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ISS INSIDE SELF-STORAGE

The Premier Magazine of Self-Storage Professionals

Self-Storage Real Estate:

The game has changed. Are you prepared?



Inside ...

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Performing a Self-Storage Checkup

When was the last time you took an in-depth look at your local market and your facility's competitive position? Would you be prepared to compete against a new facility in your market? In these uncertain economic times, a facility checkup is a crucial exercise to ensure a healthy future for your business.

Symptoms

Be on the lookout for certain symptoms indicating an ailing market. Begin by keeping detailed records of all phone and Internet inquiries received from renters and track how many of them turn into paying customers.

Over several months you'll be able to see if the pace is holding steady or if calls and conversions are declining. A downward trend in the percentage of inquiries turning into renters could indicate a serious condition in the market.

Also review your rental-rate history and note trends following your last rate increase. If you lost customers as a result, determine how long it took to lease up again. Renters becoming more price-sensitive are another indication your market is tightening.

Finally, don't forget to track your physical and economic occupancies. If you've increased rental concessions and incentives to maintain your occupancy then your market could be in for a decline.

Causes

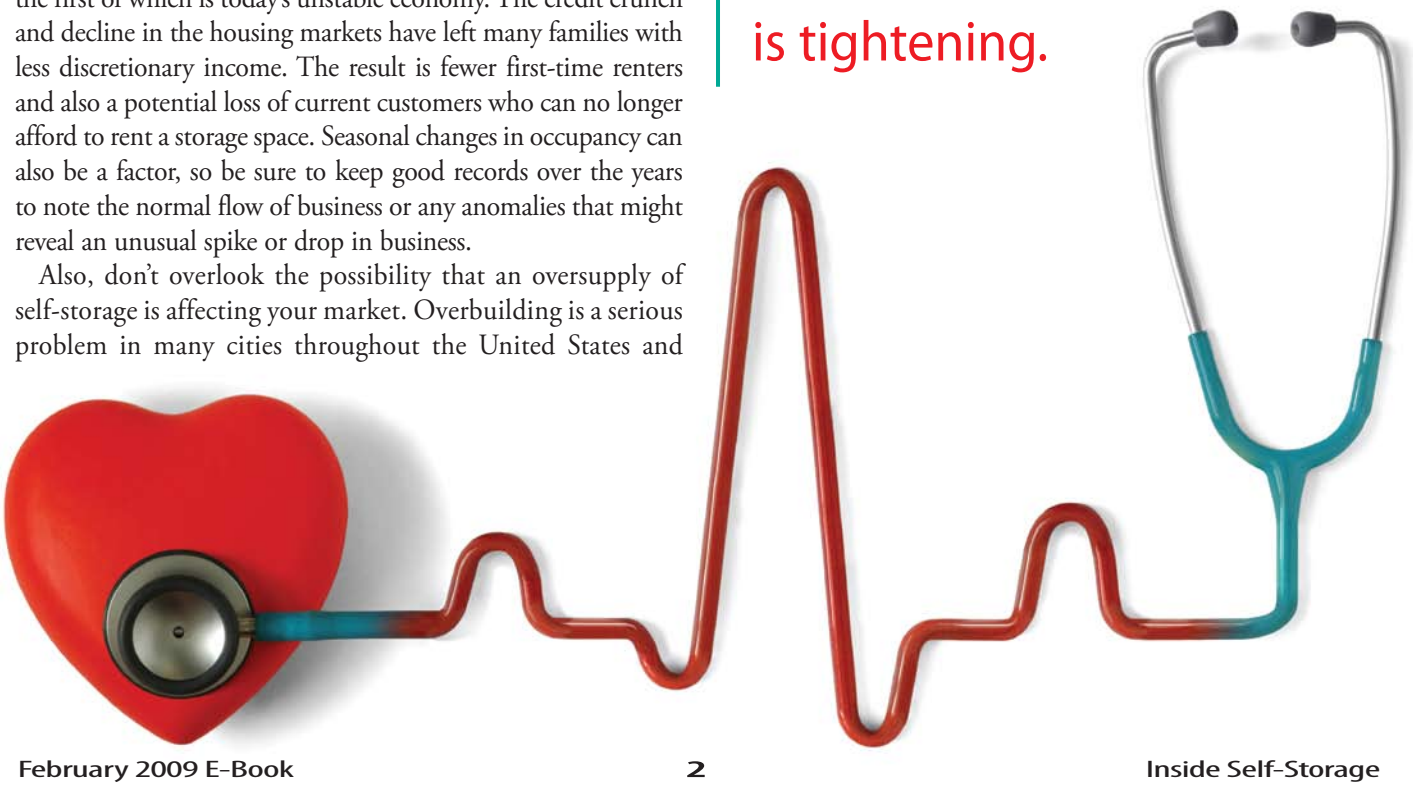
Several underlying factors contribute to a declining market, the first of which is today's unstable economy. The credit crunch and decline in the housing markets have left many families with less discretionary income. The result is fewer first-time renters and also a potential loss of current customers who can no longer afford to rent a storage space. Seasonal changes in occupancy can also be a factor, so be sure to keep good records over the years to note the normal flow of business or any anomalies that might reveal an unusual spike or drop in business.

Also, don't overlook the possibility that an oversupply of self-storage is affecting your market. Overbuilding is a serious problem in many cities throughout the United States and often has damaging effects on the rest of businesses in the area. Consider how a new facility in an established market area can impact the overall occupancy of the market.

For example, let's envision a market with 300,000 square feet of self-storage supply in a 3-mile radius. If the market has an overall occupancy of 85 percent, then the current demand for self-storage is 255,000 square feet. If a developer plans to enter this same 3-mile radius with a new facility, consisting of another 60,000 square feet, then the new total supply of storage in this market would be 360,000 square feet. At the current demand of only 255,000 square feet, this new market would now be facing occupancy of around 70 percent, down nearly 15 percent from its stabilized rate!

It would take a tremendous amount of population growth or additional demand coming from outside the 3-mile radius to return this market back to 85 percent occupancy. What should concern all current owners most is the older, lower-quality facilities will likely suffer the worst decline because the new site—with all its bells and whistles—can draw customers from the competition.

Renters becoming more price-sensitive are another indication your market is tightening.



Prevention

Taking preventive action can make all the difference in how your facility weathers a changing market. We've developed the Annual Facility Checkup to accurately evaluate your operation against current and potential competitors. This evaluation, combined with your own valuable experience and knowledge, will give you tools to make informed decisions about how to remain competitive.

A word of caution: You must be completely objective when completing the evaluation and as thorough as possible in obtaining all details. Your results need to accurately reflect the market conditions to be useful to you.

A sample copy of the Facility Checkup form is included in this article to illustrate the analysis. If you would like a blank form, visit www.selfstorage.com/argus/toolbox/checkup.htm to download a copy. The form is merely a guide, so feel free to add other items to the list that affect your market.

To begin the checkup analysis you need to define your market trade area, generally a 3- to 5-mile radius from your location. You may also want to include additional facilities just outside this area as they have the potential to impact your market.

Plotting all of the self-storage businesses in the area on a map will give you a good idea of market supply and what areas are likely to see future self-storage development. Visit your local planning and building department to inquire about projects on the drawing board; they could play a major role in the future success of your business. Add these locations to your list and then commence your evaluation by visiting all the facilities. Talk with the manager or owner at each location to learn as much as you can about their operations and how they market to potential renters.

Following your visit, use the checkup form to rank various criteria on the list such as location, visibility, access, signage, traffic counts and appearance. Be as objective as possible as you rate each item on a scale from 1 to 10. Obtaining each competitor's rental rates will also help give you a better picture of the marketplace. If you can't get these during your visit, try calling the facility to get an idea of their salesmanship and special offers. You must be careful how you obtain rental rates because discussing prices with competitors could be considered antitrust price fixing. It's best to do this anonymously.

Last, but not least, perform the same evaluation on your own facility. Add the scores and look at the various rental rates, noting where you rank in relation to the competitors on your list. If your scores are lower than the average in any of the categories, consider those items to be a priority for your next maintenance project or capital improvement. Perhaps you will also find that new or planned projects will significantly enlarge the market and that you must take some dramatic steps to remain competitive. Even if you have the best property in the best location in market, you will know better how to sell your facility against the competition and where you can benefit from the pricing structure.

Sample Facility Checkup Form

	8th & Main	Ash & 4th	First St.	New Project	Our Facility	Average
Location	8	6	9	9	9	8.2
Visibility	7	8	7	7	6	7
Access	4	10	8	7	9	7.6
Signage	5	5	7	8	5	6
Traffic	10	4	8	10	8	8
Appearance	9	6	8	10	8	8.2
Total Points	**43**	**39**	**47**	**51**	**45**	**45**
Occupancy	83%	63%	87%	N/A	91%	81%
Rates						
5x10	$70	$85	$69	N/A	$75	$74.75
10x10	$115	$130	$110	N/A	$119	$118.50
10x15	$145	$155	$140	N/A	$149	$147.25
10x20	$160	$185	$150	N/A	$160	$163.75

Let's review the sample checkup to see what the future looks like for this hypothetical market. The property at 8th & Main earns average scores among the group and also has competitive rates. Its greatest advantage is high traffic exposure, which is a factor that an owner has little control over.

Ash & 4th is pricing units significantly higher than the group, which is likely hurting its occupancy. If the owners bring their rates down to a more competitive level, they could impact the market as they enjoy a high-visibility location with excellent access.

The facility on First Street is a strong competitor with good occupancy and high scores in all categories. The New Project entering the market has the potential to do some major damage. It has a high-traffic location and an appealing appearance, plus the facility will likely have all the bells and whistles to attract new customers.

Our Facility is in a relatively good position for now. Our occupancy is the highest among all the competitors and rates are average for the market. Once the new project opens, we will have to address the low scores in signage and visibility to avoid falling victim to the inevitable drop in occupancy that will occur.

An Apple a Day

We recommend completing the checkup process at least once per year to be sure you don't miss any pricing changes or competitive threats on the horizon. A completed checkup provides you with some very powerful information to prepare for the future and, over time, you will possess a tremendous amount of information about the trends and intricacies in your market.

With a potential recession looming and problems in credit markets, these steps—taken now—will help you weather tough times. Being proactive, rather than reactive, is the best way to ensure your self-storage business will be strong and healthy for years to come. **ISS**

Author: Amy Hitchingham, Argus Self Storage Sales Network



Best Practices for Buying an Existing Business

Purchasing an existing self-storage facility can be a great introduction to the industry if you know what you're getting. The question is: What should you look for when you buy, and why?

Before you purchase a facility, evaluate your investment strategy. Are you looking for a steady rate of return, say 5 percent, 7 percent or 10 percent? Do you prefer minimal management responsibility and maintenance issues?

If this is the case, find a site that has reached stabilization, meaning the property has achieved market occupancy (typically 80 percent or more, annually) and rental rates. Stabilized properties may be your best fit if you're prepared to "clip coupons" to achieve a steady rate of return on a monthly and yearly basis.

If, however, you want a higher rate of return or don't intend to hold the property long, hunt for one that is a "value-add" play. This scenario is not for the faint of heart. These properties usually have issues related to management, advertising, competition, age of structure, etc. If your goal is to improve a site's performance and you have the resources to do so, look for your diamond in the rough.

The Right Fit

Regardless of your investment strategy, you'll need a proper fit. Some pointers: Always purchase based on actual operating numbers not pro forma. Provided by the seller/broker, a pro forma projects how the property *can* perform, but you need hard numbers confirmed by the following:

- Profit-and-loss statement for at least the past two years
- Annual occupancy report for the past two years
- Occupancy report for the past 12 months, by month
- Rent roll showing total number of units, sizes, climate control and rental rates
- Delinquency report for the past 12 months, by month

This data will reveal what, if any, problems exist at the facility, and help you determine if the investment is suitable. For example, let's say a rent roll shows the property at 95 percent physical occupancy, but the monthly profit-and-loss statement reveals a 70 percent economic occupancy based on monthly receipts. It could be some rents are pre-paid, verified by higher revenue collected in preceding months. It could also mean a high number of delinquencies. If this is confirmed in the delinquency report, a red flag should be raised.

Other questions to ask the seller or broker include:

- **Why is the property for sale?** If the seller is motivated, the purchase price may be negotiable.
- **Does the seller have other properties; if so, are they for sale?** Find out why this particular property is being sold as opposed to other assets. You may be able to buy multiple properties at a discount.
- **What have other properties sold for recently?** This gives clues regarding the seller's perception of property value.
- **What is the market rental rate, vacancy and cap rate?** These numbers determine what you should pay for the property.
- **Who manages the property?** If the seller is also the manager, he may be paying himself a salary above or below market, or nothing at all.
- **What are the capital expenditures for the past five years?** Every property needs regular maintenance. If none has been done, chances are you'll be doing lots of repairs if you buy.

Patience, Patience

Never buy on a whim; analyzing the data you've collected is essential. Each investor must decide for himself if a property suits financial goals. Let the numbers, not emotions, be the deciding factor. The following are some of the most common financial techniques used when analyzing a deal:

- **Cash-on-cash return**—The annual before-tax cash flow received. This simple calculation should tell you right away whether to proceed with the project. It is derived through a two-step equation:
  1. Net Operating Income - Debt Service = Net Cash Flow
  2. Net Cash Flow/Equity = Cash-on-Cash Return
- **Capitalization rate (cap rate)**—Rate of return used to derive the value of an income stream. This is the annual rate of return you'd earn if you were paying all cash for the property. It varies by location, age, operating history and market. As an investor, target a benchmark cap rate for your deals. The equation: Value of Property = Net Operating Income/Cap Rate.
- **Internal rate of return**—The true rate of return on equity over a period of time. This calculation more accurately determines the return received over the life of an investment with compound interest factored in. This is a must if you're looking at a value-add project with varying cash inflows and outflows.

Set a benchmark for each of the ratios outlined above and only invest in deals that meet or beat your goal. Patient investing is paramount.

Let's Make a Deal

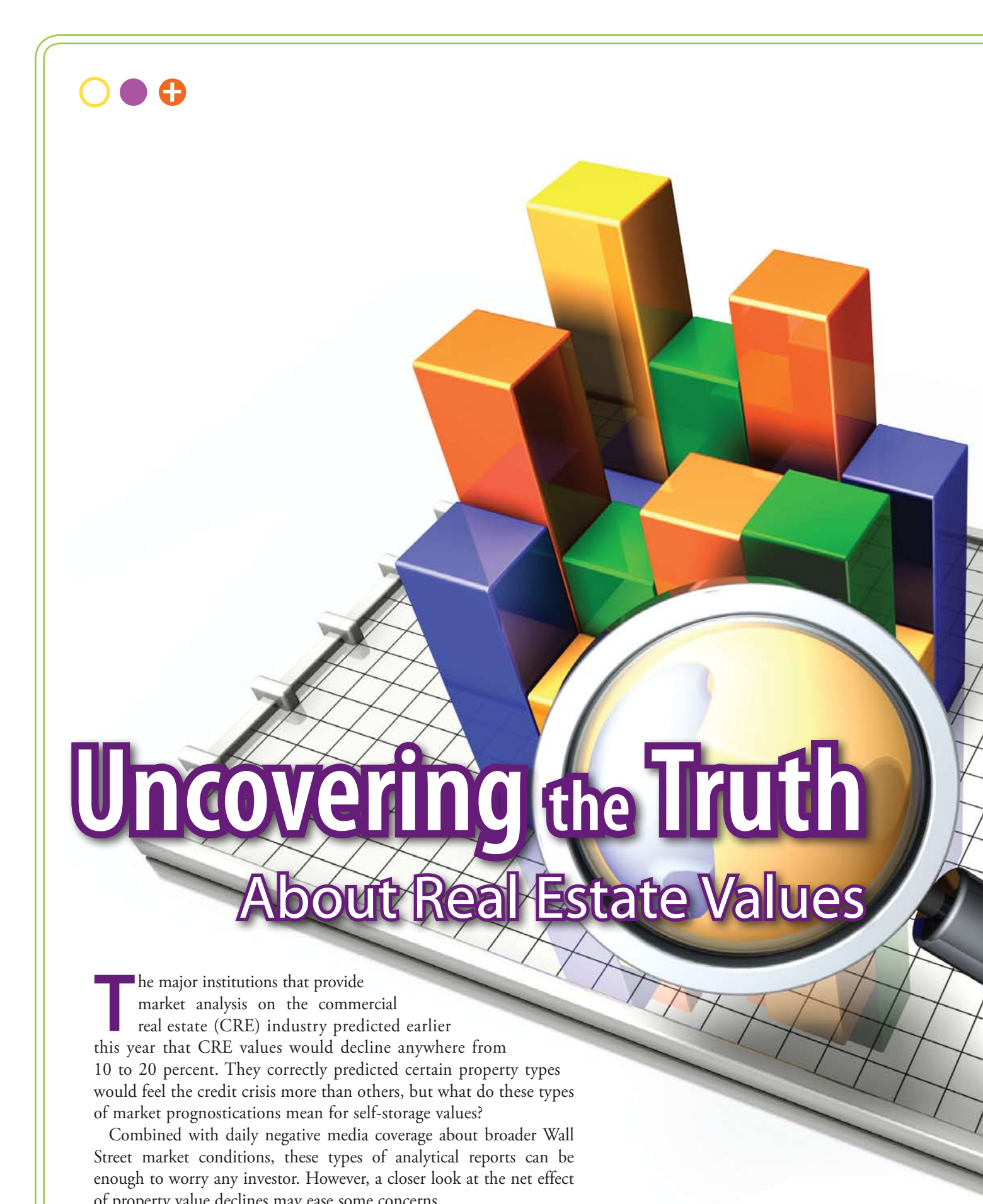
What is a good deal? More important, what is a good deal *for you*? Just because the numbers work for someone else does not mean the property is an ideal investment. For stabilized properties, you need to meet your projected rate of return. For a value-add property, things get more complicated. Here are some examples of investment strategies that can be implemented:

- **Property with a high occupancy that has not raised rents.** Acquire the facility and raise rental rates across the board to equal market rates. You may lose some tenants, but overall revenue numbers should be substantially higher.
- **High-occupancy facility with room for expansion.** Buy it and plan to expand. Consider adding units in phases to reduce out-of-pocket expenses associated with expansion.
- **Low-occupancy facility.** Acquire the property and increase the advertising budget to amp up promotions. Ideally, you want to be the first facility people call for storage.
- **Older, somewhat rundown property.** Many sites just need to be spruced up: Paint buildings, reseal parking lots and driveways, and put up new signage. A clean, fresh-looking site will attract tenants who place a premium on storing belongings in a nice, safe-looking facility. Often, they're willing to pay more for it.

"Never buy on a whim; analyzing the data you've collected is essential. Each investor must decide for himself if a property suits financial goals."

Look at your buying options cautiously and creatively. Sometimes it doesn't take much to improve a facility's appearance and income stream. Regardless, don't buy a self-storage property unless the price is right and you can meet your own predetermined benchmarks through the purchase. A successful investment career is ahead of you if you can do both. **ISS**

Author: Matt Lexow-Gray, S&W Capital and Realty



Uncovering the Truth
About Real Estate Values

The major institutions that provide market analysis on the commercial real estate (CRE) industry predicted earlier this year that CRE values would decline anywhere from 10 to 20 percent. They correctly predicted certain property types would feel the credit crisis more than others, but what do these types of market prognostications mean for self-storage values?

Combined with daily negative media coverage about broader Wall Street market conditions, these types of analytical reports can be enough to worry any investor. However, a closer look at the net effect of property value declines may ease some concerns.

First, the media's tendency is to exaggerate issues such as CRE values. If you look closely at numbers used in media reports, you'll see they are typically based upon a market's peaks and troughs, which create wider perceptual swings for readers. But, everything is relative, so when hearing reports of widespread margins, keep in mind what those margins are relative to.

Two recent storage industry examples can help put this into perspective: the revival of the Detroit storage market and the downturn in South Florida.

Ups and Downs

For the past few years, the Michigan economy has experienced recessionary periods with loss of jobs, income and population. Storage performance in the Detroit area was at an all-time low and viewed as one of the worst performing markets in our industry. Recently, Detroit has been cited as one of the better performing markets for REITs in 2008.



As a second example, hurricanes ravaged communities in South Florida in 2005 and created instant demand for self-storage. Once area homes were rebuilt or renovated, storage tenants exited the market, which immediately decreased occupancy levels. With renters gone, the South Florida storage market became a hindrance for REIT performance.

In both of these examples, the reports were based on the peak and trough of each market. In Detroit's case, the downturn was so significant that a bottom was reached. Now that the market is experiencing positive gains, the growth numbers become magnified and reflect a healthy market. In South Florida, occupancy levels hit all-time highs across the board immediately following the storms. But once the market returned to normalcy, the year-over-year decline was viewed negatively even though the market was back to pre-hurricane levels.

The same theory can be applied to the CRE industry and the decline in self-storage values.

The period from 2005 through the first six months of 2007 could arguably be termed as the CRE (including self-storage) relative to transaction activity and pricing. Using storage commercial mortgage-backed security activity as a benchmark, more than $6 billion was placed in self-storage during this period compared to just $2.5 billion from 2000-2004.

Transaction activity from 2005 to mid-2007 was at an all-time high with the capital markets being the main driver. The availability of capital combined with historically low interest rates and creative debt options allowed investors to purchase properties at a feverish pace, which benefited sellers and created an artificially inflated market.

During this peak period, investors could secure financing that required little equity—in some cases as little as 10 to 20 percent—which enabled them to capitalize on an aggressive lending market. For the first time, the low amount of required equity allowed private investors to participate in an arena with the larger institutional players on a fairly level playing field.

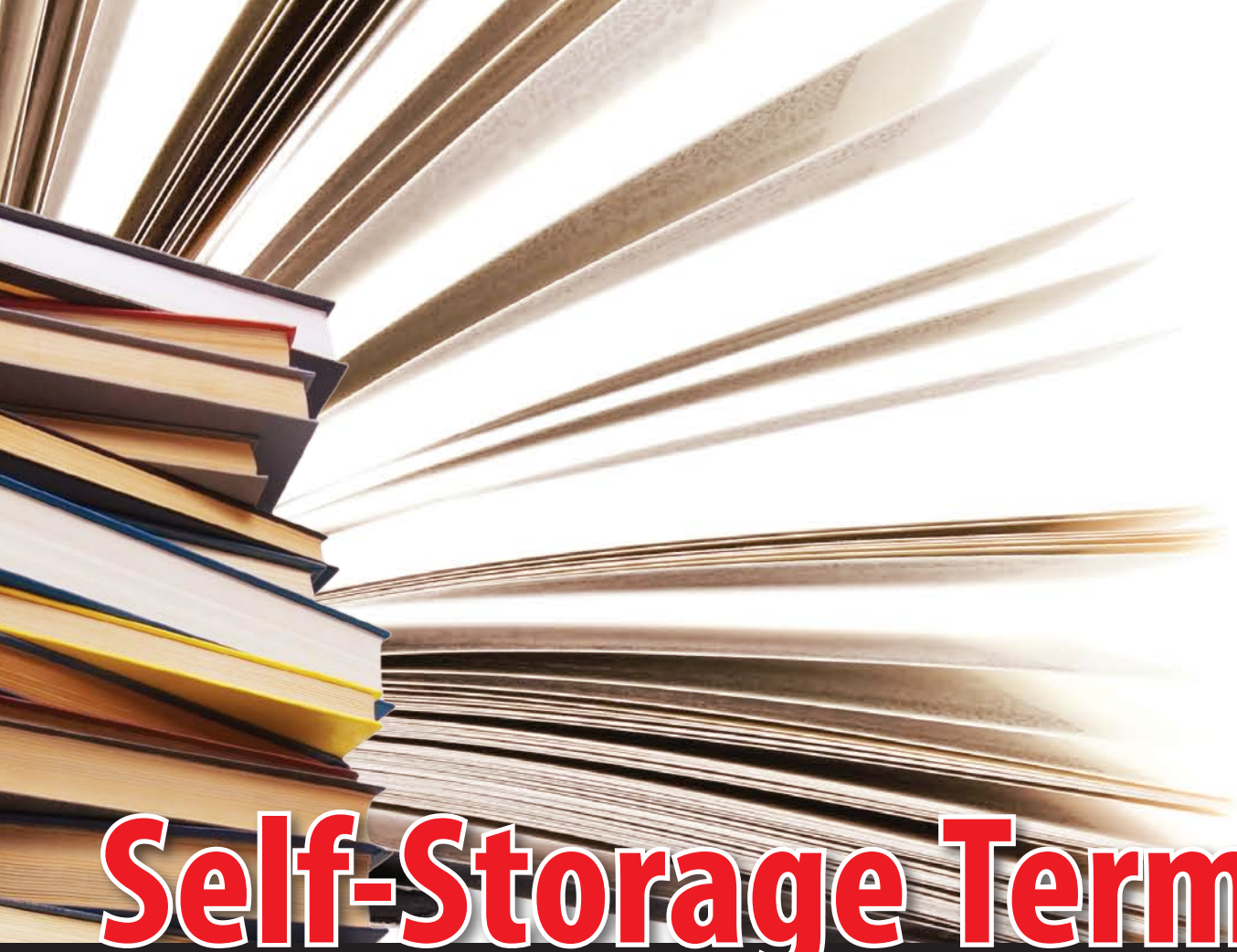
Today's CRE Values?

During the peak, class-A properties would trade in the plus/minus 5 to 6 percent cap rate range with the stabilized return in the 7to 7.25 percent range. Concurrently, high leverage and sub-6 percent financing was available to provide enough room to increase returns, albeit not significantly. In today's market, class-A stabilized product continues to trade within that same 7 to 7.25 percent cap-rate range, but the key term within that statement is "stabilized," whereas two years ago a premium would have been achieved with the "potential upside" story of the property.

Although media reports continue to depict a declining CRE market, the self-storage industry has continued to post respectable numbers relative to revenues and occupancy. Storage REITs are once again among the top investment performers in 2008 and have shown that our industry is able to withstand a national economic downturn relative to other real estate asset classes.

While increasing storage occupancy and revenue trends may not continue in 2009, they have helped alleviate some of the property-value declines that worry investors. As reports continue to appear showing that CRE values are in decline, just remember that everything is relative. **ISS**

Author: HFF LP (Holliday Fenoglio Fowler, LP)



Self-Storage Terms and Definitions



We tend to toss around words that relate to the self-storage business—class-A property, cap rate, NOI—but not everyone may know what they mean. In addition, software applications may use different terms for the same calculation. Here is a Storage 101 review of some common industry terms.

Actual rent: The sum of actual rental rates for occupied units. (Does not include fees, insurance, merchandise, etc.)

Break-even occupancy: The occupancy level at which a facility's expenses and revenue are equal. A facility will exceed break-even and show a profit when gross rent exceeds expenses plus debt service.

Capitalization rate: A measure of performance and an indication of value. The expected rate of return on a property. A cap rate is expressed as a percentage. A cap rate of 10 can be expected to return an annual return of 10 percent.

NOI / Cap Rate = Value

Example: $130,000 / 8 percent = $1,625,000

Conversion: The process by which an existing structure is re-designed for use as a self-storage facility or the process of converting units to support supply and demand. (Example: a former Kmart store is transformed into a self-storage facility, or two 5-by-10s are reconfigured into a single 10-by-10 unit by removing a wall.)

Concessions: Dollars not received as a way to obtain more rentals, i.e., discounts, free truck or unit rental. (Remember, every dollar not collected reduces the value of the facility.)

Closing ratio: The number of prospect leads or contacts needed for a rental. For example, if you have 10 people who contacted you for a unit and eight rent, your closing ratio is eight divided by 10 or 80 percent. Track your own closing ratio and the store's to see how you measure up.

Storage facility property classifications: Many experts will grade a potential project's competitors by weighing factors such as appearance, accessibility, visibility, security features and whether there is onsite management.

Class-A properties: Properties featuring above-average design and construction quality. They generally command the highest rental rates and have a superior location in terms of desirability or accessibility.

Class-B properties: Properties with adequate design and construction quality, which may not be reflective of current standards and preferences. These typically command average rental rates and are generally well-maintained and desirable to most tenants.

Class-C properties: Properties that offer adequate functionality but few amenities. Their physical condition is acceptable but may have some deferred maintenance. They generally command below-average rental rates and are usually in less desirable locations.

(A property's classification can change with renovations and upgrades or neglect.)

Deferred maintenance: The overall impact of postponing or neglecting maintenance and periodic repairs. This saves money in the short run but frequently results in shortened asset life or more costly repairs later. This is different than preventive maintenance.

Due diligence: The process of investigating and obtaining the details of a situation, often in conjunction with the purchase of real estate (Doing your homework).

Debt service: Payments made on the facility's loan. This is the interest, fees and principal due to the bank on a monthly basis.

Diversification: The technique of reducing risk by investing in different things.

Economic occupancy: The occupancy in terms of dollars compared to gross potential.

Gross Rental Income divided by Gross Potential Rent = Economic Occupancy.

Feasibility study: A study to determine the likelihood of the success of a project. It usually contains assumptions on rates, market conditions, construction costs, etc. It is one part of the due diligence process.

Generations of storage facilities: To date there are three generations of self-storage facilities:

First generation 1965-1988: Metal buildings with rows of garage-type storage in industrial parks or on other land that otherwise would have no real use. Usually no climate control.

Second generation 1989-1993: Characterized by improvements such as better locations, paved driveways, security technology, computerization, climate control, etc.

Third generation 1993 to present: State-of-the-art facilities in prime locations with high drive-by-traffic counts, excellent visibility, signage, temperature or humidity control, business-oriented areas. Some are designed to resemble upscale hotels or office buildings. Offer ancillary services such as wine or firearms storage, boat/RV storage and upscale amenities such as WiFi and business services.

Gross income: Income minus expenses before taxes.

Gross potential rent: The total dollar amount the facility would gross each month if every unit were rented at the street rate.

Lease up (aka absorption period): The period of time needed to fill a self-storage facility. A storage facility is usually considered fully rented or leased up at 85 to 90 percent. Occupancy must be held for three to six months.

Market radius: The area surrounding a self-storage facility in which the facility is competing for customers. According to the National Self Storage Association, 95 percent of the average facility's tenants either work or live within a 3- to 5-mile radius. As the number of facilities increase, the radius decreases. Additionally, the density of the market area and natural barriers such as bridges, bodies of water, freeways, etc., also have an impact on a facility's market radius.

Net operating income (NOI): Income minus expenses before taxes or debt service.

Net rentable square feet: The number of square feet of the facility allotted for rental units. (Does not include hallways, office, lobby or common areas, maintenance or electrical rooms, etc.)

Physical occupancy: The number of square feet of the facility that is rented.

Potential rent: The dollar figure the facility is expected to bring in each month based on the current tenants and current rental rate. (Assumes everyone pays their rent.)

Traffic reporting or lead sourcing: This has a number of different names but the point is to track and measure where your leads and tenants originate, answering the all-important question: "How did you hear about us?" question. Tracking is critical to determine what is working in your marketing plan so you can be more efficient with your advertising dollars.

Unit occupancy: The percentage of units rented at a facility. Example: Total 700 units with 546 rented. 546 divided by 700 = 78 percent unit occupancy.

Vacancy rate: Percentage of the facility not yet rented; the opposite of occupancy. (Example: Total 700 units with 546 rented = 78 percent unit occupancy, 22 percent vacancy rate. 700 divided by 546 = 154; 154 divided by 700 = 22 percent.)

You will encounter these and many more terms in your self-storage career. Learn them, understand them fully, or ask others to explain them clearly until they make perfect sense. Remember: Knowledge is power. Understand the above terminology and it will empower you and your self-storage business. **ISS**

Author: Linnea Appleby, PDQ Management Solutions Inc.

The Ins and Outs of Negotiating Acquisitions

Self-storage is a booming $21 billion business nationwide. It has nearly doubled in size during the past decade, with one in 11 households renting space in nearly 50,000 U.S. facilities. No other business offers the return and the ease of ownership of self-storage.

People generally enter the business via two routes: they buy land and develop a new facility, or they buy an existing facility. With the difficulty in finding suitable land, obtaining the correct zoning and securing financing, purchasing an existing facility is often the easiest, quickest and least risky way to get started.

Once you find a site you want to purchase, how do you negotiate the contract? The following are pointers on what to include in the purchase agreement to protect your rights as a buyer.

Buyer Representation

Besides making sure you get good value for the purchase price, it's important to have the right representation during contract negotiation. Typically, the seller is the only one represented by a real estate agent, and so the contract may lean in the seller's favor. To counter this advantage, consider engaging an experienced self-storage broker to represent your interests. Generally, there is no cost for this service, and it could save you from spending too much and experiencing potential problems.



Many purchase contracts prepared by a seller's realtor lack provisions designed to protect the buyer. For example, the buyer may assume a certain item is included in the purchase price, only to find out later it was omitted in the terms. If there's something you want out of a sale, put it in writing; that's the purpose of the contract.

Important Deal Points

Below is a partial list of deal points to negotiate into a purchase contract. Speaking from experience, the more comprehensive you make the agreement, the less likely you'll have any surprises after the closing.

First, the contract should state what the purchase price includes, such as:

- Land
- Buildings
- Personal property such as computers, software, security systems, tools, golf cart, etc.
- Retail inventory
- Office supplies and marketing materials
- Tenant leases
- Deposits for utilities such as electricity, phone, waste removal, etc.
- Tenant deposits
- Tenant prepaid rent
- Name of the self-storage business (corporate identity)

The contract should state that the seller consents to a non-compete agreement. For example, the seller will not be an owner, investor, employee or consultant in any self-storage business within in a 5-mile radius or 15-minute drive of the site.

The contract should set a date for due-diligence items to be delivered to the buyer. You may also want to request that any delivery days past the due date add to the due-diligence time period. The deliverables should include:

- Monthly profit-and-loss statements for the past year, certified by the owner as correct
- Last three months of bank statements
- Last three years of tax returns
- Copy of the latest insurance binder
- Copy of a past title-insurance binder
- Property-tax bill for the most recent year
- Rent roll with unit numbers, rent amounts, unit sizes and move-in dates, certified by the owner as correct
- List of delinquent tenants with an aging report
- List of pre-paid rents
- List of any security deposits

- List of personal property to be included in the sale
- List and contact information for suppliers of key equipment, recurring maintenance, printing, supplies, etc.
- Sample copy of the standard lease
- Copy of the latest environmental study (phase I or II)
- Copies of all contracts relating to the facility, including those for Yellow Pages, pest control, software, security systems, waste removal, snow plowing, landscaping, etc.
- Copy of the most recent appraisal
- A full-size copy of most recent "as built" survey
- A copy of all building/site plans
- Copies of letters and permits, including Certificates of Occupancy for each building, showing the municipality's approval of use
- Copies of any cell-tower leases
- Copies of any billboard leases
- Copies of commercial-tenant leases
- Dates of break-ins for last three years with police-report file numbers

Your contract might include other important issues such as how the deposit is handled and financing contingency options. It might address whether the facility is being sold with room for expansion, the use of 1031 exchange as part of the acquisition, or whether you're buying the facility based on pro forma versus historical financials.

Representations and Warranties

In addition to essential deal points, consider what representations (reps) and warranties you will request from the seller. These are formal statements referring to past or present facts or matters essential to the contract. Your agreement may also provide that if the statements are wrong, you have certain remedies, such as the right to a partial return of the purchase price.

The idea is for you to identify the critical facts, circumstances and assumptions on which you rely when deciding to enter the contract. The reps and warranties section of the contract requires the seller to expressly state certain facts or matters and stand behind them—or pay the price for breaching them.

Many state-approved commercial real estate forms contain a standard set of reps and warranties. But don't hesitate to add whatever you feel is necessary. Here are some items to consider:

- The seller has full power and authority to execute the sales agreement and carry out the transactions contemplated by it.
- The seller has promptly prepared and filed all federal, state and local tax returns and reports as are and have been required to be filed, and all taxes shown thereon to be due have been paid in full, including but not limited to, sales tax, withholding tax and all other taxes of every nature.
- The seller has good and merchantable title to all of the business' properties and assets.
- At closing, such properties and assets will be subject to no mortgage, pledge, lien, conditional sales agreement, security agreement, encumbrance or charge, secured or unsecured, except for those taxes which shall be pro-rated as of the date of closing.
- The seller represents that all items provided in the due-diligence list are correct to the best of his knowledge.
- The seller represents and warrants that all revenue-generating activities are approved under the current zoning regulations for the property.
- The seller is not aware of any new competition coming into the market (within a 5-mile radius) other than what is listed as an attachment.
- The seller has no knowledge of pending or proposed zoning changes other than what is listed as an attachment.
- The seller has no knowledge of future road changes, condemnations or easements that may affect the property other than what is listed as an attachment.

Yellow Flag or a Deal-Breaker?

Some of the deal points, reps and warranties listed above are more important than others. Whether there are some deal-breakers in the list really depends on the overall contract terms, price and upside potential of the business.

Don't lose sight of what you're trying to accomplish, and don't shoot yourself in the foot trying to negotiate the best contract ever written. If a seller refuses to provide a due-diligence item or won't agree to one of the reps and warranties, it may indicate a problem. At the least, it's a yellow flag.

For example, let's say the facility you're purchasing has revenue from outdoor boat/RV parking included in the net operating income. If you find out, after negotiating a purchase price, that the property is not zoned for this use, you're at risk of losing that revenue and may be over paying for the business. You may still want to complete the deal, but at a minimum, you have an opportunity to re-negotiate the price to reflect the potential loss of revenue being generated from a non-approved use.

Each Acquisition Is Unique

Keep in mind the above list of contract considerations is not comprehensive. Even if you were able to include all of these points in your purchase agreement, it wouldn't guarantee a trouble-free transaction. Each acquisition is unique and will have its own set of issues and opportunities.

The bottom line is, as a buyer, you should have representation in the purchase of your storage business. The real estate broker who represents you should not only be qualified to help you evaluate the acquisition from a financial point of view, he should have the experience negotiate a purchase contract that could save you time and money. **ISS**

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5 Steps to a Great Appraisal

Life has changed from the days when you could walk into your lender's office with an appraisal in hand and get a loan. In today's lending environment it is the lender who decides the appraiser and you, the property owner, are often left out of the whole valuation process.

Your first knowledge of the appraiser's estimate of value comes when the lender tells you how much it is willing to loan. But it doesn't have to be that way. There are several steps you can take to become part of the process and assure there are no unpleasant surprises when the appraisal report ends up on the lender's desk.

Finding Value

It is the appraiser's job to express an opinion as to the value of your facility. This is where you come into the picture—by working with the appraiser to assure he receives the historical operating performance data and any other evidence from the marketplace that supports his conclusions.

You should care about receiving a properly supported appraisal and not just the right estimate of market value, because your loan proceeds are often based upon more than just the market value. Often it is the appraiser's estimate of future net operating income (NOI) that limits loan proceeds. An appraiser could prepare a report resulting in a value conclusion to meet the lenders loan-to-value (LTV) ratio, but fails to meet the lender's required debt-service coverage ratio (DSCR).

Step 1: Prepare for the Appraiser

Your best opportunity to receive a proper appraisal is to meet with the appraiser in person at the beginning of the process. You'll need to bring every bit of information pertaining to your property (deeds, tax bills, income and expense statements, etc.), and spend time going over the data with the lender.

Reproducing the same documents for the appraiser seems redundant and a waste of time. However, going over many of the same documents with the appraiser can pay big dividends. This is your best opportunity to make sure the appraiser understands and appreciates your asset and how it is performing.

When the appraiser calls to schedule the inspection, ask which documents he needs in addition to what the lender has already provided. Be sure to have copies of everything you provided the lender just in case the information wasn't passed. For instance, you may have just had a successful real estate tax appeal and next year's real estate taxes will be lower. This could be easily missed by the appraiser.

Due to the nature of appraising, scheduling a specific time of day to make the inspection is often impossible so plan to be available all day. Let the appraiser know you have rental surveys or other data to share and he will make an extra effort to be on time.

Tip: Everyone's time is limited, but taking time to meet with the appraiser at the onset of the appraisal process can save you time and money. Bear in mind, it is not your job to convince the appraiser what your facility is worth—don't even try. However, it is your job to see the appraiser has all the necessary information regarding the subject. (For more on this, see the list below.)

You would be wise as well to ensure the appraiser also has every possible bit of evidence from the market, which will lead to a better value conclusion—one that is well supported by facts and not just opinions. Here is a partial list of documents your appraiser might request:

- Unit-mix report
- Itemized income and expense statements
- Subject sale history
- Current tax bill(s)
- Site plan
- Legal description or title report
- List of recent capital improvement

Step 2: Prepare for the Property Inspection

The appraiser will determine the quality of construction, current condition and competitive position in the market. The appraiser will look for items of deferred maintenance, such as buildings in need of paint, broken or damaged doors, cracks in the pavement, etc.

Regardless if a building needs a fresh coat of paint, the overall appearance says volumes about tenant appeal and what kind of owner you are. Just as body language says more than words, trash littering the property, dirty vacant units or bathrooms, overloaded trash bins, burned out hallway lights and fences in need of repair all say a lot about the kind of operation you're running.

The appraiser will compare your facility to your competitors, so take this opportunity to explain how it differs from the competition. For example, point out that all your units have ground-level access, or your closest competitor is only 80 percent occupied because it has too many small units, is harder to access from the busy street or driveways are too narrow for rental trucks. This isn't putting down the competition, it's stating facts that might not be so obvious to the appraiser.

Remember, you live with your facility day in and day out, 365 days a year. The appraiser has only a short time to learn everything about it and determine how it will perform in the future.



Step 3: Discuss the Competition

The appraiser will survey the competition to establish market rental rates, assess the level of concessions or discounts offered and determine the level of physical occupancy in the neighborhood. This all has a bearing on the level of tenant demand, so share your knowledge as to which facilities are most competitive and why.

Tip: Give your appraiser a list of competing facilities. This is your opportunity to point out who your real competition is so the appraiser doesn't use the mismanaged 30-year-old facility down the street to estimate rental rates and physical occupancy levels.

If there is a new facility in your neighborhood, don't be afraid to point it out. Better you point it out and explain your opinion of its potential impact than the appraiser reaching his own conclusions without the benefit of your input.

Step 4: Discuss the Financials

It's important to go over the operating statements with the appraiser. Make sure he understands each line item. Point out expenses that may not be a normal reoccurring operating expense, or one that is not typical of other self-storage facilities. Perhaps you chose to "expense" the recently installed new roof on a small building instead of capitalizing it. You need to let the appraiser know or he might assume your maintenance budget runs higher than it actually does.

Also, you may need to point out differences in management styles. For instance, perhaps you offer a discount to fill vacancies on a particular size of units to fill them. Otherwise the appraiser may assume the level of rent you are collecting is the best you can do.

You also need too address the issue of existing tenants paying below current market rental levels. Perhaps you have not pushed rental increases to existing tenants as much as you should. Point this out. That additional income is referred to as "hidden NOI" because it drops directly to the net operating income line on the financial statement.

Tip: If you know you will be applying for a loan in the next few months, start increasing the rent to existing tenants paying below market rates now so you don't have to deal with the issue later.

Make sure the appraiser understands that, nationwide, currently more than 65 percent of all facilities offer potential tenants some form of concession or discount. It has become a way of life for this industry. The appraiser should not become alarmed when learning the competition offers concessions.

Instead, take the time to explain how you use concessions or discounts to drive revenue and occupancy. Remind the appraiser that discounts result in renting a unit you may not otherwise have filled, and to a tenant who typically stays longer than intended.

Step 5: Share Your Knowledge of the Current Market Conditions

The appraisal process involves the use of historical data, including sales. The expansion and contraction of mortgage capital impacts value and, in the case of self-storage, that means there have been fewer sales. For that reason, the appraiser may need to explore other neighborhoods or markets to find evidence of investment parameters such as the price per square foot of net rentable area and cap rates.

Tip: If you have the opportunity to review the appraisal, make sure the sales used were recent and from comparable markets reflective of the level of demand found in the facility's neighborhood.

The self-storage industry will soon start to transition from a weakened market to an improving one, and reliance upon older sale prices could cause the appraised value to trail (or lag) the market. For this reason, it is a good idea to provide the appraiser with some current listings if possible.

Part of your job is to make sure the appraiser understands how well self-storage is performing despite all the bad news in today's economy. If you are like most owners, your net income has either slightly declined or not at all. Make sure the appraiser knows self-storage values have not declined like the many other types of real estate because most facilities are performing well.

Let the appraiser know self-storage cap rates have not increased as expected because most facilities are still performing at or above the owner's expectations. Listing prices have not declined as anticipated because of continued good facility performance.

Look for Discrepancies

You can choose not to be a part of the appraisal process and, perhaps, you will get lucky. But remember, luck is no accident; it is the result of diligence. The appraiser's task is to measure and mirror the expectations of informed market participants. You can help assure that happens by providing your insights and a sense of your market's current conditions.

Ask the appraiser to call you when the report is finished, but before it's submitted to the loan organization to see if there are any major discrepancies between the facility's actual operating income and expenses and the conclusions reached by the appraiser.

Remember, the appraiser cannot discuss conclusions, but if there were big differences, this would be the time for the appraiser to understand why and to be prepared to support his conclusions with market evidence. **ISS**

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Is it the Right Time to Buy Self-Storage?

Cap rates are up, prices are down, interest rates are just a little higher, competition is down and, best of all, cash-on-cash returns—the Holy Grail of investing—are up!

It certainly appears that some real opportunities exist for experienced self-storage owners to pick up some nicely priced, quality built, well-occupied properties, earn a handsome cash-on-cash return and yet have significant upside potential when the market improves. However, it is not a time for amateurs. One really needs to understand the self-storage business to be sure that the underlying business value is there.

Many of you may ask, "Is this the bottom?" No one knows for certain but we know one thing for sure: This isn't the top!

If you do have your eye on a property, many other questions need to be posed:

1) Will the facility maintain economic viability well into the future?

2) Can it be improved or better managed to secure long-term viability?

3) Is the cash-on-cash return significant enough to warrant the current investment?

4) Do you have the experience and knowledge to recognize the risks and potentials of the investment and the talent to manage the property in an effective manner?

As you answer these questions, listen to both your "gut" and your "brain," making sure they both answer "yes" before you decide.

A Closer Look

To gain better insight, let's look at some numbers that illustrate the recent history of self-storage real estate.

	Early 2007	Mid-2008
Revenue	$300,000	$300,000
Expenses	$100,000	$100,000
NOI	$200,000	$200,000
Cap Rate	7.25	8.5
Value	$2,758,620	$2,352,941
Loan to Value	80%*	70%*
Loan Amount/Rate	$2,206,896/6%	$1,647,058/6.5%
Equity	$551,700	$706,000
Debt Service Payment	$170,400	$133,400
Cash Flow	$29,600	$66,600
Cash-on-Cash Return	5.3%	9.4%

**Note: Cap rates and available loan terms are generally consistent with class-A properties in the respective time frame.*

Many of you may ask, **"Is this the bottom?"** No one knows for certain but we know one thing for sure: **This isn't the top!**

As you may have noticed in the example, the price is down, the loan is smaller, relative leverage has dropped and the cash-on-cash return on equity is up a whopping 77 percent to 9.4 percent—not a bad tax-sheltered return.

The only negative is the equity requirement is up, but then again, you are earning a great return on that equity, which is really the name of the game. And this comes with a nice advantage: If cap rates go back down, at the same income the facility will produce a $400,000 increase in value—a 57 percent return on your new larger equity.

Worst-Case Scenario

Take a moment to think about what will happen if this isn't the bottom and prices go down further. First, your returns will not change and all of the positive things mentioned before will remain true. Not a bad outcome for being partially wrong on the timing.

There is one possible serious downside to waiting too long to see if prices go down further. Think for a minute about the potential of inflation going up and the Federal Reserve aggressively raising interest rates in earnest, or the banks really tightening up on lending and rates. Take it from a guy who had a construction loan ticking off at 19 percent in 1983: You won't like it at the bottom.

One last item: Very few people who own self-storage do sell because of changes in the market. They usually sell for personal reasons, such as retirement, relocation, illness, divorce, etc. This means many fine performing properties could be on the market at any given time.

Don't let this unique time in the real estate market pass you by. Be sure to do your homework and consult a self-storage expert to make sure the opportunity is right for you! **ISS**

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