

# A Rising Star

## Self-storage tops the charts

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*Just as down-on-his-luck Vince Papale makes pro in the movie Invincible, self-storage has made “pro” in the financial world. From Main Street to Wall Street, lenders are storing capital in the self-storage asset class. In public and private markets, lenders are finding safety and returns in self-storage real estate.*

Loan losses for self-storage commercial mortgage backed securities are the lowest of all asset classes. Specifically, loan losses were 2.3 percent over the past 10 years. As for returns, self-storage REITs yielded 19.3 percent (annual) — second highest among 12 REIT asset classes, as of second-quarter 2006. Exceeded only by apartments at 19.3 percent, self-storage beats office, shopping centers and industrial property. These returns account for appreciation and dividends.

Measuring dividends only, storage REITs have ranged 4.5 percent to more than 7.5 percent over the past four years. Comparatively, in June, common stock dividends averaged 1.96 percent for the common stocks 500 index published by Standard & Poor’s.

From humble origins as a burgeoning asset class, storage has become a \$15 billion industry with more than 41,000 facilities in the United States and five publicly traded REITs. It’s also an export industry, with hundreds of facilities developed in Europe over the last 10 years. More recently, Asian markets have begun developing facilities. The self-storage asset class has clearly made the pros.

### **From Humble Beginnings**

Self-storage development began after World War II in the United States as a tool of land banking or interim use. Some reports indicate Corpus Christi, Texas, opened the first modern facility in the 1960s. Over the last 50 years, the industry has grown immeasurably.

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

Assuming the industry is 50 years old and has 41,122 facilities nationwide (*2006 Self Storage Almanac*), the growth rate has averaged 822 facilities per year. This “McDonalds” growth pace means at least two new self-storage facilities have been constructed every day in the United States over the last 50 years!

More than 90 percent of facilities are owned privately (not publicly traded companies). Most are owned by small, local owner-operators. Consolidation in the industry is a current trend as operation costs tend to be lower for regional, multi-facility companies.

Consequently, consolidation in the industry is a trend that will continue. The industry's 10-year growth is summarized in Table 1.

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

### **Sophistication of the Class**

Capital flow, both equity and debt (private and public), has increased due to comparatively high returns. Moreover, the appeal of self-storage compared with other real estate investment 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 percent to 45 percent, compared to 60 percent or more for apartments. Consequently, self-storage facilities tend to hold value better and recover faster than other assets when real estate markets sour.

### **Market Analysis**

As an asset class, self-storage is a local, neighborhood business. For example, approximately two-thirds of a typical suburban facility's customer base comes from a three-mile radius.

Other resourceful market analyses are provided by The Self Storage Industry Group of Cushman & Wakefield, which surveys investors, developers, managers, brokers and bankers, accounting for more than 100 million square feet of storage property.

A recent survey highlights key information on market conditions for self-storage, capitalization rates, financing, optimism index and more. Results of the survey also indicated that, 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 devoted solely to the self-storage asset class.

While most investors indicate continued and growing demand for self-storage, concerns exist, particularly of overbuilding by market newcomers. Yet, capitalization rates are declining and prices increasing.

With market conditions the best ever, financing widely available and investor interest at an all-time high, one nationwide broker mentioned the possibility of the "B" word for the industry. The "B" word, or bubble, is mass-psychological phenomenon occurring when the herd follows the trend and continues to invest with like a bull without regard for the possibility of a bear. Local research will remain investors' most important tool.

## Lending Criteria

Typically, lending criteria is based on 80 percent loan-to-value at a 1.2 debt-coverage ratio, with 10-year terms and 30-year amortization. Construction loans are tied to LIBOR, usually in the range of 150 basis points over (current rates as high as 8 percent on construction loans). 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 percent to 7.5 percent range.

Recently, the debt-coverage ratio has been more challenging than loan-to-value. Also, with recent increases in 10-Year Treasuries, rate volatility has been a concern. Nevertheless, interest rates remain at historic lows for self-storage 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. Self-storage may not be exactly *Invincible*, but the asset class has definitely reached stardom.

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