

SUMMER 2007 SELF STORAGE INVESTOR SURVEY

CAUTIOUS GAME PLAN

by R. Christian Sonne, MAI, MRICS
 Managing Director, Self Storage Industry Group

A cautious game plan is the trend in the Summer 2007 Self Storage Investor Survey as players are watching the game from the sidelines, waiting for the capital crises to stabilize. Consequently, overall capitalization rates remain stable at 7.19% nationwide, an insignificant variance of 7 basis points from one year ago. Nevertheless, self storage remains a winner in terms of comparatively high returns accompanied by low loan loss ratios. As many investors are focusing on defensive play, the self storage market has stabilized.

Stabilization is a new play to self storage after a five-year downward trend in overall capitalization rates. The Summer 2002 Investor Survey indicated an average overall capitalization rate of 9.52% nationwide, declining to 7.19% five years later, an incredible drop of -233 basis points (-24.47%). Investor's greatest concerns are now related to financing and the cost of capital, because higher interest rates will cause capitalization rates to rise and values to fall. High leveraged owners are concerned about a double negative to cash flow: increasing interest rates and declining values.

The Summer 2007 Investor Survey was completed by the Self Storage Industry Group of Cushman & Wakefield through primary survey research (interview and Internet responses) of over 50 market players representing more than 100 million square feet of self storage property nationwide. Respondents are primarily involved in the self storage asset class and include investors, developers, managers, owners, brokers, and bankers and lending fiduciaries. The results, and five-year trend, are summarized in the Key Indicators table.

Swimming Naked?

Uncertainty was exacerbated this summer by concerns raised by rating agencies of relaxed underwriting standards in the CMBS market (in addition to losses in 2007 of sub-prime residential loans). These concerns led to as much as \$50 billion of unsold loans through Wall Street conduits. As Warren Buffet said, "It's only when the tide goes out that you can see who's swimming naked." (*The Economist*, January 14, 2006)

Fortunately, the strength of the asset class is a strong operating history characterized by relatively high returns and low losses. Consequently, capital will continue to flow to self storage from Wall Street conduits to Main Street Banks as well as life insurance companies and other private lenders. Investors who are relatively new players to the self storage game such as Simply Self Storage remain bullish on the asset class and have purchased over 200 facilities in the last few years. Other private equity firms prepare IPOs for potential new self storage REITs. Investor interest, both public and private, continues for self storage. Pricing

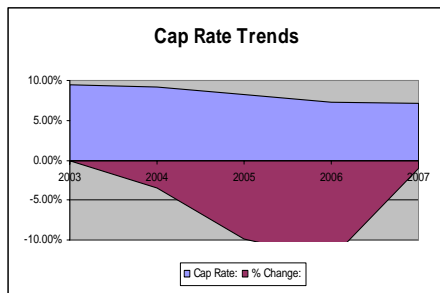
the risk of debt, given the events of the 2007 market, will likely rise. Moreover, due diligence is already being increased, led by pressure of underwriting agencies and "B" piece buyers. In the past, bank regulators have expressed concerns of real estate loans to Main Street banks and increased due diligence. Now, the market is responding faster than federal regulators. Even though the Federal Reserve has not increased the federal lending rate, the market has increased the cost or price of debt resulting in higher interest rates in response to concerns of due diligence and to entice buyers of the loans.

2007 Self Storage Investor Survey: Key Indicators					
	Summer 2007	Summer 2006	Summer 2005	Summer 2004	Summer 2003
Trade Area					
Range:	2.00 - 5.00	1.00 - 6.00	1.00 - 5.00	1.00 - 5.00	1.50 - 5.00
Mode:	3	3	3	1.5	1.5
Average:	3.33	3.14	3.3	2.8	2.82
Change:	6.05%	-4.85%	17.86%	-0.71%	—
Demand (SF per Person)					
Range:	3 - 10	2 - 10	3 - 12	2 - 12	2 - 8
Mode:	6	5	5	4	4
Average:	6.12	5.7	5.36	5.27	4.87
Change:	7.37%	6.34%	1.71%	8.21%	—
Capitalization Rate					
Range:	6.0% - 9.0%	6.0% - 9.0%	7.0% - 10.0%	7.5% - 11.0%	8.25% - 11.0%
Mode:	7.25%	7.00%	8.50%	9.00%	9.50%
Average:	7.19%	7.26%	8.28%	9.19%	9.52%
Change:	-7 Basis Points	-102 Basis Points	-91 Basis Points	-33 Basis Points	—
Absorption Time					
Range:	18 - 36 Months	18 - 43 Months	12 - 44 Months	18 - 40 Months	18 - 36 Months
Mode:	30 Months	30 Months	24 Months	24 Months	24 Months
Average:	32 Months	30 Months	27 Months	24 Months	23 Months
Change:	+2 Months	+3 Months	+3 Months	+1 Month	—
Marketing Time					
Range:	1 - 12 Months	1 - 6 Months	1 - 12 Months	1 - 6 Months	1 - 12 Months
Mode:	4 Months	4 Months	1 Month	1 Month	1 Month
Average:	3.66 Months	3.14 Months	3.06 Months	2.89 Months	3.95 Months
Change:	+0.52 Months	+0.08 Month	+0.17 Month	-1.06 Months	—
Profit (on cost only)					
Range:	10.0% - 25.0%	15.0% - 25.0%	10.0% - 30.0%	8.0% - 25.0%	8.0% - 30.0%
Mode:	18%	20.00%	20.00%	20.00%	20.00%
Average:	17.63%	20.13%	20.14%	17.10%	14.34%
Change:	-12.42%	—	17.78%	19.25%	—
Optimism Index (1 - 10)					
Range:	3.0 - 9.0	3.0 - 10.0	3.0 - 9.0	5.0 - 10.0	5.0 - 10.0
Mode:	6	7.0	6.5	7.0	7.0
Average:	6.25	6.5	6.65	6.9	6.83
Change:	-3.85%	-2.26%	-3.62%	1.02%	—
Market Conditions					
Under-Supplied	6%	15%	15%	3%	6%
Over-Supplied	52%	50%	50%	54%	47%
Equilibrium	42%	35%	35%	40%	47%
Strategy					
Buy	15%	18%	20%	27%	28%
Sell	60%	50%	60%	46%	26%
Build	25%	32%	20%	27%	30%

Anecdotally, clients of appraisal services are returning to quality. It is becoming less about turn times and cheap fees and more about the ability to analyze markets carefully and thoroughly. In this regard, our proprietary econometric model is now being utilized in all states in the country and in Canada. The model analyzes existing supply, but also forecasts demand based on demographic data. These tools of analysis have fueled a significant increase in our business and market share in 2007, a result of market concerns about due diligence.

Cap Rate Trends

While discounted cash flow use as a tool of analysis is increasing for the self storage asset class, approximately 75% of our respondents rely on direct capitalization. This is because self storage has no “below the line” or non-operating expenses, so net operating income and cash flow are virtually the same. There are no tenant improvement costs nor leasing commissions. Reserves and capital expenditures tend to be paid in the repairs and maintenance category of operating expenses over time. Cap rate trends are summarized below.



The Internal Rate of Return (IRR) or yield capitalization hovered around 10.00% using a ten-year model (un-leveraged). Capitalization rates represent a stable scenario or forecast going forward twelve months of net operating income. The

most dramatic change in trends is the percentage change in overall capitalization rates. Due to the rising cost of capital, the rate of change was literally off the chart in 2006; now the trend line shows an increasing forecast in the future. Depending upon interest rates, overall capitalization rates may rise as much as 25 basis points over the next year.

Loans remain widely available for the self storage asset class, and the survey indicates a typical loan in the 6.00% to 7.00% range with a ten-year term, 25-year amortization, a 75% loan to value ratio and a 1.20 debt coverage ratio as typical parameters. However, most surveyed believe interest rates will continue to rise throughout 2007 and debt coverage ratios will climb. To illustrate the impact of interest rates on overall capitalization rates, the simple Band of Investment is utilized as a tool of analysis. Parameters include a 75% loan to value at a 6.50% interest rate amortized over 25 years.

For purposes of analysis, the return to equity will be based on 4%. The analysis is summarized as follows:

Simple Band of Investment					
Component:	Ratio:		Rate:	=	
Mortgage:	.75	X	.0810	=	.0608
Equity:	.25	X	.0400	=	.0100
R_e	100%			=	.0708

A 50-basis-point increase in the interest rate results in an overall capitalization rate of 7.38% if the return to equity remains the same. On \$100,000 of net operating income, this results in approximately a -5% decline in value. However, equity returns often rise with capital increases because risk is a concern to all parties and concomitant herd mentality of investors. Additionally, leverage ratios may decline and debt coverage ratios increase, causing further downward pressure on asset pricing.

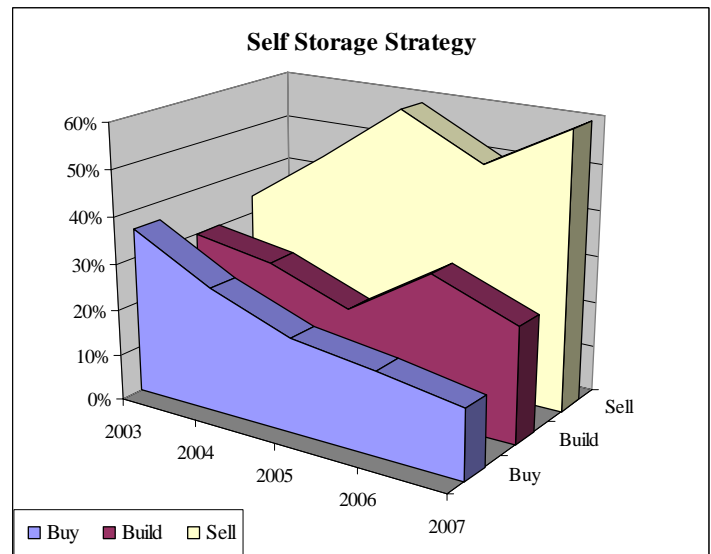
Most respondents continue to describe market conditions as “over-supplied” and the optimism index declined slightly to 6.25 (on a scale from 1 lowest to 10 highest). The decline in optimism is a slide

of nearly -10% from the peak optimism expressed in 2004. Similarly, the average absorption time increased by two months to an average of 32 months after completion of construction to stabilized occupancy and income. Marketing time or the time to sell a property increased to 3.66 months.

Cumulatively, the data reflects concerns of over-building and uncertainty about interest rates. In this regard, it is important to remember that self storage remains a local or neighborhood business. What happens in the local trade area is more important than national, regional or CBSA (core based statistical area) trends. Investors estimate an average trade area of 3.34 mile radius or a slight increase over last year.

Demand for self storage property, measured in terms of rentable square feet per person, increased to an average of 6.12 square feet per person. This reflects an increase from 5.70 in 2005, a change of +7.37%. Comparatively, the 2007 *Self-Storage Almanac* reports there are nearly 43,000 facilities nationwide that represent 6.40 square feet per person.

In terms of strategy, the sell strategy is at an all-time high. Investors expressed concerns about rising interest rates and lower cash flow. Additionally, some felt that values have been at an all-time high and are likely to decline in many areas. However, sellers are reluctant to sell for lack of better, alternative investments. Brokers indicate a “reality gap” between buyers and sellers, making deals challenging to close.



End of the Day?

To use the oft-quoted expression, “at the end of the day” self storage remains a core real estate asset with superior returns and low loss levels. The sophistication of due diligence will increase over the next year, further separating the market into winners and losers. Value and cap rate elasticity will be a function of local trade area metrics, and less a qualitative reaction of the general market. Market fundamentals by asset will determine who is swimming naked, not herd mentality. Clearly, investors will continue to store capital in self storage.

R. Christian Sonne, MAI, MRICS is Managing Director of Cushman & Wakefield’s Self Storage Industry Group, a nationwide real estate consulting team specializing in appraisal, feasibility, and market study of the self storage asset class.

Cushman & Wakefield of California, Inc.
 Valuation Services, Self Storage Industry Group
 2130 Main Street, Suite 130
 Huntington Beach, California 92648
 714-374-0334 telephone | 714-374-0336 fax
www.cushmanwakefield.com/valuation

