%**.*

5. Many sellers have determined that now is a good time to sell for both market and personal timing issues. Are sellers seeking reasonable market pricing and are there difficulties in locating qualified buyers at market prices?

Shields: I tend to question how many "real sellers" are in the marketplace today. My judgment is that there are some sellers who are not ready for reality. They are not ready to accept that values have dropped due to the market conditions. They are waiting for the buyers who will pay yesterday's prices and they are willing to wait. I think they will have a long wait. There are still buyers who want to buy self storage but there are fewer who can pass the lending scrutiny. The buyers who are strong and qualified have good banking relationships and are willing to wait for properly priced locations at which time they will react.

Blake: It is never difficult to find buyers at market prices. The trouble we are seeing in the Upstate New York market is that there is a lack of sellers willing to price their properties at reasonable market prices.

Cinelli: Sellers are still not realistic about reasonable market prices for their facilities. Only recently have we seen sellers start to listen to the market and what banks are saying about values. In our area, most of the buyers are serious and qualifying for loans is not an issue – it is the qualifying of the properties that is a problem!

Mendola: Sellers still want the highest value for their self storage investment because they recognize that self storage is getting more expensive and more difficult to build than ever before. It is like looking at a stock like Google when it was \$745 per share. Now that Google is under \$700, the investor still wants the higher price for the stock. This is the same condition for sellers of self storage. It is difficult to get buyers to commit to properties where the price is higher than current market rates support. However, if the facility has high barriers to entry and is located in a growing area, it will still command the best price possible.

McCune: *Sellers always want yesterday's price when markets are contracting; somehow the review mirror is easier to see than the windshield of the future. The reality is that self storage facility prices, even after a one point adjustment in cap rates, are still at very near historically high values. Most commercial real estate cycles last in the range of three or four years so if you are thinking about selling, it is still a good time to consider selling. The combination of any decline in revenues, because of overbuilding or a recession, plus an increase in cap rates can really impair values (a one dollar drop in revenues reduces the value by \$12.50.) The combination of declining revenues and increasing cap rates can be devastating to current values. If you think this can't happen, then you weren't in the business in the 1980s.*