

# »» A Closer Look at the Capital Markets

## Self-storage remains an attractive investment during the Great Recession

By John R. Nikolich

**Let's not sugarcoat it:** Capital markets are ugly and have been since September 2007 when the debt capital markets shut down. The bad news is the ugliness has persisted for three years. The good news is we're closer to the end than the beginning.

In an article published in 2006, I wrote, "In real estate, there always seems to be a disconnect between 'uses of capital' and 'availability of capital.' Currently, capital is readily available, but there is a shortage of desirable investment opportunities. The only sure thing is that prevailing conditions always change, and it is likely that there will be an abundance of investment opportunities but a dearth of capital, in the not-too-distant future, as a result of some unforeseen event that draws capital away from real estate."

Little did I imagine how prescient that observation would be. Over the past three years, there's clearly been a lack of capital, but there has also been a lack of investment opportunities. Lenders learned in the 1990s that once they took over properties, they experienced an additional 20 percent discount in pricing from vulture investors who understood the banks needed to liquidate assets quickly due to their lack of operational expertise.

Today, lenders have been reluctant to take back properties and decided to continue extending loans, hoping for a better day. This is better known as "pretend and extend." Additionally, floating-rate loans, benchmarked to 40-year-low interest rates, have kept struggling real estate owners alive for the time being.

### Access to Capital

Beginning in 2009 and continuing through 2016, approximately \$2 trillion in commercial real estate debt will mature. While the debt side of commercial real estate has been held together with Duct tape, it too has its breaking point and we're almost there. Lenders have significantly discounted real estate loans internally, and with the recent valuation rebound off the 2009 lows, once the banks are able to liquidate properties for a price higher than carrying value, they'll be able to book a "profit," which will result in markedly improved transaction volume. Soon opportunities will be on the horizon and access to capital will be critical.

Although focus is typically on cost of capital, we need to keep in mind that the lowest cost of capital is irrelevant if the going-in basis is wrong. If a property was purchased at the peak (2004 to 2007) with a 5 percent



interest rate on the debt, even if zero percent interest rate debt was available, it wouldn't make up for the 20 percent to 30 percent reduction in value. Availability of capital will be critical going forward—better to have the appropriate going-basis with a higher cost of capital that can be optimized over the next few years as capital markets recover.

### Self-Storage Tested

The self-storage industry is experiencing its first real test since its beginnings in the early 1970s. At the time, the economy was in terrible shape, but self-storage was in its infancy and demand exceeded available supply; therefore, the deep recession didn't have much impact on the sector.

With the evolution of self-storage and the amount of development experienced over the past 10 years, the industry is mature and experiencing its first true economic test. It's a common belief that self-storage prospers in good and bad times. In good times, the population is more mobile, producing high utilization. On the flip side, when there's an economic downturn, people downsize their homes. While they may part with their residences, they're less inclined to part with their "stuff," which bodes well for the industry.

Operationally, storage has experienced a numbers of peaks and valleys since the Great Recession began in 2008, and the industry has weathered the storm relatively well when compared to other real estate asset classes. In the office sector, when the giants fall, they fall hard (we aren't quite there yet), and the retail sector is under demolished. The United States has 26 square feet per person of retail space while Europe has 2 square feet per person. That's right—no typo. There could be some interesting conversion opportunities coming.

Lately, we've seen storage occupancies dip below 85 percent and, in some instances, dangerously close to 80 percent. Breakeven occupancy, inclusive of debt

payments, is at 65 percent, so established properties are not in danger of defaulting on a cash-flow basis. However, the margin of error is becoming increasingly uncomfortable as consumers are reviewing personal expenditures as incomes decline. It's important to monitor operating performance for signs of consumer weakness and to closely watch the net move-in/move-out ratios.

### Self-Storage Resilience

Five years ago, self-storage began transitioning to an institutional asset class with all the positive attributes of each core real estate sector (multi-family, office, retail and industrial) without any of the disadvantages. Storage debt default rates were among the lowest in commercial real estate, and storage was the darling of investors. That all changed with the onset of the Great Recession, and institutional investors retreated back to what was familiar and comfortable—core real estate. Unfortunately, a number of investors got into the storage industry during 2004 to 2007 at peak valuations, so while operationally storage has held up well, in hindsight, their timing wasn't ideal.

While some investors have fled self-storage, they are beginning to recognize and appreciate the resilience of the sector and the stable operating performance it delivers, and renewed interest is emerging. Another interesting source of capital that has emerged for storage is retail investors.

In the real estate downturn of the early 1990s, many real estate companies were faced with two options: filing bankruptcy or going public as a real estate investment trust (REIT). Retail investors were the key to the public REIT market's success. They were attracted by strong dividends and were able to invest in REITs at a low-cost basis and participate in asset appreciation, a nice twofer.

Meanwhile, institutional investors who put money in real estate in the late '80s were the sellers. REITs transitioned from

retail to institutional ownership from the mid-1990s to the mid-2000s, and private institutional real estate ownership also increased significantly as real estate became a desired asset class, subsequently driving up pricing. Many investors are currently licking their wounds and selling off real estate assets again, and retail investors are positioned to pick up the pieces and get in at the right basis at the bottom of the cycle. *Déjà vu?*

Self-storage doesn't possess the shortest lease (that distinction belongs to hotels, with a one-night lease), but it also doesn't experience the immediate drop-off in demand of the lodging industry. While inflation isn't a concern in the near term, with real unemployment hovering close to 20 percent, eventually inflation will appear. When it does, properties with shorter lease durations will have the ability to adjust rates quickly to take advantage of increasing prices and act as an effective inflation hedge.

As long as storage continues to weather the storm, investors will remain attracted to the sector and be eager to provide capital to leading operators who have a strong and deep management team and a demonstrated record of success and are willing to co-invest alongside outside investors. Stay tuned; things will get interesting soon. Be prepared to take advantage of compelling investment opportunities.

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