THE EQUITY
SIDE OF CAPITAL

A Dollars And Sense Investigation *Worth Making*

By Benjamin K. Burkhart

You've heard that there are two sides to every story and you can't know the whole truth until you've heard both sides? The same rings true in our self-storage world. There are at least two sides to every deal. In this article, we'll look at one very important side of your deal: equity.

When preparing to finance a new business, most of us think in terms of debt financing: thep ortion of capital we raise through pledged collateral or stock in our business. This is often where most of the capital for a self-storage transaction is raised. However, the more challenging piece of any deal may be the equity side, which, typically must be in place before a corresponding loan can be secured.

Equity can be attracted in various forms, including contributions from friends and family, private investors, tenancy in common "syndication," and partnerships. As the owner, originator, and managing partner of a deal, your responsibility is broad. You must understand and predict the financial performance, define the appropriate deal structure, quantify returns, arrange debt financing, and acquire the appropriate level of understanding to present your deal to potential investors. Piecing together the equity in a deal can be tedious and rewarding at the same time.

Know The Deal Intimately

As you begin working toward acquiring or developing a self-storage property, your first step is to understand all aspects of transaction costs, financial performance, risks, market strengths and weaknesses, and potential exit strategies. Any potential investor will demand quality due-diligence. You must be able to quantify and qualify concretely all aspects of the deal.

Start with your own research. If you are developing a property, spend time getting to know your market, your competitors, the political landscape that may impact development approvals, and projected financial requirements and performance. There is no substitute for being in the market, seeing the traffic, analyzing the competition, and observing firsthand the mix of businesses and potential tenants.

The next step is to bring objectivity to the deal by engaging a team of due diligence professionals to further drill down into the market and quantify financial performance. Risks must be assessed, capital and operational costs must be quantified, and the market must be understood. Engineers, market consultants, management professionals, accountants, and attorneys can all add the level of objectivity investors will demand. Before approaching investors, anticipate the tough questions and be able to answer them.

Structure the deal to be advantageous to both yourself and to investors. You may or may not be willing to accept partners. You may require that you keep control of the overall deal. Define all the parameters of thedealyouwanttostructur eintheearlyphasesand make that your goal. Define how profits, losses, dividends, or preferred returns, if any, are to be allocated. Be sure to consult with a tax attorney on the best entity structure for attracting investors (LLC, S-Corp., partnership, etc.).

Know The Returns

Before investing in a mutual fund, you look at past and projected returns. You may size up the fund's broad market. You compare it with other funds. Is it priced high? Low? You examine operational costs and what the fund manager is making. This risk versus reward

Self-storage investment capital comes in two forms—debt and equity. By using the right mix of the two, you can enhance your overall returns.

analysis drives capitalism and our economy. At the end of the day, you buy something you are comfortable with and have analyzed according to your goals. This holds true in all types of investments.

Some investors look at every aspect of a potential investment as they analyze the risks and potential returns. Some look at the bottom line. Most have a threshold return they will accept. Your analysis of your self-storage deal must contain everything about financial performance that has impact on the investor. Expense ratios, market comparisons, cash-on-cash returns, leveraged returns, sources of debt financing, and upside potential must be presented in easy-to-understand, yet detailed formats.

On an acquisition deal, historical performance is typically easy to present. On a development project, however, projecting market absorption, operations expenses, and market strength can be tricky. Hence, have someone on your team who understands self-storage development and knows how to project these key variables. The depth and quality of your presentation is crucial in finding investors.

Acquisition Deal

Let's say, for example, that an originating investor has identified a $7 million purchase price for an established storage property. The equity required to do the deal is $1,450,000 and the remainder of the capital will come from debt. A simplified version of the deal may look like this:

Purchase price	$7,000,000
Acquisition costs (lender's & other fees)	$245,000
Total costs	$7,245,000
Equity	**$1,450,000**
Non-Recourse debt	$5,795,000

Let's assume the originating investor's equity in the deal will be $450,000, leaving $1 million to be raised from investors.

Tenancy In Common

Owners who share a fractional, undivided interest in a property are Tenants in Common (TIC). TIC arrangements or "syndication" may be an option for the owner in the above acquisition example.

The originator of the deal, or "sponsor," is the one who syndicates, or puts together the investors and the deal structure. The sponsor identifies the asset, performs the due diligence, secures the contracts, assembles the overall deal structure, procures the financing, and sells fractional equity interests to the individual equity investors. The sponsor is also responsible for developing the TIC agreement, which spells out in detail the responsibilities of individual TICs and the sponsor. This agreement also provides details of how day-to-day operations of the asset are to be managed. Depending on how a TIC deal is structured, the sponsor could manage the asset for a fee or simply act as an investor.

In the acquisition example above, a TIC structure could benefit all parties. The sponsor could sell $100,000 (6.8 percent) interests in the asset. These investors might be found in the sponsor's own network (think of those looking for 10-31 exchanges). Assembling TICs in this deal could include several smaller investors who otherwise might not have the time or expertise to put together a profitable deal, and the sponsor can benefit from participating in the deal and perhaps from a fee income outlined in the TIC agreement.

This type of structure requires strong information and well-documented due diligence. Investors want to know details of their investment, risks, and expected returns. Depending on the structure of your TIC agreements, a deal may or may not be federally regulated. Before assembling a TIC deal, be sure to review tax implications and federal and state regulations with a qualified tax attorney.

Development Deal

Building a new self-storage property has different dynamics than an acquisition deal. Site selection, market research, due diligence and feasibility analysis, real estate purchase, engineering, permitting, loan fees, and construction management are just some of the costs a developer will incur before the first profit dollar is ever made. See this example:

Land	$750,000
Development costs	$125,000
Loan fees	$35,000
Construction	$4,500,000
Interest	$200,000
Operating cash flow	$250,000
Total	**$5,860,000**

Joint-Venture Partnerships

Joint-venture partnerships are often found in development deals. In a joint venture, the duties of the partners must be clearly defined in the beginning, and ownership might not always be structured along strict lines of equity contributions. For example, someone might contribute the land, while another contributes financial strength and backing required by the lender. Whatever the duties of each partner, the key to these relationships is to be very clear—up front. Define, in writing, who makes important decisions and how ownership is divided and shared.

In our development example, it will take approximately $5.9 million in capital to make the deal work. Assuming a 25 percent equity requirement, that equals almost $1,500,000. Partner A may contribute the land, free-and-clear, as his equity stake in the deal. Partner B may pledge up to $250,000 in cash as needed, and Partner C may make his contribution in the form of construction and operation management for a period of time, reducing shortfalls and construction costs. Ownership in this scenario might be Partner A, 50 percent; Partner B, 25 percent; and Partner C, 25 percent. Ownership and responsibilities must be negotiated and well-defined to keep everyone happy in the long run. When negotiating a joint venture, be sure to account for all of your time and responsibilities as you contribute to the overall project.

At the end of the day, your capital is in two forms: equity and debt. Be mindful of how to generate the lowest cost of that capital, with the right mix of the two, and boost your overall returns.

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