ARGUS
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Market Monitor

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A note from Ben Vestal: As we enter 2011 we are settling into what everyone has been referring to as the "new reality" of the real estate market. Gone are the days of 7% cap rates and we are now learning the new rules of self storage financing. I have asked two industry veterans and self storage owners to share their thoughts on ways self storage owners can capitalize on today's market conditions and what they have been doing to maximize and protect their investments.

2011 Outlook: Self Storage Investment and Financing Management

By Bruce Bahrmasel and Neal Gussis

Since the onset of the recession in 2008, millions of Americans have had to adjust to lower personal incomes, job losses, decreased asset valuations and shrinking investment portfolios. Simultaneously, commercial real estate values have plummeted by as much as 40% from their 2007 benchmark highs. With such financial difficulties, many people have simply tried to hang on until better days.

We think those better days may be coming in 2011 given these recent encouraging signs of economic improvement:

- The stock market has posted solid gains
- Business earnings are rising
- Unemployment appears to have bottomed out
- Many lenders – especially larger national and money center banks – have healthier balance sheets and are selectively soliciting loans again, albeit on conservative terms
- Valuations and actual sale prices are rising for top- and mid-tier self storage facilities with proven (i.e. trailing 12-plus month income) operating performance

Even with these positive indicators, we are clearly not out of the recessionary woods yet. There continues to be uncertainty about the strength and duration of any real economic recovery, and of course, many storage properties are still distressed and overleveraged. With our nation's shifting financial and political climates, you should carefully evaluate and manage your property assets by determining what you can do <u>today</u> to maximize their value and limit investment exposure from future uncertainties. To start, consider reviewing your property financing, exit strategies and cash position.

From Our Own Experience

As we begin 2011, most self storage owners still have adequate equity in their property investments and are doing fine, even if facility occupancy levels and revenues are flat or slightly down. We recommend these owners review their financing to determine if they can improve their position since mortgage rate indices – such as Treasuries, Prime and Libor – are all currently at historically low levels. For them, it could be a perfect time to capitalize on low interest rates and work with their current lender who has a vested interest in ensuring that borrowers can make monthly debt payments and pay the loan off in full at maturity.

If your loan has less than three years to maturity, consider asking your lender to extend or modify it to the longest loan term possible (typically five years) at current interest rates. While most three- to five-year term deals are now between 5% and 6%, you may get an even lower rate.

Consider an example from the authors' own experience. We share ownership of two Midwestern storage properties. We recently extended and modified their loans by lowering the interest rate from 6.25% to 5.5%, changing the amortization schedule and extending the loans an additional two years so that they now mature in four years. We not only save money each month with the lower interest rate, but the longer maturity period allows us to extend our horizon to either sell or refinance the properties.

How Did We Do It?

It started when several large banks approached us for our business with highly attractive refinancing rates. This led us to conduct a survey of local area banks to determine available loan rates and terms. Armed with this information, we were in a more advantageous position to try to leverage a better deal with our current lender, which is a small community bank. We had several points working in our favor: 1) Our bank viewed us as reliable borrowers they didn't want to lose, 2) They wanted us to continue making debt payments while simultaneously reducing our loan exposure, and 3) Our bank is a healthy community institution with a streamlined credit review and approval hierarchy, thus they could manage their asset (our loans) in a responsive and favorable manner.

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A lender's decision to refinance a commercial property is highly dependent on several factors, including the lender's size, balance sheet health and current policies, as well as if they have been acquired through a previous bank failure or are currently owned by the FDIC. Their ability and willingness to work on a financing request may also hinge on whether your current loan is a CMBS product. Our successful refinancing was helped by the fact that we understood our bank's motivations and financial situation. Take time to make a similar evaluation to competitively analyze currently available terms in your area.

Time to Sell and Turn Equity into Cash?

There is still tremendous acquisition interest for stabilized institutional-quality storage properties, as well as smaller facilities and those in secondary markets. Of course, investors continue to price size, quality and location into their bid prices. With such strong buyer interest, this could well be the right time to sell a property and remove a great deal of risk from the table.The two most common reservations we hear from storage owners about selling a property are: 1) How they can replace the property's income stream, and 2) A reluctance to pay the resulting tax liability. These legitimate concerns deserve closer examination.

First, it's just a matter of time before interest and tax rates increase. And when they do, there is a direct inverse relationship to property valuation. With equity being the difference between a property's debt and value, your equity position constantly fluctuates. While you could previously convert equity to cash through refinancing, nowadays about the only way to tap cash from your investment is through a sale. Even worse, a refinancing caused by a maturing note may result in the need to infuse cash, making even strong performing properties ineligible for refinancing. As a result, you could face the real prospect of having to bring cash to the closing table in order to refinance a loan, which in turn will result in higher future monthly debt payments. If you find yourself in this scenario, it may indeed be a very good time to consider selling your property.

On the positive side, keep in mind that self storage remains one of the most highly sought after and attractive real estate property classes. As you begin 2011, review your loan position and consider whether refinancing makes sense given today's low interest rates, or if perhaps you should sell sooner rather than later because of such unknown risks as overall economic conditions, conservative lending requirements, property valuations and future tax consequences. As we learned from our recent personal experience, it's never too early to carefully consider how you can secure your self storage property investment.

Bruce Bahrmasel *is an Argus Broker Affiliate and real estate broker for Landstar Realty Group.* ***Neal Gussis*** *is the Chicago-based Managing Director of Capital Markets at The Corvus Group.*