

Domestic Self-Storage Market

STABILITY IN AN UNCERTAIN TIME

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INVESTORS STORING CASH IN THE SELF-STORAGE INDUSTRY CONTINUE TO FEEL OPTIMISTIC EVEN THOUGH THE U.S. ECONOMIC RECESSION AND CAPITAL MARKET DEPRESSION HAVE NEGATIVELY IMPACTED RENT INCREASES AND OCCUPANCY. In addition, financing remains very difficult to obtain even in strong markets as deleveraging continues, causing overall cap rates and yield rates to rise.

Interest in this asset class, particularly from private equity firms, continues to increase because of steady cash

flows, high returns, and low loss ratios. In addition, investors like the fact that there are no tenant improvement costs or leasing commissions and limited large capital expenditures. Despite investor interest, closed deals are a rarity now. One broker in Arizona reports that there are currently 41 self-storage facilities for sale within the state, but no sales have been reported thus far in 2009. Similarly, a California broker reports that only two self-storage assets have traded in the state year to date.

On a positive note, new construction has slowed considerably. Some estimate that less than 250 self-storage facilities will be constructed in 2009 nationwide, a huge decline from the peak pace of 2,500 about four years ago.

LENDING

Strong owners seeking financing indicate that favorable long-term debt (65.0% loan-to-value ratios, interest rates ranging from 7.00% to 7.50%, 25-year amortization, and debt coverage of 1.20) is increasingly difficult to find. In one recent instance, a seasoned regional operator with 20 self-storage facilities was facing a loan renewal. The lender would not discuss the deal with them even though the loan involved a stabilized asset, strong sponsorship, and was current in payments. While the loan was eventually renewed for one year at the same terms, this scenario illustrates the trepidation among lenders, as well as their growing preference to renew deals for shorter terms of six months to three years rather than structure new, long-term loans.

SURVEY FINDINGS

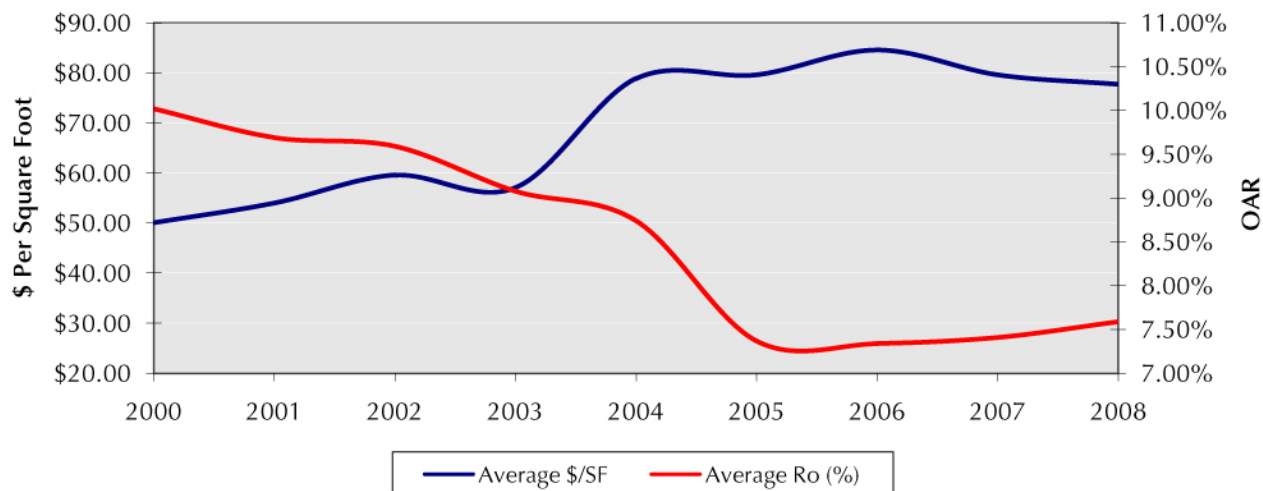
Overall cap rates have continued to increase at a pace of 8 to 10 basis points a month over the past year in response to macroeconomic challenges and credit market concerns. As shown in Table DSS-1, the average overall cap rate of 8.50% stands 50 basis points higher than the average six months ago. The overall cap rates reported for this market reflect stabilized, Class-A/B self-storage facilities in suburban areas.

Some respondents expressed hope

Table DSS-1
DOMESTIC SELF-STORAGE MARKET
Second Half 2009

	FIRST HALF 2009	SECOND HALF 2008
DISCOUNT RATE (IRR)^a		
Range	10.00% – 12.00%	10.00% – 11.00%
Average	11.25%	10.75%
Change (Basis Points)		+ 50
OVERALL CAP RATE (OAR)^a		
Range	7.00% – 10.00%	7.00% – 10.00%
Average	8.55%	8.00%
Change (Basis Points)		+ 55
RESIDUAL CAP RATE		
Range	8.00% – 10.50%	7.00% – 10.50%
Average	8.75%	8.50%
Change (Basis Points)		+ 25
MARKET RENT CHANGE RATE^b		
Range	1.00% – 5.00%	1.00% – 5.00%
Average	2.00%	2.50%
Change (Basis Points)		– 50
EXPENSE CHANGE RATE^b		
Range	2.00% – 5.00%	2.00% – 5.00%
Average	3.00%	3.00%
Change (Basis Points)		0
AVERAGE MARKETING TIME^c		
Range	3.00 – 12.00	3.00 – 12.00
Average	9.50	6.50
Change (%)		+ 46.15
a. Rate on unleveraged, all-cash transactions b. Initial rate of change c. In months		
Source: Cushman & Wakefield		

Chart SS-1
NATIONAL SELF-STORAGE TRENDS
 2000 to 2008



Source: Cushman & Wakefield

that the upward trend in overall cap rates would ease by the third or fourth quarter of 2009 as capital market pressure begins to subside. As one investor predicts, "We may not be at the bottom by then, but we should be able to see the bottom by then."

Similarly, yield rates are also rising but at a slower pace than overall cap rates. This is primarily a function of slower growth rate assumptions used in estimating net operating income and cash flow. As more investors use discounted cash flow analysis, replacement reserves, rarely applied in self-storage asset analysis in past years, are now becoming a common "below-the-line" expense at a range of \$0.10 to \$0.15 per square foot.

BUYERS AND SELLERS

The pricing gap between buyers and sellers remains wide. In one recent unsuccessful deal, a 50-asset portfolio failed due to bids involving 9.00%-plus overall cap rates. The seller expressed caution over selling to "grave dancers" while the buyer had concerns about the strength and durability of the cash

flow during a recession.

Despite these issues, confidence exists for self-storage ownership due to its relatively stable cash flows. In fact, many Survey participants indicate that the self-storage industry is "recession resistant." Still, investor caution does exist, and most respondents estimated that cash flow (measured by occupancy and income) has declined 5.0% or less as a result of the recession.

Currently, investors are poised for acquisitions, but waiting for markets to bottom out. Meanwhile, due diligence continues as investors separate the winning trade areas from the oversupplied ones. In general, investors are staying away from self-storage properties that were developed in growth markets that were waiting for rooftops to be constructed. Offerings most attractive are in small to large portfolios with a minimum of five properties within one city. This allows for management efficiency, not occupancy, to drive a "value-add" acquisition's rate and yield.

Investors also suspect that industry consolidation is likely in the months ahead. Approximately 80.0% of self

storage is non-institutionally owned or operated.

CONCLUSION

In the near term, self-storage cash flow is expected to remain stable relative to other asset classes. Over the long run, this trend will attract equity and capital financing. As a result, overall cap and yield rates should stabilize as transaction volume increases and the industry consolidates. In Chart SS-1, pricing met overall cap rates near 9.00% in mid-year 2003. This may suggest that overall cap rates will stabilize near 9.00% going forward. In the meantime, as one self-storage operator said of this interim period of waiting for the recovery, "Meanwhile, I'll sit back and enjoy my cash flow." ♦

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