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Is The Industry Reaching Capacity?

By R. Christian Sonne, MAI

Self-storage mania may describe the euphoric mood the real estate market has developed for the asset class. Interest from both Wall Street investors and Main Street bankers has encouraged record investment levels and funded a development pace exceeding four new facilities per day for the past ten years! Investors and developers have been eager to cash in on the fundamental economic strengths of self-storage property. Consequently, the market has record-high pricing fueled by record-low overall capitalizations.

These seemingly manic conditions can also be contrasted with the depressive thoughts of the *2006 Investor Survey*: the single greatest concern of the self-storage industry is over-supply. This paradox suggests changes are ahead in the self-storage market. These changes include higher interest rates, rising capitalization rates, and lower values.

Broad statements and conclusions such as "self-storage is over-supplied" are both wrong and irresponsible because self-storage, more than most other real estate asset classes, is neighborhood specific. Thus, even in an MSA described as over-supplied, there are winners and losers within the larger market. A local trade area or neighborhood specific analysis is the best way to determine market conditions for an individual self-storage project.

Such broad statements can be irresponsible because of the potential negative impact to the asset class. On Main Street, such statements may cause bankers to slow the flow of lending capital, critical to the success of all real estate. On Wall Street, concerns of detrimental conditions to self-storage can have a psychological impact on the herd causing equity investors to withdraw. This is particularly true for self-storage, the "Cinderella" story of real estate.

As for market conditions, self-storage remains a local, neighborhood business. Thus, the solution to concerns of over-supply are in the local trade area, which is generally described within a one- to five-mile radius of a self-storage facility.

People have stuff that is important enough to keep, but not important enough to move. As comedian George Carlin said, "All you need in life is a little place for your stuff, you know?"

To supply growing demand for mini- or self-storage, there has been significant industry growth. Assuming the industry is 50 years old and has a 2006 size of 41,122 facilities nationwide (*2006 Self-Storage Almanac*), the industry growth rate has been at an average pace of 822 facilities per year. This pace means at least two new self-storage facilities have been constructed every day in the United States over the last 50 years!

The pace of self-storage growth can seem immense over the last decade. With over 41,000 facilities nationwide, the number of facilities has grown by over five percent per year for the last 10 years—an average of 1,814 new facilities per year. From humble origins as an “interim” use, self-storage has become a \$15 billion industry.

It is also an export industry, with hundreds of facilities developed in Europe in the past decade. More recently, Asian markets have also begun developing self-storage facilities. While these are impressive numbers, they are not the type of robust growth associated with inflated asset classes in terms of pricing or growth. Once the “stepchild” of real estate, self-storage is now a true Cinderella story of success.

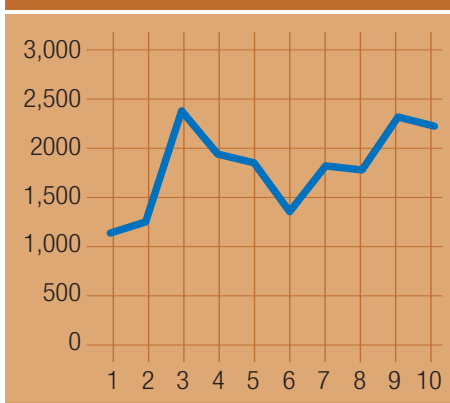
Investors Stay The Course

Based on the latest survey results, investors have chosen to “stay the course” and continue to store capital in the self-storage asset class. The *Winter 2006 Investor Survey* was completed by Self Storage Economics 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.

Results indicate that overall capitalization rates have declined to an average of 7.26 percent nationwide, an incredible decrease of 102 basis points from last year, or a change of -12.82 percent! Nevertheless, the chief concern of investors is over-supply. This paradox suggests changes are ahead in the self-storage market.

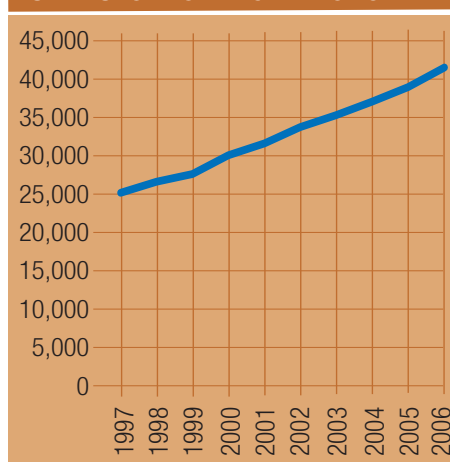
The range of capitalization rates was from 6.0 to 9.0 percent, with the most typical response or mode at 7.0 percent. Capitalization rates represent a stable scenario or forecast going forward twelve

SELF-STORAGE ANNUAL NEW FACILITIES



Source: Self Storage Economics and the *Self-Storage Almanac*

SELF-STORAGE FACILITY GROWTH



Source: Self Storage Economics and the *Self-Storage Almanac*

months of net operating income. Coastal states tend to have lower overall capitalization rates, while inland states tend to have higher overall capitalization rates. This trend suggests that institutional quality property may primarily be defined by location for self-storage property. Although less than 20 percent of the respondents utilize discounted cash flow analysis for self-storage property, the Internal Rate of Return (IRR or yield capitalization) hovered around 10.50 percent, also a decline from the 2005 survey results.

Loans remain widely available for the self-storage asset class, and the survey indicates a typical loan in the 6.50 percent to 7.50 percent range with a 10-year term, 25-year amortization, a 75 percent loan to value ratio, and a 1.20 debt coverage ratio as typical parameters. However, most of those surveyed believe interest rates will continue to rise throughout 2006, causing upward pressure on capitalization rates and downward pressure on values.

Most respondents described market conditions as “over-supplied” and the optimism index declined slightly to 6.65 (on a scale from one as lowest to 10 as highest). Similarly, the average absorption time increased by three months to an average of 30.62 months after completion of construction to a stabilized occupancy and income. Marketing time or the time to sell a property remained essentially the same as last year, at 3.14 months.

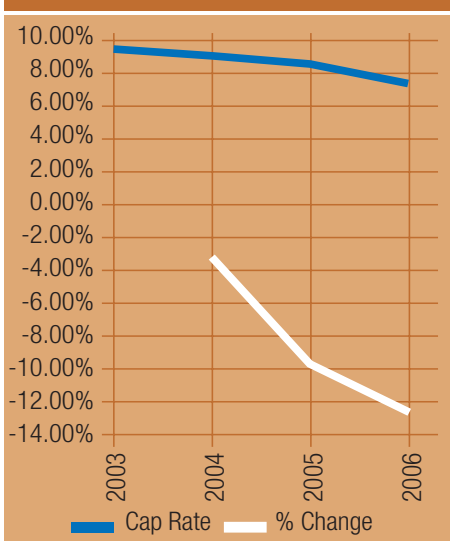
Cumulatively, the data reflects concerns of over-building and uncertainty about interest rates. In this regard, it is important to remember that self-storage remains a local or neighborhood business. What happens in the local trade area is more important than national, regional, or MSA (metropoli-

tan statistical area) trends. Investors estimate an average trade area of 3.14-mile radius, or no significant change from last year.

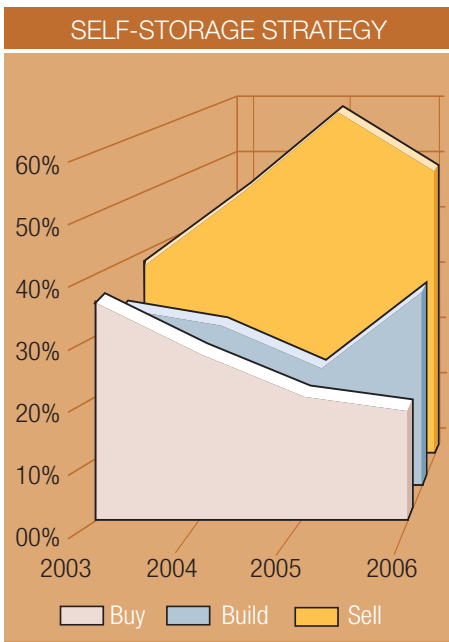
Demand for self-storage property, measured in terms of rentable square feet per person, increased to an average of 5.70 square feet per person. This reflects an increase from 5.36 in 2005, a change of +6.35 percent. Comparatively, the *2006 Self-Storage Almanac* reports that there are over 41,000 facilities nationwide, which represents 5.54 square feet per person.

Surprisingly, a record number of respondents said the best strategy is to build. However, the majority continued a three-year trend that would indicate that that selling is the best strategy for the self-storage asset class. The fact that investors express a desire to build now suggests concerns of building in the future (better to build now

CAP RATE TRENDS



Source: Self Storage Economics



Source: Self Storage Economics

than later) because of rising construction costs and rising interest rates.

One banker participant says the wave has peaked and forecasts that new construction will slow by the second half of 2006. A real estate broker says interest in building is a function of current record-high pricing for the asset class. "The combination of building, then selling yields the greatest profit in the current market conditions," he asserts.

Pricing And Sales Activity

As for pricing, current sales data nationwide indicates that the average of the asset class will exceed \$100 per square foot in 2006. This is the peak of a five-year bull market with a rising number of transactions at record pricing, as illustrated in the pricing graph.

Institutional investors continue to lead the charge in terms of pricing in the self-storage asset class. With significant equity capital and easy access to borrowing money, these investors are looking for self-storage product to purchase, especially portfolios (in general, the larger the portfolio in terms of number of facilities, the better). Following the herd, individual investors are competing to purchase self-storage facilities. Consequentially, self-storage pricing has increased over the past five years, and "self-storage mania" has ensued.

Rational Exuberance

The manic-depressive stock market crash of 1929 is the best example of speculative dementia we can reference. Yet, prior to the crash was the great Florida real estate boom (and later bust) of the 1920s. Attraction to the Florida climate combined with an abundance of land led to unprecedented interest in real estate, but the access to financing led to unprecedented speculation.

A house lot could be purchased for a cash down payment of 10 percent and monthly payments to pay off the principle and interest. The leverage provided easy entrance to the market and each purchase stimulated speculative purchasing. One participant was Charles Ponzi of Boston, who was famous for the "Ponzi scheme," an investment operation that pays high dividends to early investors out of the money coming from late investors.

Ponzi developed a "Jacksonville" subdivision that was actually 65 miles away from the city. Another subdivision offered beach-front lots that were 10 to 15 miles from water. Most lots were purchased by speculative investors who were not interested in the fundamentals of the investment. Most had not completed enough due diligence (or simple homework) to even visit the projects. By 1926, the pyramid collapsed. Inevitably, the supply of buyers declined and the incredible returns could not be sustained.

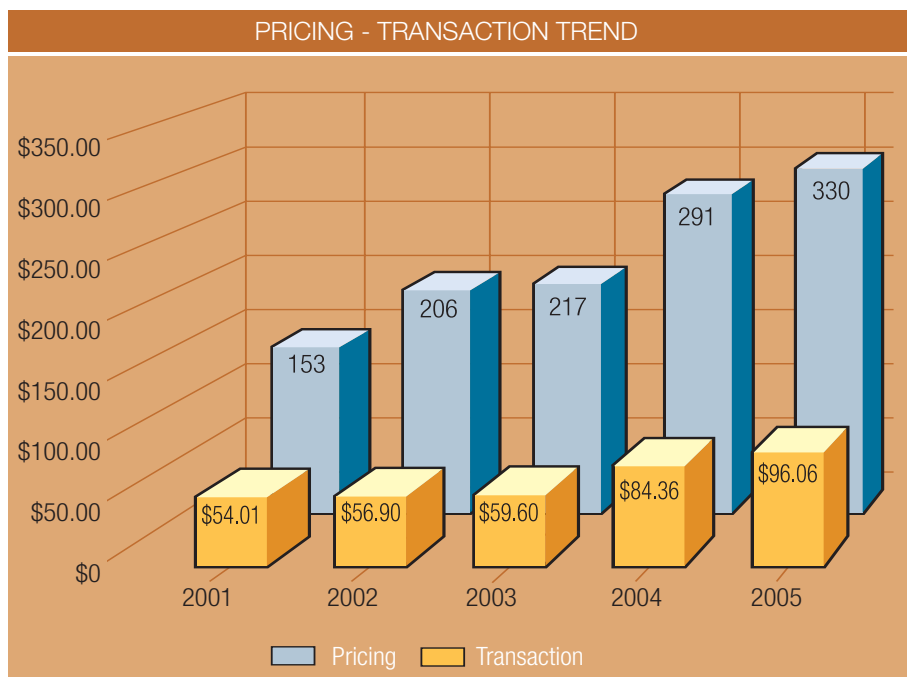
This was a classic real estate bubble—a mass psychological phenomenon that occurs when the herd follows the trend and continues to invest with the expectations of a bull without regard to the possibility of a bear. Will self-storage be another negative chapter in the history of financial excess? Maybe. The keys are rational expectations and adequate due diligence.

Self-storage is a high-quality real estate asset class with significant demand for capital. The rise of the asset class has been a function of superior returns, low loss levels in lending, and recognition of the stability of self-storage as collateral. But with demand for self-storage coming from local trade areas, self-storage investment decisions are best made based on the neighborhood market conditions.

These factors underscore the importance of market analysis in self-storage investing, and they must be considered in conclusions regarding the quantity, quality, and durability of the income level. Careful cash flow (static) modeling is required to reflect these market characteristics. With good local market intelligence, investors are choosing to store capital in the self-storage asset class.

Diagnosis And Prescriptions

Orthodox economics has the practical value of understanding and forecasting. In self-storage, there are tools such as The



Source: Self Storage Economics

Self-Storage Almanac, and a host of consultants and various modeling. Each of these sources varies in scope and reliability. The common denominators of success in self-storage are local market analysis and rational decision-making, which hinges on the recognition of market conditions.

A note of caution is in order: A database is a great tool of analysis but is certainly not the panacea to all self-storage problems. Many databases are mined from public records that rely on gross square footage (self-storage is rentable square feet), thus exaggerating existing supply. Moreover, some database information is purchased from business lists derived from SIC codes that erroneously define a “car barn” that is actually a used car lot as a self-storage facility. Some survey research may be too limited for practical application. Again, field research (visiting each facility) in a local trade area is always best.

Without spending crazy money, most investors can survey the projects within a three-mile radius of an existing facility and, by simple observation, begin to understand a market. If 10 facilities are analyzed and average occupancy within the trade area is 75 percent, the market is probably saturated. (The age of facilities and stable market conditions must also be considered.) On the other hand, if a market consistently has occupancy at 90 percent or above with no specials on rental rates, this is a good indication of demand for additional self-storage product.

Benchmarks such as 5.54 square feet (*Self-Storage Almanac*) can also be useful. Thus, if a market is below the benchmark and has high occupancy, these facts become good indicators of demand. On the other hand, if the local market is above the benchmark and has lower occupancy, these may be indicators of saturation.

It is also important to remember that, over time, markets tend to self-correct. The antidote to the disease of too much speculative construction is less debt. Even now, after 16 straight increases to the 10-year treasuries, the market is already correcting. As debt costs rise, feasible new construction declines. Of course, the investor must have the sensibility to face the facts.

Crunching The Numbers

Some have argued that this market is somehow a new paradigm—as if markets

and values only rise. Like the sea, the tides of market conditions rise and fall. So how much is too much? It all depends on local market conditions. For some markets, 3.0 square feet of self-storage per person is too much. In other markets, 6.0 square feet is not enough. This again underscores that local market analysis is the key. There is no substitute in self-storage analytics than visiting and analyzing the local competition.

These expressions, outlined in the data of the *Investor Survey* underscore the importance of careful market research. It is insufficient to measure the past trends based on historical data. In this regard, an in-depth investor survey looks to the future by measuring the expectations of market players. Self-storage is a neighborhood-specific asset with wide variances of market conditions even within a particular city or MSA. Therefore, local research remains the most important tool to investors.

After crunching the numbers, the data indicates interesting sub-trends within an incredible bull run over the past five years.

- Capitalization rates have declined from 9.52 percent in 2003 to 7.26 percent in 2006, an amazing reduction of 226 basis points over four years. This represents an average decline of 56.50 basis points per year! This is a meaningful change from the long-held rule of thumb that self-storage cap rates are always “10.” It underscores the sophistication of the asset class and recognition of the quality and durability of this income-based investment.
- The concern of over-supply has not significantly changed in four years. In 2003, 47 percent of respondents described the self-storage market as over-supplied. In 2006, 50 percent of respondents described the self-storage market as over-supplied. These concerns reasonably reflect the asset class considering the pace of new self-storage new construction.

In the future, many will say the self-storage market is over-supplied. In reality, the entire asset class cannot be described so simply. Of all asset classes in real estate, local market conditions determine winners from losers in the self-storage asset class. Market conditions will certainly change over the next year among valid concerns of rising interest

rates and over-supply. Yet, investors will stay the course and continue to store capital in self-storage. Now, more than ever, local market analyses will separate the bulls from the bears.



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