

# Simple Answers to Finance Questions

**A** major factor in the profitability and success of a self-storage facility is mortgage financing. Balancing your long- and short-term goals can be tricky—but necessary. Here are some common questions and answers to guide you through the maze.

## **What is the best type of financing for new builds?**

The first step toward moving your storage facility from groundbreaking to grand opening is often a construction loan. The financing is typically through a floating-rate mortgage and may require a personal guarantee; it may also have a “mini-permanent period” that will take effect at the completion of construction.

A construction loan will provide 80 percent to 90 percent of a project’s development costs. These loans are often provided by local banks, but brokers bring national lenders to the table, providing options not available



from local institutions. One attractive element that brokers can offer is a fixed-rate construction loan with a fixed-rate term after closing, removing the risk of rising interest rates during critical construction and lease-up stages of your new site.

## **What key financial decisions should an owner consider before making extensive improvements or expanding a project?**

Owners should always evaluate long-term business goals before improvement or expansion projects. If you add to the property, what economies of scale are there? How much will labor costs

decrease by automating? Another element to consider is time. When you put money in, how quickly will you get a return on your investment?

Let’s say the storage owner wants to sell in a few years. By expanding from 200 to 400 units, the business will attract the attention of larger and more aggressive buyers, which raises the property’s value. Owners of quality self-storage facilities can tap into better rates when refinancing.

Keeping the facility well maintained and operating productively is important, but sometimes a major capital investment can be rewarding. In doing an analysis, understand what may or may not be considered an “improvement” by customers. When thinking about changing the dynamics of your facility, you must study how the market is evolving and changing. Will the improvements increase occupancy and rental rates? Another critical factor is whether or not the owner is looking to sell or refinance the property in the near future.

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## What financing options are available for an existing facilities?

Dramatic changes in financing storage facilities in the last 36 months have produced great opportunities for property owners. Right now, national investment banks, pension funds and life insurance companies are lending money at very low interest rates. By locking in a low, fixed-interest rate for up to 10 years, a borrower can avoid the interest rate risk incurred when taking out a floating-rate construction or rehab loan at a local bank. Rather, an owner can pull cash out of the existing structures and use proceeds to upgrade the facility—under a long-term fixed rate of approximately 6 percent in today's market with no personal guarantee.

Storage facilities are considered a strong asset class by the investment community, and the values of these properties have increased accordingly. When interest rates were higher, properties were valued using 11 to 12 percent cap rates; now they can be as low as 7 percent. Therefore, a property valued at \$3 million a decade ago is now worth \$4 million. With that \$4 million you can borrow up to \$3.2 million. So, if you only owe \$2 million, for example, you can borrow up to \$1.2 million in extra proceeds to reinvest in the subject property, invest in another asset, or diversify into another asset class. Thus, by tapping into the equity in a stabilized property, a borrower can cash out a refinance and use the proceeds to improve the existing facility.

Every owner eventually will have to make key financial decisions about building and grounds improvements such as a new security system, interior renovations, better lighting and landscaping upgrades. The long-term viability depends on the owner taking steps to keep it competitive in the market.

## Available Loans

**Conduit or CMBS loans** have the most favorable rates and terms but include stipulations some borrowers may find unacceptable. On the positive side, conduit loans offer non-recourse debt, a 30-year amortization, and the most aggressive loan proceeds. They also require complex loan documents and supporting paperwork, along with in-depth surveys and premium insurance coverage. Additionally, the prepayment penalties for a conduit are not constant. These loans have defeasance prepayment penalties that fluctuate with bond-market changes.

**Portfolio lenders** write mortgages they intend to keep on their books; these tend to be more flexible and are usually non-recourse. However, in exchange for a more streamlined loan process and simpler loan documents, the rate is slightly higher than conduit transactions. They use several different prepayment methods including step-down prepayment penalties. These loans are an excellent fit for many borrowers.

**Construction and bridge loans** typically have floating rates and are designed for properties being built, rehabbed or taken over by new management. Interest rates may be slightly higher due to the short nature of the loan term. Prepayment penalties are minimal with bridge loans because they're designed for short-term, turnaround transactions that the borrower can quickly refinance with a long-term fixed rate loan after adding value to the asset.

### Any pointers for refinancing?

There are three basic goals in refinancing: cashing out equity, eliminating interest-rate risk, and lowering monthly costs. As your property's value appreciates, so does the opportunity to pull out equity. In terms of recouping equity, can you earn a better return on cash if you put it in another investment? Will you be able to diversify your personal net worth and assets?

Any savings earned by refinancing at a lower rate is important, but you should also think about the remaining time on current loans. A new loan may not lower your rate, but if your current low rate expires in two years, you may want to lock in for 10 years with a new mortgage now while rates are still low.

### How does an owner narrow down the choices?

Owners can review three basic options when choosing the perfect financing fit for a project: conduit loans, non-recourse portfolio lenders and construction/mini-perm/bridge loans. Smaller firms are often more nimble in helping borrowers through the mortgage process and tailoring the loan to specific needs. You will want to choose someone who knows the self-storage industry; understands your facility's financial goals, typical income and expense levels; has reviewed the business model; and has evaluated the true value of your facility and comparable self-storages.

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