

Finance Experts Hopeful Worst is Over

Smaller operators struggle to keep up.

By Laura Williams-Tracy

After a two-year drought of deals through an oppressive recession, self storage appears to be bouncing off the bottom.

Brokers and financiers say the worst is over and the outlook is improving as sales volume increases and private equity rushes in to invest in an asset class outperforming other commercial property types.



"The healthy players with cash in hand will take advantage of the situation."

~ Shawn Hill
The BSC Group

"We've seen an increase in 20 percent in transaction of sales in first half 2010 compared to first half of 2009, and I see that accelerating through the year," says Chris Sonne, leader of Cushman & Wakefield's self storage industry group.

The larger REITs (real estate investment trust) and owner/operators spent the recession cleaning up their balance sheets, and now many are in a strong position to make acquisitions.

"The publicly traded companies had to get their act together faster than the average mom and pop because they report to Wall Street," says Shawn Hill, a partner with Chicago-based The BSC Group. "The pain they were feeling has been addressed and their stock prices are looking good. That's what's driving the acquisitions."

At the same time, private investors who've sat on the sidelines for two years waiting for an attractive deal now think storage may be it. The asset class has held up better than retail and office buildings, and private investors believe once again there's money to be made in the industry.

Smaller, privately-held operators who've been slower to improve their financial picture—some facing a bleak refinancing options—could be the targets of such acquisitions. They'll either sell to larger players or bring in additional investors of their own to shore up their financials.

These circumstances set the stage for a period of consolidation within the industry.

A Better Outlook for the Bigger Companies?

"Now the big guys are going to gobble up the little guys and new guys are coming in," Hill says. "You are going to have the have-nots get wiped out and haves will have more."

Among the recent spate of transactions was Public Storage Inc.'s April announcement that it had agreed to buy 30 self storage facilities from A-American Self Storage, mostly in southern California, for \$189 million.

"That was the first big portfolio transaction we've seen in two years," Sonne says. "When a giant self storage company says it's time to get in acquisition mode, that's telling they think the outlook is strong."

Other well-positioned players are also looking for new properties to buy.

Two-year-old Strategic Storage Trust, a publicly registered, non-traded REIT, is in acquisition mode, and has purchased more than 30 properties in 14 states and is looking for more.

The atmosphere favors larger players, says Steve Hryszko, vice president and broker with CB Richard Ellis's self storage advisory group, based in Cleveland, Ohio.



"Most of the [properties] we're seeing are in some level of distress."

~ Steve Hryszko
CB Richard Ellis

Self storage appears to be cycling back to a time when the large owner operators and REITs held a dominant position in the industry, Hryszko says. As credit became easier to get in the early part of the decade, smaller players were on an equal footing when making offers. After the drought in deals for the past two years, Hryszko says the REITs and large owners have the advantage again and are in a position to buy.

Some smaller operators may be in a strong financial position, Hryszko says, but to buy or refinance they'll have to put more money in the deal than in the past, and that's not an attractive option coming off of a difficult recession.

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Frustrating operators in their quest to buy competitors is the dearth of properties available for sale, Hryszko says. "Most of the ones we're seeing are in some level of distress."

The number of properties available nationwide is at an all-time low, Hryszko says. Many that are coming on the market are anywhere from 70 to even 30 percent occupied.

"The small guy can't finance a 30 percent occupied property," he says, "but the larger players can do it."

Hill says attractive deals can be found, even among properties that have their challenges. "You can find diamonds in the rough all over the place. There are opportunities out there, but you need to be creative and resourceful."

Financing the deal once it's found is part of polishing that diamond. The ease of financing the purchase of a new property or a portfolio of assets is improving, but remains challenging. Capital is available again, albeit at more conservative terms than three years ago.

"There is financing available, but it's not for the weak or the timid," Sonne says. "The due diligence is tedious, and lengthy and frustrating."



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*~ Chris Sonne
Cushman & Wakefield*

Those who win approval for financing are finding good interest rates, with fully amortized 10-year bank loans.

Improving conditions and equity capital coming into the market are creating downward pressure on cap rates. Sonne predicts overall cap rates could be as low as 7.25% within two years. Through in the first half of 2010 overall cap rates averaged 8.45%.

"There's cautious optimism, in part because operations are improving," says Jim Davies, managing director of Belgravia Capital in Irvine, California. "We're seeing conservative pro formas, which means some lessons have been learned."

Davies says life insurance companies have become more active lenders, offering 5 to 10-year fixed, non-recourse loans with 55 to 65 percent leverage.

Some commercial mortgage-backed securities programs are back, but rare and only for loans greater than \$10 million.



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Belgravia Capital*

"That market has a ways to go but its coming back slowly," Davies says.

Hryszko says some smaller banks are financing smaller deals, but requiring more money down than most buyers want to front.

Still, the gaps are narrowing.

Davies says regional banks are finally warming to the idea of writing down storage loans to a level that can make sense for new investors to come in and help a troubled owner buy the loan from the bank. Even the larger money center banks are willing to entertain a DPO, or discounted purchase offer.

Hryszko believes that for two years there's been a big disconnect between what sellers believed their property was worth and what buyers wanted to pay. That gap is narrowing and brokers and others are seeing multiple offers on portfolios, something that was unseen during the recession.

"Most owners say they are seeing opportunities to write offers on, but very few are successfully making acquisitions. There are a handful of buyers having success," Davies says. "I'm hearing there are 20 or 30 offers on quality portfolios. There's going to be more coming throughout the second half of 2010."

Growing demand for what's currently perceived as a better bet than other types of commercial real estate will drive up prices—at least for a time—until bank appraisals no longer come near market exuberance.

"All of this will lead to a huge period of consolidation," Hill predicts. "The healthy players with cash in hand will take advantage of the situation." ❖