Domestic Self-Storage Market

Growth to Flatten in Self Storage

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The past year has been characterized by significant growth in terms of occupancy and income for the domestic self-storage market while overall cap rates and yields continued to compress. Robust market activity was led by portfolio acquisitions, totaling over $2.0 billion thus far in 2013 – a pace that doubled the prior two years. Recently, however, self-storage REIT stocks have either stabilized or declined, suggesting cautious optimism in the public marketplace. As a result, many market participants expect income and occupancy growth in the domestic self-storage market to flatten while overall cap rates and yields stabilize.

According to Self Storage Performance Quarterly published by Self Storage Data Services, year-over-year results as of the third quarter of 2013 show flat (0.0%) growth for the sector's physical occupancy and a 1.1% decline for rental income. At the same time, however, the report shows self-storage REITs with a 2.0% gain in occupancy and a 1.2% growth in rental income.

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

	SECOND HALF 2013	FIRST HALF 2013	SECOND HALF 2012
DISCOUNT RATE (IRR)[a]			
Range	8.25% – 11.00%	8.50% – 11.00%	8.50% – 11.00%
Average	9.25%	9.50%	9.75%
Change (Basis Points)		– 25	– 50
OVERALL CAP RATE (OAR)[a]			
Range	5.50% – 8.50%	5.75% – 8.50%	6.25% – 8.50%
Average	6.25%	6.55%	6.75%
Change (Basis Points)		– 30	– 50
RESIDUAL CAP RATE			
Range	6.00% – 8.50%	6.00% – 8.75%	6.50% – 8.75%
Average	6.50%	6.75%	7.00%
Change (Basis Points)		– 25	– 50
MARKET RENT CHANGE[b]			
Range	3.00% – 6.00%	3.00% – 6.00%	3.00% – 6.00%
Average	3.25%	3.50%	3.50%
Change (Basis Points)		– 25	– 25
EXPENSE CHANGE[b]			
Range	2.00% – 5.00%	2.00% – 5.00%	2.00% – 5.00%
Average	3.00%	3.00%	3.25%
Change (Basis Points)		0	– 25
AVERAGE MARKETING TIME[c]			
Range	2 – 7	2 – 7	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

Optimism Still Prevails

Overall, our Self-Storage Optimism Index for the second half of 2013 reports an average score of 7.50 (1 – lowest, 10 – highest), or the highest score recorded over the past ten years. Similarly, most respondents (45.0%) believe that this market is at equilibrium, also the highest percentage response in the past ten years. Lastly, in terms of strategy (buy, sell, or build), 52.0% of Survey respondents feel that market conditions dictate buying now – the highest percentage in the history of C&W's Survey.

While investors interviewed during the second half of 2013 expressed confidence in the sector's operational metrics for 2014, they expect rental growth to slow. While concerns of interest rate increases in 2014 and uncertainty regarding the Fed's monetary policy are the primary reasons investors feel both income and occupancy will "flatten" in the industry over the next 12 months, spreads on interest rates appear to be declining. In fact, November 2013 was a positive month for the CMBS market with more than $10.0 billion issued and AAA spreads declining to below 95 basis points, as per Cushman & Wakefield. In addition, Bloomberg reported $63.5 billion of offerings so far this year and another $14.5 billion in the pipeline. Thus, it appears uncertainty in government fiscal and monetary policy is somewhat offset by strength in the private economic sector.

Nevertheless, this market's average initial-year market rent change rate assumption declines 25 basis points during the second half of 2013 (see Table DSS-1). Still, the range remains unchanged.

Overall Cap Rates

Even though this market's average overall cap rate declines 30 basis points during the second half of 2013, investors foresee cap rates stabilizing in the first half of 2014 with future changes being directly linked to changes in interest rates. While certain investors express concerns that self-storage overall cap rates would begin to move upward in 2014, the ability to quickly adjust rental rates diminishes inflationary concerns and keeps their optimism high.

Within the self-storage industry key cash flow assumptions (discount rates, overall cap rates, and residual cap rates) continue to vary based on asset class (see Table DSS-2). As expected, the averages for these cash flow assumptions remain lowest for Class-A assets – properties usually located in metros with high barriers to entry, with accessible locations, superior construction and finish, and above-average maintenance and security.

Where Is New Supply?

With the U.S. self-storage industry's median occupancy hovering in the mid 80.0% range and rental income demonstrating a general trend of growth, many market participants are beginning to look at opportunities for new construction. In addition, many REITs are reporting joint ventures with developers to purchase facilities upon completion (with a certificate of occupancy) to avoid having a lagging asset on the books during construction.

Despite the desire to build new product, data indicates only modest supply growth. Over the past four quarters, only 116 new self-storage property starts were reported for the United States, as per F.W. Dodge. This level is down over 40.0% from the pace recorded from the third quarter of 2008 to the second quarter of 2009 and down over 75.0% from the peak building years during the boom cycle of the 2000s. One reason for the lack of new self-storage development is a lack of new construction financing from traditional, "Main Street" banking sources.

CMBS Debt Due

With over $20.0 billion in CMBS debt coming due on self-storage assets between 2014 and 2017, many investors and owners are now attempting to lock in low rates. Compared to the rest of the commercial real estate (CRE) industry, self-storage CMBS maturities represent approximately 4.2% of the total CMBS debt maturing in the CRE in 2014. This percentage rises steadily through 2017 at which time it will represent 5.1% of the CRE industry's CMBS maturities.

Conclusion

Over the long run, low levels of new supply suggest continued strength for the domestic self-storage market's fundamentals. If both supply and demand remain near equilibrium, rents and occupancy levels should continue to rise in 2014, albeit at a more moderate pace of growth. With regard to investments, market participants view the future of interest rates as the prime factor that will determine the direction and magnitude of sales volume and pricing for self-storage assets. ✦

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]			
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Average	6.00%	6.75%	7.75%
RESIDUAL CAP RATE			
Range	6.00% – 6.75%	6.50% – 7.75%	7.75% – 8.50%
Average	6.25%	7.00%	8.00%

a. Rate on unleveraged, all-cash transactions

Source: Cushman & Wakefield; second half 2013