Domestic Self-Storage Market

Fundamentals Remain Strong

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Underlying fundamentals remain strong in the domestic self-storage market, resulting in continued robust growth in operating results. As of the fourth quarter of 2013, year-over-year results for self-storage REITs show increases of 2.7% for physical occupancy and 8.1% for rental income, according to Self Storage Performance Quarterly. Many market players believe this pace of income growth will slow over the long term to between 3.0% and 4.0%.

Favorable fundamentals combined with limited additions to supply continue to lure investors to this sector with a continued focus on acquiring portfolios, such as the recent deals involving Veritage and Mini U portfolios for over $400.0 million.

Capital sources new to self storage include top-50 global investors that like the higher yields in this "core-plus" sector compared to the yields typically generated by traditional core commercial real estate assets, like apartment, office, and retail.

Table DSS-1
DOMESTIC SELF-STORAGE MARKET
First Half 2014

	FIRST HALF 2014	SECOND HALF 2013	FIRST HALF 2013
DISCOUNT RATE (IRR)[a]			
Range	8.00% – 11.00%	8.25% – 11.00%	8.50% – 11.00%
Average	9.15%	9.25%	9.50%
Change (Basis Points)		– 10	– 35
OVERALL CAP RATE (OAR)[a]			
Range	5.25% – 8.50%	5.50% – 8.50%	5.75% – 8.50%
Average	6.12%	6.25%	6.55%
Change (Basis Points)		– 13	– 43
RESIDUAL CAP RATE			
Range	5.50% – 8.50%	6.00% – 8.50%	6.25% – 8.75%
Average	6.35%	6.50%	6.75%
Change (Basis Points)		– 15	– 40
MARKET RENT CHANGE[b]			
Range	3.00% – 6.00%	3.00% – 6.00%	3.00% – 6.00%
Average	3.50%	3.25%	3.50%
Change (Basis Points)		+ 25	0
EXPENSE CHANGE[b]			
Range	2.00% – 5.00%	2.00% – 5.00%	2.00% – 5.00%
Average	3.00%	3.00%	3.00%
Change (Basis Points)		0	0
AVERAGE MARKETING TIME[c]			
Range	2 – 6	2 – 7	2 – 7
Average	2.5	3.0	3.0
Change (▼, ▲, =)		▼	▼

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

DCF Analysis Still Favored

Investors continue to focus on discounted cash flow (DCF) analysis as their primary valuation methodology. When modeling DCFs, the need to use bifurcated growth rates has increased as property performances have been improved by competent management. While market rents are modeled to grow at the rate of inflation, income-in-place is modeled at a higher rate of growth. As shown in Table DSS-1, market rent change rate assumptions range from 3.00% to 6.00% and average 3.50% for the first half of 2014.

When modeling DCF analyses, the compound rate of growth of the net operating income (NOI) over the holding period when added to the going-in (overall) cap rate generally equates to the internal rate of return (IRR or discount rate) within 50 basis points. For example, a 6.50% overall cap rate with a cash flow that generates a compound rate of growth in NOI of 3.65% will likely result in a discount rate or IRR ranging from 9.75% to 10.65% (plus or minus 50 basis points of the combined total of 10.15%).

Typically, the DCF includes a terminal (residual) cap rate 25 basis points higher than the going-in cap rate (on average). While a property's overall value has historically been bifurcated 50.0%-50.0% between cash flow and reversion, investor confidence in the self-storage sector has led to placing more emphasis on the reversion (as much as 60.0%).

The resulting DCF value is usually tested against a direct cap model with the spread between both approaches typically being less than 5.0%. This narrow gap is due to steady cash flows and the absence of significant vacancy during the holding period. Plus, a lack of leasing commissions and tenant improvement costs allow self-storage cash flows to be relatively close to NOI.

Quality Matters

As publicly traded self-storage firms worry about dilution to stock pricing from ownership of sub-par facilities, they are mainly focused on owning Class-A and Class-B properties, as well as properties in the top-50 metro areas which generally have higher rental rates. Data by class is summarized in Table DSS-2.

Capital Market Update

Even though the Fed forecasts that interest rates will increase in late 2014, causing 10-year Treasuries to increase 20 basis points, strong competition among self-storage lenders has made interest rates relatively stable or even declining. At the same time, CMBS new issuance spreads have been slightly tighter since the beginning of the year with super-senior bonds inside of 90 basis points and a range of BBB- classes in the 345- to 395-basis-point range.

Key points from Cushman & Wakefield Capital Markets Research's *International Investment Atlas 2014* released in April are below.

- Momentum is building as confidence returns.
- Demand is broadening to new areas and sectors.
- A rapid but front-loaded recovery is now underway.
- Change, not growth, is set to drive medium-term demand and performance.
- Investors are well advised to buy the stock not the market.
- An abundance of real estate equity funds exist.

With regard to overall cap rate trends, investors are more optimistic than six months ago about the compression trend continuing. Initially, rates were forecast to flatten in the first half of 2014 with future changes being directly linked to changes in interest rates. Continued momentum in acquisitions, however, has continued the compression trend. One investor reluctantly acknowledged that cap rates continue to decline, saying "We hate it because product is getting very expensive."

This sector's average overall cap rate peaked in 2009 at 8.55%, 243 basis points above the current average of 6.12%, indicating an average annual decline of nearly 50 basis points. As shown in Table DSS-1, the cap rate compression trend continues, albeit at a slower pace.

While some speculate that new development in this sector will increase substantially, new construction starts are less than 150 facilities annualized as of the second quarter of 2014 – well below the natural rate for self-storage annual supply growth of 1.0% or about 500 facilities a year.

Conclusion

Strong fundamentals and limited growth in supply are resulting in rising income and occupancy in the self-storage sector. As a result, investor interest remains robust and cap rate compression continues. Investor confidence in this sector is demonstrated in both the public and private markets. In the public sector, REIT stocks are trading at record pricing, suggesting a long-term confidence in the self-storage sector with greater emphasis on future returns. In the private market, acquisition volume remains high for both single assets and portfolios with new players including global, experienced investors who see the long-term strength of this niche sector, which many now argue is a core asset class. ✦

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

	CLASS-A	CLASS-B	CLASS-C
DISCOUNT RATE (IRR)[a]			
Range	8.25% – 9.25%	9.00% – 10.00%	10.00% – 11.00%
Average	9.00%	9.75%	10.50%
OVERALL CAP RATE (OAR)[a]			
Range	5.50% – 6.50%	6.25% – 7.50%	7.25% – 8.50%
Average	6.00%	6.75%	7.75%
RESIDUAL CAP RATE			
Range	6.00% – 6.75%	6.50% – 7.75%	7.75% – 8.75%
Average	6.25%	7.00%	8.00%

a. Rate on unleveraged, all-cash transactions
Source: Cushman & Wakefield; first half 2014