Domestic Self-Storage Market

Investing with Confidence

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Continued gains in property cash flows have sustained confidence among investors in the domestic self-storage industry during the first half of 2013. As a result, overall capitalization rates (cap rates) and yield rates remain on a downward trend. In terms of industry performance, year-over-year results show increases of 3.1% for physical occupancy and 4.8% for rental income as of the first quarter of 2013, according to Self Storage Performance Quarterly published by Self Storage Data Services.

Investing Wisely

While the self-storage industry is performing well, investors are being more selective, segmenting cap rates by investment quality. For example, the average overall cap rate for a Class-A facility (physical and investment quality) can be as much as 175 basis points lower than for a Class-C facility (see Table DSS-2).

The differential noted between the market segments' overall cap rates is also found when comparing discount rates and residual cap rates. As the property class moves down from Class-A, investors see more risk and require higher yields – a similar pattern in other CRE property types.

Market segmentation for the self-storage industry is generally defined as follows:

Class-A self-storage assets:

- located in top-50 metro areas, usually with high barriers to entry
- excellent locations with access to attract tenants able to afford rents in the upper percentile of the marketplace
- superior construction and finish
- above-average maintenance and security
- professional on-site and off-site management

Class-B self-storage assets:

- average location, access, and visibility
- construction quality ranges from average to good
- maintenance ranges from average to good
- security ranges from average to good
- full-time on-site and competent off-site management

Class-C self-storage assets:

- secondary, less-desirable locations with poor access and limited visibility

Table DSS-1
DOMESTIC SELF-STORAGE MARKET
First Half 2013

	FIRST HALF 2013	SECOND HALF 2012	FIRST HALF 2012
DISCOUNT RATE (IRR)[a]			
Range	8.50% – 11.00%	8.50% – 11.00%	8.50% – 11.00%
Average	9.50%	9.75%	10.00%
Change (Basis Points)		– 25	– 50
OVERALL CAP RATE (OAR)[a]			
Range	5.75% – 8.50%	6.25% – 8.50%	6.50% – 8.50%
Average	6.55%	6.75%	7.00%
Change (Basis Points)		– 20	– 45
RESIDUAL CAP RATE			
Range	6.00% – 8.75%	6.50% – 8.75%	6.75% – 8.75%
Average	6.75%	7.00%	7.25%
Change (Basis Points)		– 25	– 50
MARKET RENT CHANGE[b]			
Range	3.00% – 6.00%	3.00% – 6.00%	3.00% – 6.00%
Average	3.50%	3.50%	3.50%
Change (Basis Points)		0	0
EXPENSE CHANGE[b]			
Range	2.00% – 5.00%	2.00% – 5.00%	2.00% – 5.00%
Average	3.00%	3.25%	3.00%
Change (Basis Points)		– 25	0
AVERAGE MARKETING TIME[c]			
Range	2 – 7	3 – 6	3 – 6
Average	3.0	3.0	3.0
Change (▼, ▲, =)		=	=

a. Rate on unleveraged, all-cash transactions b. Initial rate of change c. In months
Source: Cushman & Wakefield

- construction quality ranges from fair to average
- maintenance ranges from fair to average with minimal or no security
- managed by the owner and may not have on-site manager
- older facilities with growing functional and/or economic obsolescence

Over the last five years, investors have increased their due diligence when investing in self-storage assets. As a result, discounted cash flow (DCF) analysis has become the preferred methodology when valuing assets and preparing enhanced revenue models.

Portfolios Are Hot

The appetite for self-storage portfolios is increasing. In the span of a week, several investors analyzing portfolio offerings called the transaction market either "hot" or "crazy." While the cap rate spread between a single-property sale and a portfolio deal was as much as 100 basis points for Class-A and Class-B quality assets, the new consistent normal seems to be 100 basis points. Moreover, it appears portfolio cap rates are now compressing faster than single-asset cap rates.

In some instances, experienced buyers are losing bids in early rounds as the best and final offers are experiencing significant premiums, sometimes exceeding a seller's expectations. Even though most portfolio buyers prefer to acquire and then manage assets, equity investment is increasing in portfolios where new equity is placed to acquire a controlling interest in the assets, but the assets continue with the minority owner as manager.

Even though the desire to acquire self-storage portfolios reflects this sector's continued strong performance, it is difficult to accumulate portfolios as the sector remains highly fragmented with less than 20.0% of all facilities institutionally owned. In fact, the ten largest self-storage operators own only 11.0% of all facilities in the United States.

CMBS Debt Due

While confidence in this asset class remains high, investors are concerned about the Federal Reserve's (the Fed) policy regarding quantitative easing. While most investors are confident that interest rates will remain low through 2013, concerns linger for 2014 and beyond due to a potential change in the Fed's leadership. With over $20.0 billion in debt coming due over the next five years, investors and owners are now attempting to lock in low rates.

Credit is increasingly available for real estate, including self storage. Year to date, CMBS lenders have issued $38.0 billion or almost $10.0 billion more than last year, according to Commercial Real Estate Direct. Preliminary estimates for 2013 indicate continued and significant growth in CMBS lending. National and regional banks, as well as life companies, continue to lend to the self-storage sector. However, borrowing is led by strong sponsorship. Borrowers with poor balance sheets may still encounter difficulty obtaining financing.

Overall Cap Rates

Self-storage cap rates are expected to continue to decline in 2013. Comparing the spread in self-storage cap rates and the ten-year treasury suggests compression is reasonable. Over the past 12 years, the average spread has been 425 basis points. Now, with record low treasuries, the spread is approximately 486 basis points – the third highest in the last 12 years. Many investors believe the spread will decline over the next year, leading to lower cap rates and higher values in the self-storage industry. ✦

Table DSS-2
DOMESTIC SELF-STORAGE INDUSTRY
Market Segmentation by Investment Quality

	CLASS-A	CLASS-B	CLASS-C
DISCOUNT RATE (IRR)[a]			
Range	8.50% – 9.50%	9.00% – 10.00%	10.00% – 11.00%
Average	9.00%	9.50%	10.50%
OVERALL CAP RATE (OAR)[a]			
Range	5.75% – 6.75%	6.25% – 7.50%	7.50% – 8.50%
Average	6.25%	7.00%	8.00%
RESIDUAL CAP RATE			
Range	6.00% – 7.00%	6.50% – 7.75%	7.75% – 8.75%
Average	6.50%	7.50%	8.25%

a. Rate on unleveraged, all-cash transactions
Source: Cushman & Wakefield