

Special Report: National Self Storage Industry

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EVEN THOUGH INVESTORS REMAIN “CAUTIOUSLY OPTIMISTIC” REGARDING CURRENT MARKET CONDITIONS AND TRENDS IN THE NATIONAL SELF STORAGE INDUSTRY, VARIOUS CONCERNS EXIST, ACCORDING TO A SURVEY CONDUCTED BY SELF STORAGE ECONOMICS, LLC (SSE) DURING WINTER 2003. Chief among them is the risk of overbuilding, particularly in the western United States. Such a threat is likely the result of “self storage assets going from being viewed as the stepchild to the prince of real estate,” as one seasoned investor notes. Unfortunately, with strong returns continuing to lure a plethora of newcomers to this asset class, fears of market saturation are easily understandable.

This special report highlights the survey findings compiled by SSE. It also provides an overview of general market conditions, as well as trends and concerns relevant to this unique asset class. SSE completed the survey through tele-

phone interviews with over 50 respondents, including self storage investors (private, regional, and public), owners, developers, managers, brokers, analysts, and bankers from throughout the United States and one investor in Europe. In total, the respondents account for over 150 million square feet of self storage property.

DEFINING A TRADE AREA

Self storage is a “neighborhood specific” business. Consequently, market conditions in one neighborhood or trade area can vary significantly from another in the same city. When valuing a self storage asset, defining its trade area is almost as important as analyzing the market characteristics that comprise it. According to SSE’s survey, investors use trade area rings ranging from one to five miles in diameter and averaging 2.82 miles.

Since trade areas are not always easily definable, many survey participants noted that ring analysis could be

insufficient in certain situations. As a result, one participant suggested using a series of rings and irregular, polygon shapes in order to accurately define a trade area. After all, a trade area with a 1.5-mile ring may suggest an oversupply of space, while a 3.0-mile ring may indicate an undersupply.

HOW MUCH SPACE IS TOO MUCH?

Self storage demand, measured in terms of square feet per person, is very difficult to predict and varies per trade area. According to the survey, demand typically ranges from two to eight square feet per person and averages 4.87 square feet per person. Individual survey responses relating to demand are shown in Figure 1.

Since a good product, a favorable unit mix, and competent management do not typically compensate for a saturated trade area, oversupply represents the single most important detriment of project success. The main reason is that it can

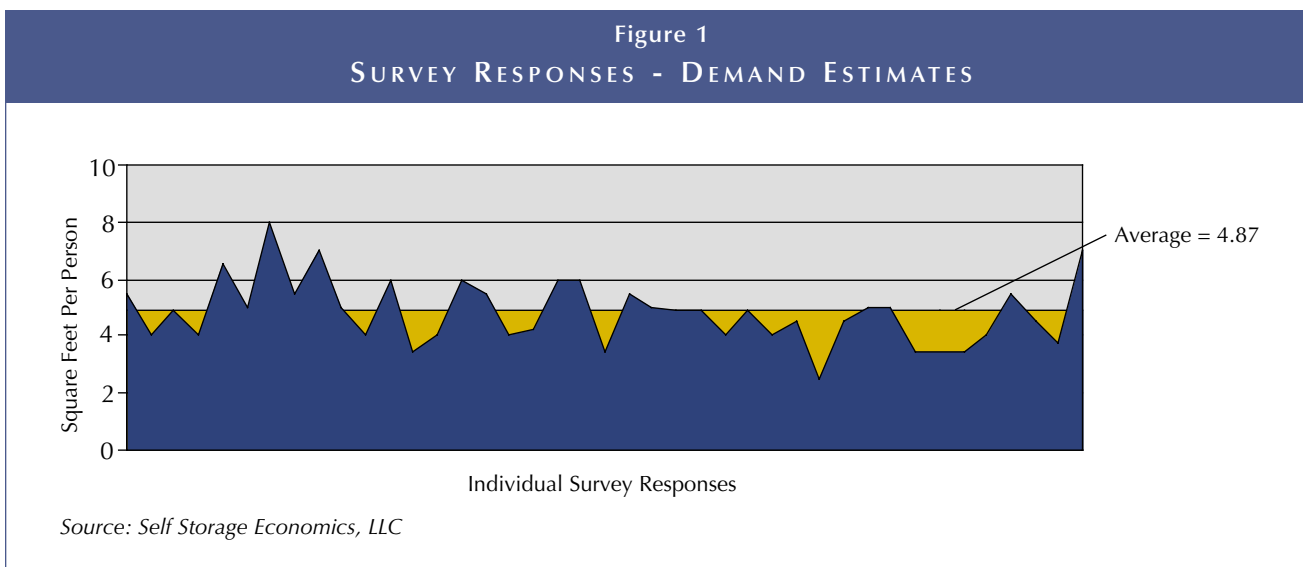
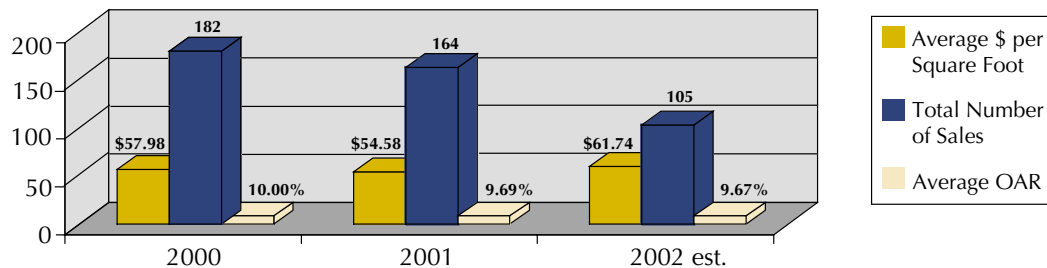


Figure 2
NATIONAL SELF STORAGE TRENDS



Source: CoStar Group; compiled by Self Storage Economics, LLC

take years for oversupplied markets to recover, particularly trade areas that experience slow population growth trends.

Unfortunately, many participants expressed frustration at calculating demand accurately due to wide elasticity among trade areas. As a result, trigger points for new development vary among developers. In fact, one participant noted that they simply always build if supply reaches less than four square feet per person within a trade area. Thankfully, increasingly complex modeling techniques and a growing sophistication within this industry are being implemented in order to more accurately forecast demand.

VALUATION METHODOLOGY

Over 90.0% of survey participants indicate direct capitalization as their preferred method of valuation for self storage properties. On the other hand, discounted cash flow (DCF) analyses are not widely used. According to the survey, overall capitalization rates (OARs) range from 8.25% to 11.00% and average 9.52%. In general, both rural properties and second-tier facilities warrant 50- to 150-basis-point risk premiums (indicating capitalization rates as high as 11.00%). Properties that trade at OARs below 9.0% often provide “value-added” opportunities through repositioning, advertising, and/or repairing.

Although the average OAR represents only a 4-basis-point increase from SSE’s prior survey, many participants believe that OARs have decreased overall over the past two years as investment demand has outpaced opportunities. One reason that owners are reluctant to sell is that self storage returns are difficult to match in either traditional stock market investments or other real estate asset classes.

The target capitalization rate is most often applied to a projected single-year cash flow at a stabilized occupancy of at least 90.0%. Although applying capitalization rates to actual trailing income is an alternative technique used in direct capitalization, accounting techniques vary among owners and could distort value conclusions. For example, reporting below-average maintenance expenses unjustifiably boosts income levels and, therefore, would require the use of a lower capitalization rate. As a result, this method is generally used as a test of reasonableness.

A review of over 450 self storage property sales nationwide since January 2000 is summarized in Figure 2. The data represents over \$1.0 billion of transactions and indicates interesting trends that corroborate the result of the survey. Although the number of transactions has been declining, pricing has been increasing. Specifically, the average sale price stood at \$61.74 per square foot in

2002. Moreover, the average OAR has declined 33 basis points over the past two years and reached 9.67% in 2002.

ABSORPTION – TIME AND COSTS

For survey purposes, absorption time begins at completion of construction and ends at the date of stabilization of occupancy and burn off of concessions. The usual target vacancy rate is approximately 10.0% (long-term and stabilized). According to this survey, absorption time ranges from 18 to 36 months and averages 23 months.

Since self storage properties do not usually incur significant capital expenditures, such as tenant improvements and leasing commissions, absorption costs relate primarily to lost income. As a result, absorption expenses are less costly for this asset class than for most other types of real estate. One widely used technique to estimate absorption costs in this industry is simply to calculate the net operating income loss during the absorption time.

MARKETING TIME

How long does it take to sell a self storage property? According to the survey, which indicated no variance between exposure time and marketing time, it can take up to 12 months. The average marketing time was 3.95 months.

The increase in marketing time of

nearly one month is a result of more due diligence on the part of buyers. For many of them, analyzing and reviewing three years of audited statements, an accurate and current rent roll, and other ancillary income and expense data are now standard prior to the completion of a deal.

ENTREPRENEURIAL PROFIT

As a ratio of cost only, including direct building, site, and indirect costs (excluding land value), entrepreneurial profit ranges from 8.00% to 30.00% and averages 14.34%, according to the survey. This calculation is an important benchmark of feasibility. In addition, in “hot” market conditions, it is a test of reasonableness of value. Excess profit, for example, tends to breed ruinous competition. Currently, the forecast of profit remains relatively high due to rising property values. As a result, it will be interesting to see how much profit is actually collected, as markets continue to increase in supply.

OPTIMISM INDEX

The Optimism Index reflects participants’ expectations of general market conditions over the next two fiscal quarters. Based on a scale of one (lowest) to ten (highest), the scores range from 5 to 10 and average 6.83. Individual survey responses relating to demand are shown in Figure 3.

Although returns for self storage assets are strong compared to alternate investments, broad concerns of market saturation and declines in revenue have caused the Optimism Index to decline 13.21% from SSE’s prior survey. In fact, one regional operator with approximately 20 locations indicated that collected rents have declined for the first time in ten years.

With concerns of overbuilding nationwide, responses were split at 47.00% each as to whether the overall industry was either oversupplied or at equilibrium. By contrast, less than 6.00% described the market as undersupplied. The greatest concerns of oversupply are in the

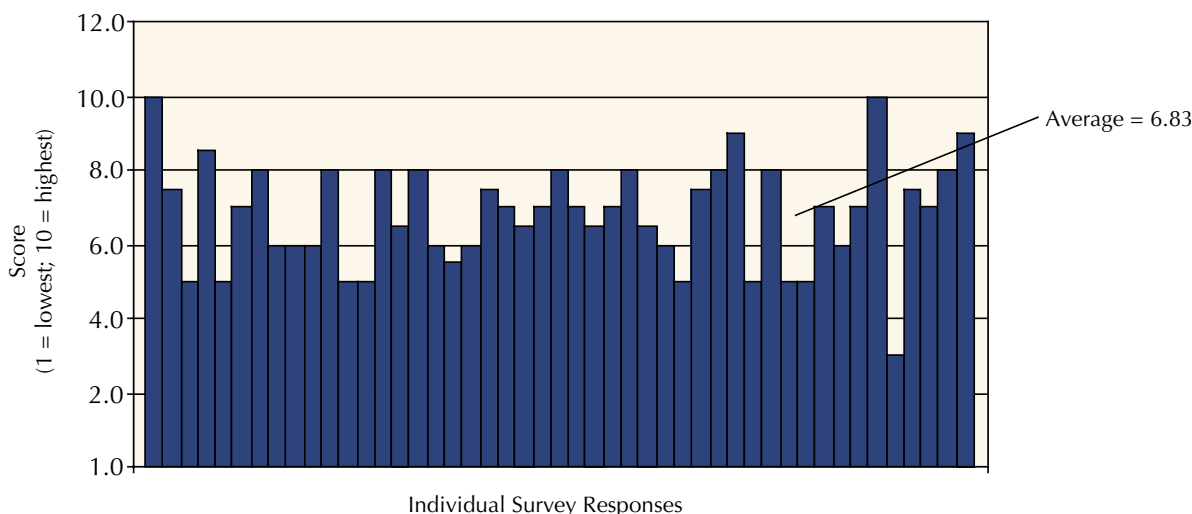
Western United States.

In terms of investment strategy, investors are virtually divided between buy, sell, and build. Although some believe that the best returns come from building new facilities since limited product is available to purchase, others are reluctant to build because of prevailing oversupply concerns. On the other hand, with property owners reluctant to sell since returns of self storage assets are hard to match, those that desire to buy are finding limited product available.

TRENDS

While a wide range of responses were given when asked about current trends in the industry, most focused on the importance of security, the desire for larger single-building projects of over 100,000 square feet, and the reconfiguring of warehouse buildings into self storage facilities. Another common theme among existing owners was a warning to newcomers about the vulnerability of inexperience, oversupply risk, and cash flow

Figure 3
SURVEY RESPONSES - OPTIMISM INDEX



Source: Self Storage Economics, LLC

SELF STORAGE KEY INDICATORS

	<u>Winter 2003</u>	<u>Summer 2002</u>
Trade Area Ring (miles)		
Range	1.50 - 5.00	1.50 - 5.00
Mode	1.50	1.50
Average	2.82	2.46
Change	14.63%	-
Demand (square feet per person)		
Range	2.00 - 8.00	1.50 - 2.50
Mode	4.00	5.00
Average	4.87	5.20
Change	-6.35%	-
Overall Capitalization Rate (OAR)		
Range	8.25% - 11.00%	8.25% - 11.00%
Mode	9.50%	9.50%
Average	9.52%	9.48%
Change (basis points)	+4	-
Absorption Time (months)		
Range	18 - 36	12 - 36
Mode	24	24
Average	23	22
Change (months)	+1	-
Marketing Time (months)		
Range	1 - 12	1 - 12
Mode	1	1
Average	3.95	3.02
Change (months)	+1	-
Entrepreneurial Profit (% of cost only)		
Range	8.00% - 30.00%	8.00% - 30.00%
Mode	20.00%	20.00%
Average	14.34%	14.81%
Change	-3.34%	-
Optimism Index (1 - 10)		
Range	5.00 - 10.00	6.00 - 10.00
Mode	7.00	8.00
Average	6.83	7.87
Change	-13.21%	-
Market Conditions		
Undersupplied	6.00%	20.00%
Oversupplied	47.00%	26.00%
Equilibrium	47.00%	N/A
Strategy		
Buy	28.00%	N/A
Sell	26.00%	N/A
Build	30.00%	N/A
Hold	16.00%	N/A

Source: Self Storage Economics, LLC

constraints.

Also mentioned by investors is an increase in the number of investors who are refinancing in order to take advantage of low interest rates, as well as to raise cash. While some of them will likely keep the equity on hand as a temporary cushion, others will use it to purchase problem properties over the next 24 months. "We can find value-added opportunities by purchasing properties from smaller operators who are facing the financing bullet and are unable to find permanent loans," states one experienced investor. Such a strategy, investors note, requires very careful due diligence of market conditions and is not for the faint of heart.

THE LAST WORD

Our findings indicate that even though the self storage industry is characterized by strong returns, several years of industry investment and expansion have rightfully increased concerns about the likelihood of overbuilding. Nevertheless, the industry continues to experience demand for financially viable projects and defining winners and losers remains very market specific.

While no one can predict the future, real estate economists use tools, such as investor surveys, to forecast future market trends. Based on the cumulative data and research collected and analyzed by Self Storage Economics, one trend is easy to forecast in 2003: key market players in the self storage asset class are requiring more data and analysis as the foundation of sound decision making.

Self Storage Economics, LLC is a full service real estate consulting company specializing in the self storage asset class. For more information on its recent survey, as well as other services, please visit their website at selfstorageeconomics.com.