

Domestic Self-Storage Market

MARKET FUNDAMENTALS VS. CAPITAL MARKETS

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EVEN THOUGH MARKET FUNDAMENTALS REMAIN STABLE FOR THE DOMESTIC SELF-STORAGE MARKET, INVESTORS ARE WORRIED ABOUT THE CREDIT CRUNCH AND THE STATE OF THE U.S. ECONOMY.

As a result, they are being more disciplined with respect to their due diligence and investment criteria and are paying closer attention to market conditions within a trade area. In turn, overall cap rates and yields are rising, and transaction volume is slowing significantly.

SURVEY FINDINGS

Self storage is a unique real estate class because demand is primarily local – within a three-mile ring on average. While market fundamentals overall remain relatively strong, performances vary greatly based on location and are typically labeled as under supplied, over supplied, or at equilibrium. About 50.0% of Survey respondents continue to describe market conditions as “over supplied” – down from 63.0% six months ago. Despite this decline, only

10.0% of them feel that development is the best strategy now. In fact, the most challenged properties in this environment are recently constructed self-storage facilities in the midst of absorption.

Many investors are also concerned about the impact of the housing downturn on this asset class. There are two views. One view is that the decline in homeownership will increase demand for self-storage product. The other view is that decreases in household income and drops in consumer confidence will cause individuals to budget more carefully, decreasing demand for self-storage space. While actual data is inconclusive, it is important to remember that over the long run, the vacancy rate for the U.S. self-storage market has been about 15.0% or less through both boom and bust market cycles.

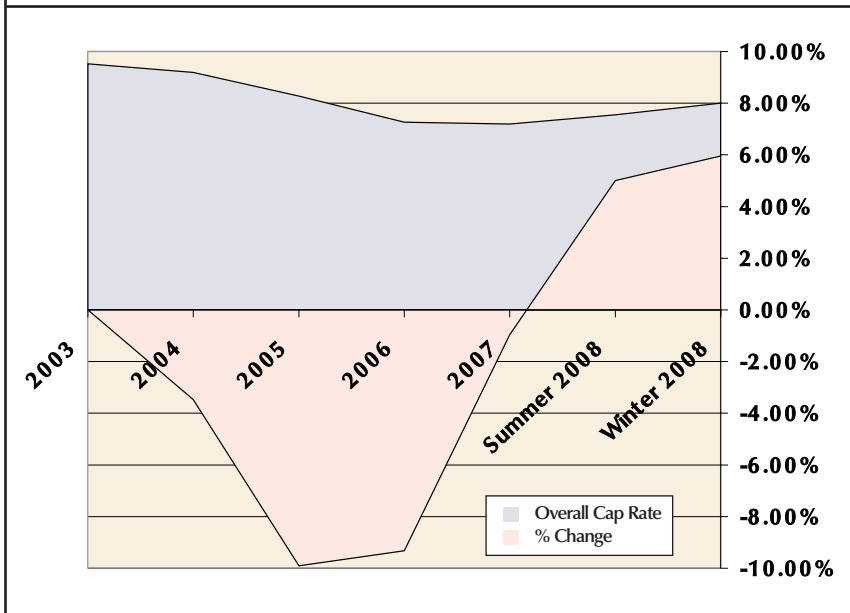
Due to greater uncertainty and universal stress, Surveyed brokers report a huge disconnect between buyers and sellers. Overall, sales volume has declined between 20.0% and 60.0% over the past year. Still, institutional money, including that of pension funds and hedge funds, is beginning to be placed into self-storage assets. In a recent transaction, Harrison Street Partners purchased 19 Simply Self Storage properties at a reported overall cap rate of 7.5% based on in-place income. Other recent buyers include large national and regional players, dancing on the graves of properties unable to be refinanced. Portfolio sales or smaller single assets, generally priced below \$3.0 million, are the most sought after by investors.

In an environment where cash flow is king, it is not surprising that self-stor-

Table DSS-1
DOMESTIC SELF-STORAGE MARKET
Second Half 2008

	SECOND HALF 2008	FIRST HALF 2008
DISCOUNT RATE (IRR)^a		
Range	10.00% – 11.00%	10.00% – 11.00%
Average	10.75%	10.50%
Change (Basis Points)		+ 25
OVERALL CAP RATE (OAR)^a		
Range	7.00% – 10.00%	6.00% – 9.00%
Average	8.00%	7.55%
Change (Basis Points)		+ 45
RESIDUAL CAP RATE		
Range	7.00% – 10.50%	7.00% – 10.50%
Average	8.50%	8.00%
Change (Basis Points)		+ 50
MARKET RENT CHANGE RATE^b		
Range	1.00% – 5.00%	1.00% – 5.00%
Average	2.50%	3.00%
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	1.00 – 12.00
Average	6.50	4.31
Change (%)		+ 50.81
a. Rate on unleveraged, all-cash transactions b. Initial rate of change c. In months		
Source: Cushman & Wakefield		

Chart DSS-1
OVERALL CAP RATE TRENDS
 2003 to Winter 2008



age assets are a magnetic for investors' dollars. As of November 30, 2008, the total return for the self-storage REIT class was down 9.19% – the smallest decline among all REIT asset classes at that point in time. Moreover, the average dividend was up 4.36%, reflecting an increase in capital flow to the asset class despite negative market sentiment regarding the stock market in general.

LENDING

Lending is still facilitated by large national banks and smaller local ones. However, lending criteria is very challenging and includes recourse loans at loan-to-value ratios not exceeding 65.0%, debt coverage ratios starting at 1.25, amortization over 25 years, and interest rates reportedly in the 7.0%-to-7.5% range. As one self-storage broker states, "Most deals in 2009 will not be from a willing seller, but from a seller forced out by financing difficulties."

VALUATION TRENDS

Due to the lower availability and the higher cost of capital, this market's

average overall cap rate increased 45 basis points over the past six months (see Table DSS-1). At an average of 8.00% (stabilized), it stands 86 basis points above the average 18 months ago. After a six-year decline, 2008 saw an increase in overall cap rates (see Chart DSS-1). Some investors estimate that overall cap rates for self-storage assets will continue to increase to historical levels in the 9.00%-to-10.00% range. However, this increase will be highly dependent on credit and economic conditions.

When applying overall cap rates, investors are increasingly relying on income in place or trailing 12-months income performance (T-12), rather than projections. One investor anecdotally reported a trend to apply an overall cap rate of 7.00% (or higher) to T-12 income as the hurdle rate for a purchase, regardless of occupancy. Along the same lines, a few respondents indicated that they do not give any credit for vacant space if a property has been stable (at 70.0%-to-80.0% occupancy) for more than two years.

Investors are also increasingly relying on discounted cash flow (DCF) analyses to value self-storage assets. Over the past six months, the average target IRR (unleveraged) increased 25 basis points to 10.75%. Growth assumptions for this IRR include an average rent growth of 2.50% and an average expense growth rate of 3.00% (although some investors are increasing expenses at a rate commensurate with inflation). The typical holding period is ten years with an average residual capitalization rate of 8.50%.

Survey results also indicate that the marketing time to sell a property and the absorption time to fill a property are both protracted compared to prior years.

CONCLUSION

Uncertainty and economic concern underlie the Survey results, yet market fundamentals for the self-storage asset class remain reasonably stable. While some investors are waiting for both the economy and credit markets to stabilize before acquiring additional assets, some opportunists are embracing a counter-herd strategy that believes now is the best time to buy cash-flow operations like those provided by self-storage assets.

While this Survey resulted in some widely divergent viewpoints, a common theme emerged for the year ahead – investors need to exercise greater discipline when analyzing market conditions and the cash flow operations of a self-storage property. ♦

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