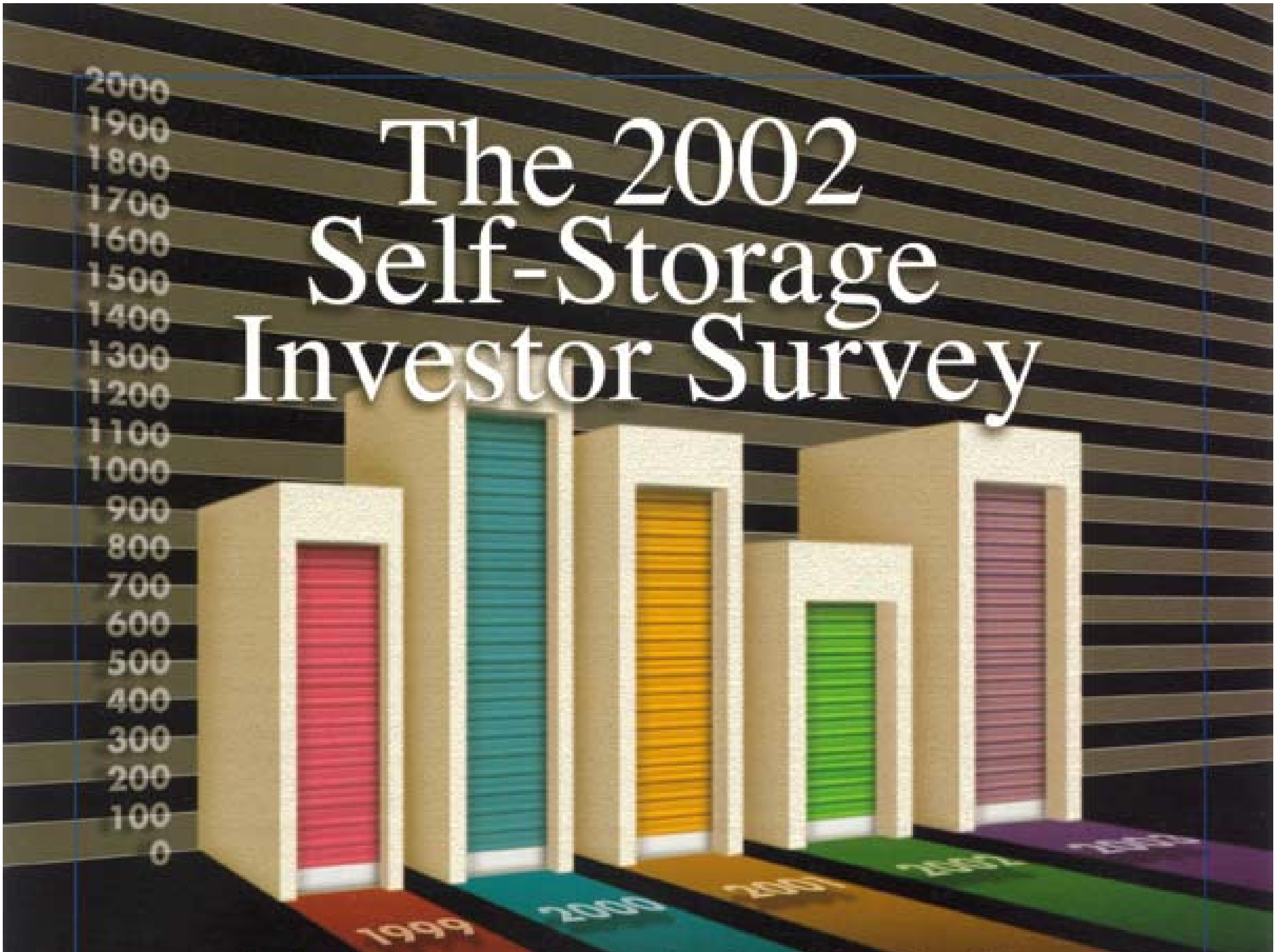
The 2002 Self-Storage Investor Survey



Industry Leaders Voice Their Opinions On Self-Storage Market Conditions

By R. Christian Sonne

"Cautiously optimistic" summarizes the state of the self-storage market according to respondents of this investor survey devoted solely to the self-storage asset class. While most investors indicate continued and growing demand for self-storage product, there are increasing concerns of over-building. Capitalization rates are declining and prices are increasing due to a limited supply of properties listed for sale.

Owners retain product because self-storage returns cannot be matched in other investments including the stock market (excluding self-storage REITs) and other real estate asset classes. Consequently, the current strategy for most investors is to buy self-storage. If a purchase is not possible at a reasonable criterion (average target capitalization rate for the survey is 9.50 percent on stabilized income), then investors will build new product. The self-storage optimism index, based on a scale of 1 (lowest) to 10 (highest), indicates an average of 7.87.

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Scope Of Research

A wise person said that if you don't know where you are going, any road will take you there. Timely information is key to successful development and operation of self-storage property. Like most data relating to real estate assets, however, data and information lag real time. Consequently, decisions about the future are often made solely on historical data. As investors continue to migrate to self-storage, current thinking regarding industry trends increases in importance. Using tools such as the *Investor Survey* can help investors navigate to successful roads in the self-storage market.

A quality and thorough analysis of self-storage property should include historical and dynamic analyses. A historical or static analysis is supply-based and can be used to forecast demand and market equilibrium. A current or dynamic analysis includes survey research of significant market players and econometric analyses to forecast demand based on demographic variables, particularly relating to the neighborhood sub-market.

The *Investor Survey* was completed through telephone interviews by Self Storage Economics during the summer of 2002. Survey respondents, including self-storage investors, owners, developers, managers, brokers and bankers from throughout the United States accounting for over 100 million square feet of self-storage property, were derived primarily from the Self-Storage Top Operators list compiled by *Mini-Storage Messenger*. The data presented is a summary of the survey and highlights key information relating to general market conditions for self-storage, capitalization rates, financing, optimism index and other current, relevant information for the asset class.

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Trade Area And Market Demand

Virtually all those surveyed indicate that the measurement of market characteristics (in terms of demand) must be confined to a local neighborhood. As noted in the *2002 Self-Storage Almanac*, it is "important to remember that self-storage is a highly localized business." Indeed, the survey indicates a trade area for self-storage product is measured in a range from a one to five mile ring with an average trade area defined as 2.46 miles (radius). Many noted that even ring analysis is insufficient, because local neighborhoods aren't usually defined that way. One investor suggested a series of rings and irregular, polygon shapes be used to accurately define a neighborhood. While a trade area with a 1.5 mile ring may suggest an over-supply, a larger trade area of a 3.0 mile ring may indicate under-supply. Clearly, the consensus of the survey was that defining the trade area is almost as important as the market characteristics indicated in the trade area.

Square Feet Per Person

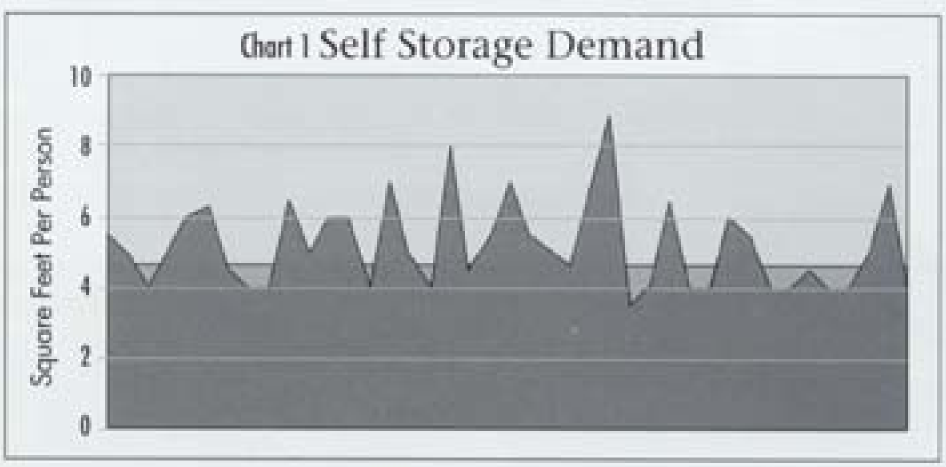
One of the most difficult questions to answer for the self-storage asset class is estimating the right amount of product needed in a trade area. Usually measured in terms of square feet per person, respondents estimated a wide range from 1.50 to 25 square feet per person. When asked to focus on a single number, the range narrowed from four to eight square feet per person with an average of 5.20 square feet of self-storage per person (see Chart 1 below).

Some investors said measurements of demand per person are very difficult to predict and are very neighborhood specific. Some developers have strict guidelines, such as trigger points for new development. For example, one investor said if the existing supply is less than five square feet per person with a 90 percent or higher occupancy in the trade area, then development is considered feasible. Others expressed frustration at calculating demand due to wide elasticity among neighborhoods. The survey indicates this was particularly true for those with large portfolios or managers and brokers exposed to properties in many different locations. One said "I gave up trying to figure out that formula" and instead relies on "wisdom and experience." Most investors expressed concern that such qualitative analyses are insufficient in the competitive market conditions. Due to strong returns on self-storage investments, more people are interested in the asset class. Consequently, there are wide concerns of over-building, some even expressing specific market areas that are considered over-supplied. With demand of only four to five square feet per capita, investors indicate over-supply is the single most important determinant to project failure. Good product, unit mix and management do not typically compensate for a saturated trade area. An over-supplied market can take years to recover.

Valuation Methodology

The *Investor Survey* indicates that over 95 percent utilize direct capitalization as the preferred technique of valuation. Others utilize a discounted cash flow model with hurdle rates applied to an internal rate of return (IRR). While many respondents expressed target yield rates on a leveraged basis, most only utilized such a technique as a test of reasonableness.

The target capitalization rate is applied to a stabilized cash flow, usually defined



as a property operating at stabilized occupancy of 90 percent or more. Stabilization techniques include utilizing market rent or market based expenses, such as adjusting real estate taxes. Some applied capitalization rates to trailing income for one year, but generally utilized a lower capitalization rate. As a test of reasonableness to direct capitalization on a stabilized basis, investors will test the implied capitalization rate based on income in place (one to three months annualized). This tool can also be utilized to test profit potential on acqui-sitions. Overall capitalization rates varied from less than nine percent to over 11 percent. The average target capitalization rate was 9.48 percent for class "A" property. Many expressed the belief that capitalization rates have decreased as transaction volume has decreased.

Others stated that rural properties or second tier self-storage facilities warrant 50 to 150 basis point risk premiums (indicating capitalization rates as high as 11 percent +). Properties that trade for sub-nine percent capitalization rates often have "value added" opportunities through management. Such opportunities include re-positioning a property through unit reconfiguration, advertising and repairing deferred maintenance. Many investors base value added purchases on improving cash flow by raising rents or decreasing expenses. Regional operators and owners of multi-property portfolios decrease expenses by blanket insurance policies, decreasing administrative expense and lowering off-site management overhead.

Absorption – Time And Costs

Absorption time begins at completion of construction and ends at the date of stabilization of occupancy and income (in concession programs). The usual target vacancy rate is approximately 10 percent. Based on the survey, the average absorption time is 22 months in a range from 12 to 36 months. Absorption costs vary per project, but most investors utilize monthly discounted cash flow analysis to assist in monitoring debt service in relation to net operating income (NOI). One technique is to estimate absorption cost based on the NOI loss during the absorption time. While one response does not make the market, it is interesting to view the myriad of experiences.

Marketing Time

This relates to the question "How long does it take to sell a self-storage property?" This question provided the most colorful of responses. One broker said it would take "less than two hours" to sell a self-storage property because of such high demand for the asset class. Many said no marketing time (this response was calculated as one month in the survey). The range was from one to six months with an average of 3.02 months. Upon further inquiry, most admitted that with exposure to the open market (although most brokers said they have cash buyers in hand), due diligence (mostly for financing) and escrow, it usually takes at least a month of marketing time. What is so interesting about this question is that the answers underscore the demand for self-storage as an investment. Such investor interest is corroborated in the public markets, with significant gains in self-storage REIT pricing over the past two years. Clearly, the self-storage star is shining bright in the investment community.

Table 1 Marketing Time: Summer 2002

Range:	1-12 Months
Mode:	1 Month
Average:	3.02 Months
Change:	n/a

Profit

According to the survey, profit (as a function of cost) is most often calculated as a percentage on land value (or land acquisition costs) and cost to build including all direct, site, and indirect costs. The calculation of profit is important because it is a simple benchmark of feasibility. Additionally, in "hot" market conditions, profit is a test of reasonableness of value. For example, excess profit tends to bring ruinous competition (an important, long-run function of bank or finance underwriting). The most often response was 20 percent profit factor. However, some developers responded that an eight percent profit on build to suit is sufficient, like a builder fee (with no money invested). Consequently, the average is skewed downward to 14.81 percent.

Approximately one quarter of those surveyed indicate returns to equity investors (return defined as both dividend or income and yield or appreciation). The data ranges from 15 percent unleveraged (all cash or equity) to as high as 35 percent on a leveraged basis (financed). The average is not utilized in this category because of wide variances among leveraged and unleveraged scenarios.

Financing

Financing availability was termed high by the majority in the survey in a response range from medium to high. Leveraging, expressed as loan to value ratio, was from 65 percent to 80 percent with an average of 72 percent. Terms most often were based on a 10-year call with a 25-year amortization period (not construction loans). Fixed rates for take-out loans varied widely from less than 6.50 percent to as high as 9.00 percent depending upon geographic region, source of funds, asset characteristics and credit. The average fixed loan rate, based on estimates by half of those surveyed, was 7.95 percent. Many noted that variable rates are much lower, even below five percent for take-out loans. Many low interest rate loans include pre-payment penalties and most quoted banks as the primary source of funds. Some bankers included in the survey indicate reluctance to link construction loans with permanent financing.

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Optimism Index

Investors were asked about general market conditions in the next two fiscal operating quarters. The data indicates a generally bullish outlook for the self-storage market. Investors surfing for good yields are confident self-storage provides the best-sized waves. Based on a scale of one (lowest) to 10 (highest), the optimism index received a 7.87 average in a range from 6.0 to 10.0.

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The most common response was 8.0. Yet, there is concern of over-building in many markets. When queried about market conditions in terms of under-supply, over-supply or market equilibrium, most stated the market is at equilibrium. Some responses expressed concern of occupancy due to over-building and noted that over-supply flattens rental rates, introduces concession programs and lowers occupancy. Market correction to equilibrium in self-storage is only facilitated by the twin pillars of long run recovery: population growth and time.

As to investor strategy, expressed in terms of buy, build or sell, investors said the best returns come from building because there is limited product available to purchase.

As to investor strategy, expressed in terms of buy, build or sell, investors said the best returns come from building because there is limited product available to purchase. Such a response is consistent with marketing time, the optimism index and trends (in terms of capitalization rate and asset pricing). Property owners are reluctant to sell because it is difficult to match the returns of the self-storage asset class in alternative investments. One broker in California lamented that the inventory of property for sale is the lowest of his career. If properties make it to the open market, multiple offers by qualified buyers are reported. Consequently, it appears that pricing is increasing.

Lastly, the survey included an opportunity for last words by participants. The interesting responses varied widely. Comments included ideas of strategy such as the development of containers or leasing land. Others mentioned the increasing role of security. A few property managers wisely expressed concerns over rising insurance costs, a function of low returns in the stock market and heightened concerns over security to real estate. A few responses from Southern California expressed concern of over-supply and "too many new players taking too many risks." Perhaps most prevalent were expressions of the importance of experience to develop a successful self-storage facility. Investors stressed the importance of competent management to properly operate an economically viable property. Moreover, the competitive position of a property is often a function of market fundamentals (supply, demand and equilibrium) enhanced by management.

Summary

The results of the *Self-Storage Investor Survey* indicate a self-storage market characterized by superior returns compared to alternative investments of real estate and equities. Yet, after several years of industry investment and expansion, resulting in record setting asset pricing, the self-storage industry is increasingly expressing public concern about the future, particularly due to over-building. The downside of self-storage is the ease of entry, causing markets to saturate quickly. For example, the *2002 Self-Storage Almanac* reports a 15-year cycle with a vacancy rate range from 10 percent to 21.60 percent with an average of 14.91 percent nationwide. This trend demonstrates the cyclical nature of the industry and underscores the importance of analysis in each sub-market. Clearly, investor sophistication is increasing in the decision process for the self-storage asset class. Market analysis of self-storage property appropriately considers industry trends, defines the subject trade area, measures conditions of supply, forecasts demand based on direct comparison as well as an econometric model of the subject trade area, and concludes with a forecast of market equilibrium. Cumulatively, these factors should be considered in investment decisions.

The *Self-Storage Investor Survey* highlights investment criteria and the current thinking regarding industry trends. Monitoring trends through the Investor Survey is one tool that can be used to evaluate the self-storage asset class. In the next bi-annual survey completed by Self Storage Economics, contemporary data and historical data can be used to evaluate decisions, compare investor criteria to historical data, test these navigation tools, and chart the continued course along successful roads in the self-storage market.

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Table 2 Self Storage Investor Survey- Summer 2002
Summary Table- Highlights

Trade Area	
Range	1.5 - 5 mile ring
Mode	1.5 mile ring
Average	2.46 mile ring
Change	n/a
Demand (SF per Person)	
Range	1.5-2.5
Mode	5
Average	5.2
Change	n/a
Capitalization Rate	
Range	8.25%- 11%
Mode	9.50%
Average	9.48%
Change	n/a
Absorption Time	
Range	12-36 Months
Mode	24 Months
Average	22 Months
Change	n/a
Marketing Time	
Range	1-12 Months
Mode	1 Month
Average	3.02 Months
Change	n/a
Profit (on Land and Cost)	
Range	8%- 30%
Mode	20.00%
Average	14.81%
Change	n/a
Optimism Index (1-10)	
Range	6-10
Mode	8
Average	7.87
Change	n/a
Market Conditions	
Under- Supplied	20.00%
Over- Supplied	26.00%