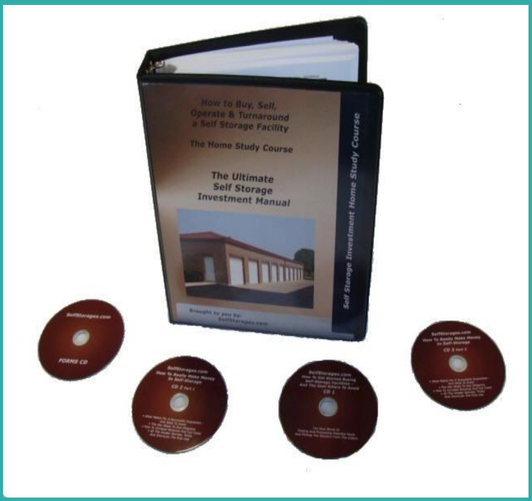
SELF STORAGE MONTHLY

July 2012



The Self Storage Home Study Course includes a manual with your 30 days of due diligence that will teach you how to BUY, SELL, OPERATE, AND TURNAROUND any Self Storage Facility.

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Memo From Frank & Dave

The self-storage industry continues to recover from serious issues felt by the U.S. economic collapse. For 2011, self-storage REITs outperformed all other real estate REITs. Occupancy returned to strong, historical levels for many operators, with Public Storage occupancy averaging over 91% in the 3rd quarter of 2011. How is this possible? Part of the strengthening is due to instability in customers' lives – people storing their goods while they try to get their lives back together, move to a new town, move-in with family members, etc. But a bigger part may be due to the reigning in of new self-storage construction. In 2010, for example, there were only around 250 new facilities built in the U.S. That's compared to the 8,700 facilities built over a two-year period starting in 2004. As long as the industry can continue to keep new construction at a minimal level, the existing self-storage facilities can continue to strengthen. And with real estate lending continually tight, it looks like new construction will be held at bay for a lengthy period.

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HOW TO BUY A NON-PERFORMING NOTE ON A SELF-STORAGE PROPERTY

When a self-storage facility defaults on its mortgage – and fails to cure the default – then the holder of the note has a tough decision to make. They can work with the borrower and try to come up with a payment schedule that the borrower can afford, they can foreclose on the property and sell it to another user, or they can sell the non-performing note to a third party. More and more, lenders are taking the third route. So how can you buy a non-performing note and not get taken advantage of.

Question #1: Why did this facility fail?

Before you even think about buying a non-performing note, you need to understand why the default is happening. Sometimes, it’s simply a case where the borrower paid too much for the facility and, no matter how good an operator they are, there is no way to afford the mortgage. How did they get in that position? Sometimes it’s that they did insufficient diligence on the actual expenses a facility has, or maybe they used unrealistic expectations on occupancy or rent increases. But it’s vital that the note buyer have a 100% understanding of why the facility has been unsuccessful. Economic factors such as overpaying are one thing. But it’s also possible that the real problem is way beyond your control to fix: a bad market, obsolete unit sizes, etc. In that event, you would simply be inheriting the current owner’s problems if you buy the note and foreclose – and you would soon fail just as they have.

Question #2: Is there a reason that the bank does not want to foreclose?

Don’t always believe the B.S. from the bank that they have not foreclosed because they haven’t had the time. Sometimes, there is a good reason they have not foreclosed. The answer can often be environmental contamination concerns. If the borrower bought the property without conducting a Phase I Environmental – and the bank believes that the property might have environmental clean-up risk – they may not want to foreclose, to make sure that they do not get in the loop as a titleholder and, as a result, responsible for the remediation. This is an easy concept to fix: you must get a clean Phase I report before buying the note. With environmental clean-up bills ranging up to $100 million, you definitely never want to buy a note without getting this done. Another issue is there are any additional liens and judgments that might impact your ability to take possession of the property if you do foreclose. You need to get with a title company to review this before you buy the note, to make sure that you are safe.

Question #3: Will the deal still make sense if the borrower comes current?

Not all non-performing note purchases end up in foreclosure. Sometimes, the borrower brings the mortgage current. Even if they have missed their official cure period, as a lender it might be a difficult case to go to court if the borrower is current on payments. This means that you have to buy the note at a high enough discount that the deal still makes sense as a note holder. If you buy a self-storage facility note that was paying 8% interest – and you buy the note for 50% of face value – then you have 16% effective interest. That’s not bad, but you might have five to ten years left to run on that note, and that might not be the type of investment you are seeking. The most disastrous effect is in cases in which the note buyer pays nearly 100% of face value, because of a perception that the facility is really worth much more than the note. In that case, not only would you be locked into the bank’s low interest rate, but the borrower might be able to refinance or sell before the note comes due, and your investment is a complete failure; you never ended up with the facility after all, and made no money along the way.

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Question #4: Will the borrower fight the foreclosure?

This is perhaps one of the greatest risks you have in buying a non-performing note. If the borrower fights your ability to foreclose, the end result for you, the note buyer, can be catastrophic. Here's what can happen in real life. Let's say that the borrower files a suit claiming that the note was flawed and that the lender had made verbal promises that gave the borrower more time to pay, or a lower loan amount, etc. Now you will have to go to court to prove your position of being able to foreclose. As a result, you now have to come up with significant legal fees and, in the interim, the borrower will suspend any and all payments on the loan. These kind of cases can take years to work their way through court and, if they lose in round one, the borrower will almost certainly appeal to a higher court. Given the recent poor performance of mortgage companies in court – and some of the resulting case law – winning may be a lot harder than you think. And if you ultimately prevail, the borrower can then file for bankruptcy and tie it up again. The only way to have any peace of mind in buying a non-performing note is to go to the borrower and see if they would sign a deed in lieu of foreclosure (basically an assignment back to the note holder) in return for cancelling the personal recourse provision, or possibly a small cash payment. We, personally, will not buy non-performing notes unless this has been accomplished. A competent attorney can write a "deed in lieu" for you to present.

Question #5: How good a deal is it, anyway?

Because of all the risk associated with buying non-performing notes, you need a really great deal to make it a worthwhile risk. Forget lenders who offer 10% or 15% off face value. We're talking more like 30% to 50%, in our opinion. The numbers have to be hugely compelling for us to want to buy a note. Sure, buying a non-performing note can be lucrative, but it also has some landmines that make it a scary proposition, and not worth the risk without a big payday. We much prefer to buy foreclosed assets, as the risk has been taken off the table, and we can close it with the safety of a title company.

Conclusion

Buying non-performing self-storage facility notes is certainly one way to make a great purchase of a self-storage facility. But be aware of the risks, and take proactive steps to protect your investment. Don't step into the shoes of the defaulting borrower and find yourself in the same position.

IT'S A GREAT FEELING TO BE FULL

Our facility in Knoxville, Iowa is full. How did we get to be so lucky? Basically, through treating the customers' right, having a fair price, and aggressive marketing. A big part of the puzzle is that we bought it at an attractive price, and don't have to worry too much to make the note payment, so we are not trying to push the rents. In our opinion, nothing hurts your credibility and causes the customers to look for new space faster than when you get the reputation for continual rent raises. So we hold the rents where they are and only raise them on individual units when they go vacant. Just like the movie "Field of Dreams", when you offer a great value, the customers will come.

Quote of the Day

"About the time we can make the ends meet, somebody moves the ends".

≈ Herbert Hoover ≈

Hoover was President at the onset of the Great Depression. He was an engineer by trade, and could not come up with solutions that were not mathematical. He was replaced with Roosevelt, who was a verbal guy more than a numbers guy. He was able to bend the truth, with enthusiastic speeches, to make the U.S. public think that the ends would meet, when he knew they would not. The big difference was that Hoover quit when he saw that 2+2 would not equal 5. Roosevelt however, kept fighting - for three terms - to find a way to make it happen, or at least buy time until things went back to normal. Roosevelt is considered one of the best U.S. Presidents; Hoover one of the most forgettable. The moral is that if you have trouble with your self-storage facility, keep on trying to fix it - never give up. Eventually, the odds are in your favor that you will be able to get the ends to line up. If you quit, they never will.