



SELF STORAGE SALES NETWORK

Market Monitor

"America's Premier Self Storage Brokers"

July 2004

Cap Rate Trends and Interest Rates

By R. Christian Sonne, MAI

A Brief Look at Cap Rate and Value

Forecasting economic trends, particularly in real estate, and interest rates is risky business. It's no wonder why economics is sometimes called the "dismal science." In the economics of self storage, the cap rate might be called part of an "abysmal" science because there is much confusion regarding cap rates. When I began appraising over twenty years ago, I took courses in capitalization theory and techniques from the Appraisal Institute. Instructors simplified the overall capitalization rate by reminding us that the rate was an overall return: to land and building; to mortgage and equity (more about these concepts later). For now, remember *IRV* or income divided by rate equals value:

$$IRV = \text{Income} \div \text{Rate} = \text{Value}$$

Still confused? The first thing to remember is that income creates value, and that it creates value in some ratio to the income. In real estate, that relationship of income to value is called a cap rate. A cap rate is simply the amount of money, defined as a percentage, which someone has to earn from the real estate to induce him to buy the property at a certain value. There are intricacies to the mechanics, but now you have the basic idea. Now think about the implications. A low return (cap rate) usually implies a higher value for the same income. Conversely, a high return usually implies a lower value for the same income. This ratio, or cap rate, is set by the actual buyers and sellers of properties for sale in the market – in other words, how much are buyers willing to pay for a dollar of income. The cost of money is important in this because most buyers borrow money to buy the property and they have to pay the cost of money before they get their return. Thus, if interest rates are high, the buyer needs to get a higher return from property so he can pay the loan and get a return higher than the bank is paying on savings. Conversely, if interest rates are low, the buyer can pay a higher price because his interest costs are lower and his alternative investments are not paying high returns.

The One "True" Cap Rate

There is often much discussion about the "right" cap rate. Borrowers complain appraisers use cap rates that are too high, banks complain appraisers use cap rates that are too low. In fact, there is not one "true" cap rate. Cap rate data is best analyzed on a stabilized basis, both in terms of physical and economic occupancy, often called a stabilized cap rate. However, properties often trade when occupancy is not ideal or stabilized and thus "Market Cap Rates" are adjusted to recognize risks, potentials and other property characteristics of individual properties creating a unique cap rate for each property. In the *2004 Investor Survey* completed by Self Storage Economics (June 2004 *Mini-Storage Messenger*), investors indicated a range of cap rates from 7.50% to 11.00% with an average of 9.19%

(stabilized). This represents a decline of 33 basis points from 9.52% represented in the 2003 *Investor Survey*. Determining the **RIGHT** cap rate for selling a property is a process that most owners need professional help assessing.

The Rising Tide of Interest Rates

Like the rising tide of the ocean, interest rates will rise over the next 18 months. This results in either a rise in the trend of cap rates, or a decline in the return to the equity component. Self Storage Economics forecasts a 2% to 3% rise in interest rates by the end of 2005, primarily due to inflationary pressures. As noted in *The Economist* (June 19, 2004, page 19), "...inflationary pressures in the United States include a GDP (gross domestic product) of 7% over the past year with a current inflation rate of approximately 3%, suggesting short term interest rates near 4%." In reality, as anyone with any kind of a savings account knows, the short term interest rates are around 1%. Long term rates are usually higher than short term rates. For example, 10-year rates are approaching 5% while the Fed short term rate is now 1.25%. This gap suggests the short term supply of money available is too high (or monetary policy supports an inducement to borrowing and spending). Moreover, with a record setting budget deficit near a half *trillion* dollars, the fiscal policy means the Government is competing with the private sector for the money supply." What is the result of all this economic stuff? The tide is rising and interest rates will shortly follow. To guess how much and how fast interest rates will move is a tough game, but you have my best forecast!

What Happens When Interest Rates Go Up?

Now you know – prices relative to income will go down in the long term if interest rates go up. This is a fact! Buyers won't buy properties if they have to pay high interest rates, and thus won't make a competitive return on their equity investment. The new question is what we mean by long term. One famous economist said, "...in the long term we are all dead." Ruling out that unkind option, prices can stay high for a period of time for a variety of reasons, which all reflect temporary imbalances in the financial and investment markets such as "no other good investment" or "irrational exuberance." However, in time the music stops and values and the money markets come into balance, just as they did in the stock market in 2000. In real estate, which is highly leveraged, the cost of money will highly dictate values because the buyer has to pay the loan before he earns a return on the money he invests, and he must have returns greater than he could get as a lender. Thus, buyers can only pay less for a reduced return in a market with higher competitive returns.

There are many other things that affect self storage values and, in my 1,000 word allotment, I can't begin to address all of them – or even do justice to the relationship of cap rates and interest rates, but I have tried to give you some insight into the mechanics and a perception that the relationship is real and not always beneficial. **Please see the enclosed Invitation to participate in a free Telecom Presentation to discuss these and other issues relating to operating in the new interest rate environment.**

R. Christian Sonne, MAI, is principal of Self Storage Economics, a data, research and appraisal firm specializing in the self storage asset class. Chris can be contacted via the company website at www.selfstorageeconomics.com.