

Lending to the **SELF-STORAGE** Industry: Cinderella Has Her Day

The self-storage asset class includes five publicly traded REITs, but over 90% of the more than 41,000 self-storage facilities in the U.S. are privately owned (not publicly traded) companies. The appraisal valuation is a most important step for lenders in self-storage, which offers several advantages over other types of real estate. With demand for self-storage coming from local trade areas, lending decisions are best made based on the neighborhood market conditions, making it ideal for community banks. Careful cash flow (static) modeling also is required to reflect local market characteristics.

Investors, both mortgage and equity, are storing capital in self-storage real estate. From humble origins as an “interim” use, self-storage has become a \$15 billion industry with more than 41,000 facilities in the U.S. In recognition of the quality of the self-storage asset class, there are five publicly traded REITs (real estate investment trusts). Self-storage is also an export industry, as hundreds of facilities have developed in Europe over the last 10 years. More recently, Asian markets have begun to develop self-storage facilities.

Once the stepchild of real estate, self-storage is now a Cinderella story of success.

Background of the Asset Class

The Self Storage Association (www.selfstorage.org) defines self-storage as a “term applied to facilities offering rental on a month-to-month basis where the tenant applies the lock...and has sole access to the unit. No bailment [care, custody, or control] is created by the facility. It is the rental of ‘air space,’ not physical boundaries.”



Self-storage development began after World War II in the U.S. as a tool of land banking or an interim use pending feasible alternative development (some reports indicate Corpus Christi, Texas, in the 1960s was the site of the first modern self-storage facility). Over the last 50 years, the industry has grown into a sophisticated asset class with wide appeal from Main Street to Wall Street, including individual developers and investors, regional operators,

national operators, and REITs.

Historically, if a developer with land had no other purpose in mind for it, the highest and best use was self-storage. Odd-shaped parcels, parcels with poor street frontage (but good access), parcels under overhead power lines or in utility corridors, or parcels on old railroad right-of-ways were prime sites for development of a self-storage facility.

With growth in advertising and the number of facilities, Americans

began to get used to the idea of self-storage. Life style changes—such as marriage, death, or moving—tend to promote the use of a facility. Most people expect to use a self-storage unit (sizes typically range from 25 square feet to as large as 400 square feet) for a short period of time. Once a unit is rented, the average stay is 12 months for residential customers, and approximately 76.9% of users are residential.¹

Public Storage, founded in

Number of Facilities	
Number:	Year:
23,972	1997
25,180	1998
27,535	1999
29,955	2000
31,947	2001
33,833	2002
35,176	2003
37,011	2004
38,817	2005
41,122	2006

1972, greatly increased the visibility and acceptance of self-storage as a viable real-estate asset class. Public Storage is now a publicly traded REIT and in 2005 was added to the S&P 500 Index. From humble beginnings, the company is now the largest self-storage facility owner and operator with nearly 100 million square feet of space nationwide. Other national companies, such as Shurgard, Sovran, Extra Space, and U-Stor-It Trust, are also major publicly traded REITs.

As the industry grew, the Self Storage Association and private companies like MiniCo, Inc., began providing resources to the self-storage asset class, furthering industry growth. Assuming the industry is 50 years old and has a 2006 size of 41,122 facilities nationwide², the growth rate has been an average 822 facilities per year. This pace means at least two new self-storage facilities have been constructed every day in the U.S. over the past 50 years!

Over 90% of self-storage facilities are privately owned (not publicly traded) companies. Most facilities are still owned by small, local owner-operators. Operational

costs tend to be lower for regional, multi-facility companies; consequently, consolidation in the industry will be a continuing trend. Self-storage growth over the past 10 years is summarized in Table 1.

Capital flow, both equity and debt (both private and public), has increased to real estate over the past 10 years due to comparatively high returns. Moreover, the appeal of self-storage compared with other real estate investments is that costs tend to be lower and operating results demand a lower yield. For example, the break-even occupancy rate for a self-storage facility is approximately 40-45%, compared to 60% or more for apartments; consequently, they tend to hold value better and recover faster than other assets when real estate markets sour. Also, REITs became eligible for Standard & Poor's indexes in 2000, increasing investor exposure and lending credibility. Self-storage returns consistently lead the market, yet have the lowest default rate of all asset classes.³

Market Analysis of a Self-Storage Facility

As an asset class, self-storage is a neighborhood business. For example, approximately two-thirds of the customer base of a typical suburban facility comes from within a three-mile radius of the subject. Market conditions by the top 10 MSAs (metropolitan statistical areas) are summarized in Table 2.

Self Storage Economics uses survey research to track investment criteria for self-storage prop-

erty. Survey respondents include self-storage investors, developers, managers, brokers, and bankers from throughout the U.S.; account for more than 100 million square feet of self-storage property; and are derived primarily from the Self-Storage Top Operators list compiled by *Mini-Storage Messenger*. The survey 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.

Led by declines in the expectations of overall capitalization rates, investors remain bullish on the self-storage asset class, according to respondents of the investor survey. While most investors indicate continued and growing demand for self-storage, there are increasing concerns of overbuilding, particularly by players new to the self-storage market. Yet, capitalization rates are declining, and prices are increasing. Market conditions are the best ever for the self-storage asset class; financing is widely available at relatively low rates, and investor interest is high. So why are investors concerned? One nationwide broker mentioned the "B" word—*bubble*, which 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.

Real estate economists are always wary of predicting the date or time of changing market conditions. Therefore, noting the concerns of the market is good for self-storage market conditions

Table 2

Market Equilibrium MSA

Metropolitan Statistical Area	Number of Facilities	Area Square Footage	2005 Population	Renter Occupied Housing	Average Household Size	Average Household Income	Rentable Square Footage per Person	Forecast Demand	Variance	Conclusion
New York-Northern New Jersey-Long Island, NY-NJ-PA	724	29,129,416	18,880,671	44.38	2.69	\$87,481	1.54	1.50	0.04	Equilibrium
Los Angeles-Long Beach-Santa Ana, CA	938	37,739,492	13,061,361	45.22	3.03	\$80,809	2.89	2.65	0.24	Equilibrium
Chicago-Naperville-Joliet, IL-IN-WI	632	25,427,888	9,538,483	29.37	2.73	\$79,462	2.67	3.52	-0.85	Undersupplied
Dallas-Fort Worth-Arlington, TX	1,083	43,573,422	5,908,048	35.15	2.75	\$79,332	7.38	3.97	3.41	Oversupplied
Philadelphia-Camden-Wilmington, PA-NJ-DE-MD	348	14,001,432	5,848,871	27.07	2.56	\$78,190	2.39	4.16	-1.77	Undersupplied
Miami-Fort Lauderdale-Miami Beach, FL	467	18,789,278	5,486,967	27.94	2.62	\$70,182	3.42	4.51	-1.09	Undersupplied
Houston-Sugar Land-Baytown, TX	1,014	40,797,276	5,401,565	33.88	2.85	\$75,280	7.55	4.23	3.32	Oversupplied
Washington-Arlington-Alexandria, DC-VA-MD-WV	411	16,536,174	5,284,007	32.32	2.61	\$101,717	3.13	3.25	-0.12	Equilibrium
Atlanta-Sandy Springs-Marietta, GA	550	22,128,700	4,980,447	29.29	2.68	\$83,886	4.44	4.04	0.40	Equilibrium
Detroit-Warren-Livonia, MI	342	13,760,028	4,592,457	24.38	2.56	\$73,482	3.00	4.58	-1.58	Undersupplied

Source: 2006 Self Storage Almanac, p. 39.

over the long run. The current upward momentum in self-storage has exceeded even the high tide of commercial-industrial real estate, yet wise investors continue to express caution, and local research continues to be the most valuable tool for lenders to an industry that is neighborhood specific and shows wide variances of market conditions even within a particular city or MSA.

Self-Storage Appraisal

Valuation or appraisal is the process of estimating the value of real estate as of a given date. The appraisal is an economic model

that analyzes all factors that bear on the value or worth of real estate. The problem is defined, the property described, and the data involved is acquired, classified, analyzed, and interpreted to arrive at an estimate of value. All property is analyzed according to the highest and best use of the property. Three primary valuation approaches to the appraisal process can be summarized as follows:

1. The cost approach—considers the value of the land as vacant, plus the cost of the improvements, including profit, less accrued depreciation from physical, functional,

and external causes.

2. The sales comparison approach—considers the recent selling prices of similar properties compared to the subject, broken down into common units of comparison, making adjustments for differences.
3. The income approach—considers the economic or contract rent (earning capacity) of the land and improvements, less vacancy and landlord expenses; the resulting net income stream is capitalized by an investment yield or capitalization rate that would be

Table 3												
Potential Gross Income												
Size	Total	Rented	Outside	Inside	Up	CC	Outside	Inside	Up	CC	Monthly Rent	Annual Rent
2.5 x 3	66	2				66				\$20	\$1,320	\$15,840
5 x 3	24	1				23				\$25	\$575	\$6,900
8 x 3	12	0				12				\$40	\$480	\$5,760
Line Subtotal:	102	3				101					\$2,375	\$28,500
5 x 5	64	17	3	48		13	\$64	\$54		\$70	\$3,694	\$44,328
4 x 10	1	0				1				\$80	\$85	\$1,020
5 x 10	114	31	7	96		11	\$79	\$69		\$90	\$8,167	\$98,004
10 x 5	43	23	10	32			\$79	\$75		\$93	\$3,283	\$39,396
7.5 x 10	45	19		45				\$99			\$4,455	\$53,460
10 x 10	130	65	30	99		1	\$139	\$119		\$160	\$16,111	\$193,332
10 x 12	1	1		1				\$140			\$140	\$1,680
10 x 12.5	3	3				3				\$175	\$525	\$6,300
10 x 14	4	1	4				\$165				\$660	\$7,920
10 x 15	83	65	55	27		1	\$180	\$165		\$200	\$14,555	\$174,660
10 x 20	123	58	111	11		1	\$225	\$225		\$260	\$27,710	\$332,520
10 x 24	12	3	9	3			\$259	\$259			\$3,108	\$37,296
10 x 25	16	15	14	2			\$277	\$269			\$4,416	\$52,992
10 x 30	5	5	5				\$375				\$1,875	\$22,500
Subtotal:	644	306	248	364	0	32					\$8,8784	\$1,065,408
10 x 25 RV:	14	14	14				150				\$2,100	\$25,200
Total Potential Gross Income											\$93,259	\$1,119,108

reasonable to a prudent investor.

Each approach is used by the professional appraiser whenever it is applicable to the valuation problem. The use of each approach depends on the type of property, the availability and suitability of the market data on which the approach is predicated, and other judgment factors. The use of two or three approaches will generally result in a range of values for the subject property, which are correlated to a final value conclusion.

As an asset class, self-storage is generally not institutional grade (although REITs are widely traded). Consequently, the investment market relies primarily on direct capitalization. This

is corroborated by survey research as contained in the National Self-Storage Market Analysis published in the *2005 Investor Survey*. Therefore, the focus of this article is on direct capitalization.

Explanation of the Approach

The income capitalization approach to value views the subject through the eyes of a typical investor. It is based on the premise that the higher the earnings, the higher the value. The approach converts anticipated future benefits or dollar income to be derived from ownership into a present value estimated through the capitalization process. Application of the approach includes the following steps:

1. Survey rents of comparable properties to estimate an economic market rent for the subject property.
2. Estimate operating expenses (including vacancy) applicable to the subject ownership (no operating history as the subject is proposed).
3. Derive net operating income for the subject property.
4. Estimate the remaining economic life of the subject based on the market or the investor's holding period.
5. Select the proper capitalization method and rate.
6. Capitalize the net operating income into an indication of value.

The potential gross income consists of rental and other income.

	Nationwide			Western Region			Comp: 1	Comp: 2	Comp: 3	Subject
Year	2005			2005			2005	2005	2005	2005
Units	Varies			Varies			1,310	540	492	644
Area (SF)	Varies			Varies			146,305 SF	50,784 SF	50,214 SF	73,493
Occupancy	Varies			Varies			81%	89%	91%	90%
Scenerio	Low \$/SF	High \$/SF	Mean \$/SF	Low \$/SF	High \$/SF	Mean \$/SF	Stabilized	Stabilized	Stabilized	Forecast
Operating Revenues										
Rental Income	n/a	n/a	n/a	n/a	n/a	n/a	\$12.95	\$13.14	\$12.95	\$13.63
Ancillary Income	n/a	n/a	n/a	n/a	n/a	n/a	\$0.65	\$0.66	\$0.65	\$0.76
Effective Gross Income	n/a	n/a	n/a	n/a	n/a	n/a	\$13.60	\$13.80	\$13.60	\$14.39
Operating Expenses										
Taxes	\$0.07	\$16.82	\$0.68	\$0.12	\$16.82	\$0.96	\$1.54	\$1.56	\$1.88	\$0.96
Insurance	\$0.03	\$4.28	\$0.21	\$0.04	\$4.28	\$0.29	\$0.10	\$0.20	\$0.11	\$0.20
Repairs & Maintenance	\$0.01	\$2.78	\$0.31	\$0.02	\$1.40	\$0.28	\$0.18	\$0.32	\$0.28	\$0.35
Administration	\$0.01	\$4.11	\$0.52	\$0.07	\$3.43	\$0.54	\$0.32	\$0.41	\$0.26	\$0.30
On-Site Management	\$0.04	\$5.24	\$0.97	\$0.09	\$5.24	\$0.96	0.65\$	\$1.08	\$1.49	\$1.00
Off-Site Management	\$0.02	\$2.40	\$0.55	\$0.02	\$2.40	\$0.54	\$0.41	\$0.64	\$0.61	\$0.72
Utilities	\$0.01	\$1.59	\$0.26	\$0.01	\$1.59	\$0.32	\$0.27	\$0.09	\$0.16	\$0.30
Advertising	\$-	\$3.00	0.27\$	\$0.02	\$3.00	\$0.33	\$0.41	\$0.98	\$0.30	\$0.30
Miscellaneous	\$0.01	\$7.31	\$0.81	\$0.03	\$7.31	\$1.13	\$0.05	\$0.08	\$0.04	\$0.01
Total Expenses (SF)	\$02.0	\$23.87	\$3.47	\$1.26	\$23.87	\$4.36	\$3.93	\$5.36	\$5.13	\$4.14
Total Expenses (% of EGI)	1.27%	99.73%	44.31%	1.27%	95.62%	43.72%	29.00%	39.00%	33.00%	28.76%

Source: 2005 Expense Guide for Self Storage, *Self Storage Economics*

- Rental income is derived from the self-storage units. Due to the number of units and various configuration possibilities, it is generally not appropriate to analyze self-storage income per rentable square foot without analyzing each unit (like apartments). Rents can vary for the basic unit types, such as outside access, inside access, upper units, and climate-controlled units. A typical rent roll is summarized in Table 3.
- Other (ancillary) income includes late fees, administrative fees, truck and equipment rentals, and retail sales of storage items (such as moving supplies). Ancillary income is typically 2-8% of gross income.

Long-term vacancy is determined by three main components: stabilized or physical vacancy, collection loss or credit, and rebates.

- A typical physical vacancy factor is 8%.
- A relatively low credit loss rate of 1% is reasonable. Industry loss tends to be low because the contents of the unit provide rent collateral.
- Rebates, generally for short terms and used irregularly, are estimated at 1% over the long run.

Under these parameters, long-term vacancy is concluded to be 10%. In general, occupancy above 90% suggests rental rates should be increased.

Self-storage facilities operate on a full-service, or gross, basis,

meaning all building operating expenses are paid by the owner, including fixed and variable expenses. Fixed expenses do not vary with occupancy and include real estate taxes and insurance. Variable expenses vary with the level of occupancy and include repairs and maintenance, administration, on-site management, off-site management, utilities, advertising, and miscellaneous. Self-storage property rarely incurs reserves for replacement. Due to a relatively low break-even point for occupancy, self-storage expenses tend to be relatively inelastic, or stable (in terms of total amount after absorption).

Data is analyzed on the rentable area per square foot and as a percentage of the effective

Table 5
Direct Capitalization and Income Summary

Rental Income	\$1,192,356		
Ancillary Income	\$47,694		
Potential Gross Income	\$1,240,050		
Less—Vacancy (10%)	\$(124,005)		
Effective Gross Income		\$1,116,045	
Less—Expenses			
Taxes	\$126,806		
Insurance	\$14,421		
Repairs & Maintenance	\$21,632		
Administration	\$21,632		
On-Site Management	\$72,105		
Off-Site Management	\$55,802		
Utilities	\$25,237		
Advertising	\$25,237		
Miscellaneous	\$721		
Total Expenses (29%)		\$(363,592)	
Net Operating Income			\$752,453
Capitalization Rate			\$0.075
Subtotal			\$10,032,712
Approach Conclusion (Rounded)			\$10,000,000

gross income. To assist in the analysis of a property's expense history and to forecast expenses, comparable expense data is referenced. The problem with using survey research is that the scope and methods of accumulating data vary for each category; the data can be skewed by a limited amount of directly comparable data. Moreover, this explains why there may be large variances in several categories, but the overall expenses are generally similar. The function of the comparable data and survey research is to provide a foundation for analyzing the subject operating history as the basis of the forecast. Expenses can vary widely, particularly when analyzed solely on a single unit of analysis, such as per square foot of rentable building area. Therefore, the data is analyzed on a per-square-foot basis and expressed as a ratio of effective gross income as an additional test of reasonableness.

The data—compiled from more than 300 properties nationwide and based on operating date year to date in mid-2005 with a 90-day collection period—is detailed on a national average, western region average, and state average (California in this case). Finally, the data is compared to three current expense comparables compiled from operating statements of projects located only in Southern California. The data is summarized in Table 4 and compared to the subject forecast. Each category of operating expense is then analyzed, concluded, and reconciled to the forecast of stabilized cash flow.

Based on the foregoing analyses, the subject expenses of \$4.14 per square foot are forecast as outlined in Table 4. The forecast is reasonable in relation to other variables (such as income). For example, the subject expense ratio is 28.76% of the effective

gross income or within the range of comparable data.

The overall capitalization rate is calculated by dividing the net operating income by the sales price. Ideally, the overall capitalization rate is selected from the market through sales of similar types of property. Comparable data indicates overall capitalization rates in the range of 6-9% in the current market. Urban and suburban facilities tend to have lower overall capitalization rates, while rates in rural locations tend to be higher. Other techniques for deriving an overall capitalization rate include debt coverage ratio (DCR) analysis and the mortgage-equity band of investment analysis.

Typically, the market data is emphasized in the conclusion of the subject's overall capitalization rate. In this regard, overall capitalization rates have been declining in recent years. In fact, based on survey results, the national average overall capitalization rate for self-storage property has declined at least 50 basis points each year. Moreover, survey research indicates nearly a 50-basis-point decline in overall capitalization rate expectations in the asset class over one year. Therefore, in this analysis, it's reasonable to conclude an overall capitalization rate of 7.5%.

Direct capitalization considers the income from one stable year of operation and capitalizes it into an indication of value. Under these parameters, the direct capitalization and the income summary are detailed for the subject in Table 5.

Conclusion

Lending capital is widely available to the self-storage asset class. Typical lending criteria are based on 80% loan to value at a 1.20 DCR. Terms are typically 10 years with a 30-year amortization. Construction loans are tied to LIBOR, usually in the range of 150 basis points over. Permanent financing is tied to the 10-year Treasury notes, also about 150 basis points over. This means loans are available in the 6.5-7% range for the self-storage product.

Recently, the DCR has been more challenging than loan to value. Also, with recent increases in the 10-year Treasuries, rate volatility has been a concern. Nevertheless, interest rates remain at historic lows for the self-storage asset class, with wide availability among Wall Street instruments and community bankers.

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. With demand coming from local trade areas, self-storage investment decisions are best made based on the neighborhood market conditions (making it ideal for local bank lending). These factors underscore the importance of market analysis in self-storage lending and must be considered in the conclusions of the quantity, quality, and durability of the income level. Careful cash flow (static) modeling is required to reflect these market characteris-

tics. With good, local market intelligence, lenders are choosing to store capital in the self-storage asset class. □

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Additional information on Self Storage Economics can be found at www.selfstorageeconomics.com. Self Storage Economics is a division of The Sonne Group, Inc., www.sonnegroup.com.

NOTES

¹ 2006 *Self-Storage Almanac* (produced by the editors of *Mini-Storage Messenger*), p. 54. Now in its 14th annual edition, the *Self-Storage Almanac* is an industry reference guide for both seasoned professionals and self-storage newcomers alike. See www.ministoragemessenger.com.

² *ibid.*

³ Storage USA no longer trades, because GE Capital purchased the REIT to return as a private company several years ago. More recently, Extra Space and Prudential purchased Storage USA from GE. Consolidation in the industry continues as a trend. Public Storage's purchase of Shurgard for \$5 billion ended a seven-month takeover conflict.

Share your comments or questions about articles appearing in *The RMA Journal* with Beverly Foster at bfoster@rmahq.org. If contacting the author directly, please "cc" bfoster@rmahq.org. Thanks.