The Sophistication of Self-Storage

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Growth, Consolidation And Financing Alternatives

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SELF-STORAGE PROPERTY, AS A SPECIALTY SECTOR IN THE REAL ESTATE INDUSTRY, remains an attractive asset class to those lenders and investors who understand the cash flow and counter-cyclical "safe haven" characteristics of the product. On a national basis, the industry offered solid fundamentals going into 2002, with the prospect for improved performance throughout the year.

This pre-2002 consensus was based on the view that supply was in check. For example, according to F.W. Dodge pipeline data, new supply per quarter had remained under 30 million square feet (annualized) for seven consecutive quarters, dating back to the fourth quarter of 1999. Through the middle of this year, and despite a first-quarter spike of 9.3 million square feet of new starts (37.2 million annually), this respite from excessive new supply appears to have firmed up industry performance.

The major storage real estate investment trusts (REITs) are clearly the most visible companies in the industry and provide an excellent gauge for the national market. Through June 30, the market-leading REITs reported same-store net-operating-income growth ranging from -1 percent to 2 percent, as compared to the same period in 2001, with the second quarter under-performing the first quarter.

While this performance would have been regarded as unexceptional during a period of stronger macroeconomic growth, the stability of cash flow and property value for self-storage portfolios is actually exceptionally attractive to investors today. This contention is fully supported by the GE Capital's $8 billion acquisition of Security Capital and Storage USA that closed in May. Institutional investors and lenders view the prospect for 7 percent to 10 percent total returns, largely driven by cash flow, as a welcome alternative to the uncertainty of equity market returns over the next few years.

Over the past 10 years, the most notable trends in the industry have been the gradual consolidation of ownership, greater sophistication of management practices, and the increasing gap between older product and high-quality new construction. Let's look at these trends in greater detail.

Industry Growth and Consolidation

The self-storage industry was formed roughly 30 to 35 years ago by mostly mom-and-pop organizations that owned and operated one- to four-site companies. Regional and national companies started to evolve roughly 25 years ago and are now represented by the handful of major REITs. Despite the size of these largest operators, the industry still remains highly fragmented, with only 40 to 50 true regional or middle-market players.

This relatively slow pace of consolidation has confused industry analysts, who continue to point to several natural-scale economies that lead one to conclude regionalization, if not nationalization, is the likely evolution. Without question, labor costs, advertising and operating supplies drive the bulk of the variable expense-line items. On the expense side, advertising is far more effective, and higher-cost advertising (e.g., television) can be justified when the cost/benefit can be spread across multiple sites in a local, regional or even national market. In regard to labor costs, scale is essential in creating a dynamic training and career-development path to retain strong managers and employees, a process that drives expense containment and revenue growth.

To date, much of the growth of larger operators has come not from roll-ups of existing facilities, but new construction or conversion of existing properties to self-storage use. While many pioneers of this industry have indeed sold out to the tempting offers tendered by the well-capitalized REITs or opportunity fund-backed players now active in this industry, the majority have not. There are several factors that have inhibited the expected trend:

- Most of the owners of the one- or two-site properties are those who view their sites as an operating business, not stand-alone real estate investments. The sites represent their job, and nepotism often exists at these properties. Selling the site would terminate not only the owners "place to go," but also the jobs of several close friends and/or relatives.
- Smaller owners are not very automated with their accounting systems. It is not uncommon to see manual or simple Excel-based reporting, where there is some question whether cash revenue matches reported revenue. While this practice may enhance proceeds to the owner, prospective buyers cannot provide adequate offers if they are working from under-reported property yields.
- Still, we expect the trend toward consolidation to accelerate modestly as 1) the investment characteristics of self-storage (relative to broader market alternatives) remain attractive to institutional investors; 2) larger and more efficient owners with better expense structures and management effectively compete against the smaller owners; and 3) many of the original owner/managers get older and sale of their properties becomes a critical component of their retirement.

Management and Operations

The trend toward sophistication in this industry can be seen in the use of more technology and better yield-management practices. Improved software and billing systems drive higher revenue and better cash management. For example, older software maintained a first-of-the-month billing process because it was the most efficient practice for manual systems. With new web-based systems, property-management data is available daily. This allows managers to bill on anniversary dates, which generates greater late-fee income from similar occupancy levels as before, simply based on collections due to consumer oversight (as opposed to credit-based issues).

The web-based reporting also provides critical occupancy and rate information that allows managers to make timely decisions regarding rate, advertising and concessions. Finally, these systems minimize the collection and administration of security deposits. Managers are comfortable to self-insure against the risk of damage to the unit while taking an administration fee. The administration fee drops to the bottom line, and the operator avoids the cost of holding, documenting and refunding a deposit.

Better operators enhance revenue by maximizing the products they offer on site. These ancillary services are complementary to the core business and can stand alone as profit centers, for example, shipping and package receiving, sale of storage containers and packing materials, and delivery/moving on a contract basis. Excess land is sometimes used for outdoor or canopy storage of RVs, trailers, boats and other oversized vehicles.

State-of-the-Art Properties

Older sites constructed of metal on concrete slab are approaching obsolescence. New sites feature multistory buildings with elevator service, climate control and individual security systems. While multistory sites have always been attractive to owners seeking greater density, the operators were often unsuccessful in leasing upper floors without significant discounts. Today, sophisticated operators have succeeded in marketing these sites, and higher-end consumers are willing to store goods of higher value (antiques, etc.), knowing climate damage and theft is less likely.

Financing Alternatives in the Capital Markets

The real estate capital markets and, specifically, the debt markets are filled with investors and lenders looking for transactions. Throughout 2001, and with a relatively minor moratorium after the events of Sept. 11, most lenders maintained their appetite to provide real estate capital to the market at reasonable pricing levels. This remains true, with Wall Street lenders, banks, finance companies and life companies all competing for transactions with in-place cash flow and strong sponsorship, albeit at varying loan-to-value

(LTV) levels.

As a general rule--depending on the hold period for the asset, fees, rate and lockouts--terms are quite favorable below the 70 percent LTV level. The market has seen several major portfolio financings over the past several months, with loan proceeds exceeding $50 million. The best examples were floating-rate transactions through Wall Street or finance companies, where the borrower accessed extraordinary LIBOR (London Inter Bank Offering Rate)-based pricing and structured a relatively low-cost hedge off the flat Treasury-rate curve.

Again, below the 70 percent LTV level, and in a proceeds range that roughly provides 1.3 times coverage on a 9 percent mortgage constant, pricing spreads are below 300 basis points, and total pricing is below 5 percent. Above the 70 percent LTV level, the market remains liquid, though there is an embedded A-note/B-note structure in those transactions that creates an investment-grade A position and a high-yield B position, each of which can be readily placed with investors seeking risk-adjusted returns. In those transactions, borrowers should also expect the request for a minimum 12- to 18-month lockout, origination fees between 50 and 150 basis points, and an exit fee from 50 to 100 basis points.

In the smaller loan market, capital is abundant for one-off or small-portfolio transactions, with loans ranging from $1 million to $20 million. Typical leverage for seasoned properties is 75 percent LTV, with the potential for 80 percent in superior locations with a new generation product. The largest funding sources for these single-asset transactions are local and regional banks and nationa conduits. Given their local market expertise, banks are best suited for construction-loan requests.

Construction financing is available at variable rates in the 4.5 percent to 5 percent range. Full recourse through completion is typical. Advance rates are usually in the 70 percent to 75 percent loan-to-cost range, with terms ranging from 18 months to five years if a mini-perm loan is part of the financing. Permanent financing is available in the 6.25 to 6.5 percent range for 10 years, assuming a spread over the corresponding treasury of 225 to 250 basis points. Shorter maturities of five to seven years are also available at slightly lower all-in rates.

Permanent financing is typically done on a nonrecourse basis, freeing up the owner's balance sheet for use in future developments. Borrowers should expect a yield maintenance or defeasance prepayment penalty until the last year of the loan. Flexible prepayment options are available to borrowers willing to accept a slightly higher interest rate. Floating-rate loans are also available for terms of three to five years. Rates on floating rate loans are usually tied to LIBOR, with an all-in rate of approximately 5 percent. Floating-rate loans provide prepayment flexibility for the owner who has not fully developed or stabilized his property and wishes to increase leverage at some point in the near future.

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