

Domestic Self-Storage Market

RATIONAL EXUBERANCE

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Strong acquisition demand for self-storage assets caused overall capitalization (cap) rates to compress at a faster pace in the second half of 2014 than in the beginning of the year, according to surveyed investors. As shown in Table DSS-1, buyer competition was very competitive for both single assets and portfolios in the third quarter of 2014, leading to a 22-basis-point decline in the average overall cap rate over the last six months. While one investor notes

that overall cap rates hover near 5.50% for Class-A product in a top-50 MSA, some brokers report sub-5.00% overall cap rates for certain portfolio deals.

When combined with restrained construction trends, steady returns and strong leasing activity have boosted investor confidence in this sector, which continues to provide robust growth in operating results. In terms of industry performance, year-over-year results for storage

REITs show increases of 3.60% in rental income as of the third quarter of 2014, according to *Self Storage Performance Quarterly*. In addition, new construction starts are less than 150 facilities annualized – well below prior years.

MARKET RENT AND DCFs

Positive fundamentals and investor optimism are reflected in this sector's market rent change rate assumption, which ranges from 3.00% to 6.00% for the second half of 2014 and averages 3.50% (see Table DSS-1). The current average is comparable to that reported six months ago and underscores investors' sentiment that the sector's incredible performance last year, led by an 8.1% growth in rental income, will not continue over the long run.

When preparing a discounted cash flow (DCF) analysis, which is the preferred valuation method used by surveyed investors, the need to analyze bifurcated growth rates has increased. Market rents may grow at the rate of inflation, while growth rates on income in place (contract rents) tend to be higher. Generally, the compound rate of growth of the net operating income (NOI) over the holding period becomes the delta between the overall cap rate and the yield rate – within 50 basis points. For example, a 6.00% overall cap rate with a compound rate of growth in the NOI of 3.65% would result in a discount rate of internal rate of return (IRR) near 9.50% (within 15 basis points of 6.00% plus 3.65%).

Table DSS-1			
DOMESTIC SELF-STORAGE MARKET			
Second Half 2014			
	SECOND HALF 2014	FIRST HALF 2014	SECOND HALF 2013
DISCOUNT RATE (IRR)^a			
Range	8.00% – 11.00%	8.00% – 11.00%	8.25% – 11.00%
Average	9.00%	9.15%	9.25%
Change (Basis Points)		- 15	- 25
OVERALL CAP RATE (OAR)^a			
Range	5.25% – 8.50%	5.25% – 8.50%	5.50% – 8.50%
Average	5.90%	6.12%	6.25%
Change (Basis Points)		- 22	- 35
RESIDUAL CAP RATE			
Range	5.50% – 8.50%	5.50% – 8.50%	6.00% – 8.50%
Average	6.15%	6.35%	6.50%
Change (Basis Points)		- 20	- 35
MARKET RENT CHANGE^b			
Range	3.00% – 6.00%	3.00% – 6.00%	3.00% – 6.00%
Average	3.50%	3.50%	3.25%
Change (Basis Points)		0	+ 25
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 – 6	2 – 7
Average	3.0	2.5	3.0
Change (▼, ▲, =)		▲	=
a. Rate on unleveraged, all-cash transactions b. Initial rate of change c. In months			
Source: Cushman & Wakefield			

Typically, the DCF includes a terminal (residual) capitalization rate 25 basis points higher than the overall cap rate. While the overall property value is a combination of the present value of the cash flows and the reversion, historically a 50.0%/50.0% weighting, confidence in the self-storage sector has led to more emphasis being placed on the reversion (up to 60.0%).

The cost-of-sale assumption remains relatively low, generally 2.00% to 3.00% and even lower for portfolios (1.00% or less).

DIRECT CAPITALIZATION

Investors continue to test DCF analyses against direct capitalization results. For self storage, the spread between both valuation methods is typically less than 5.00% due to steady cash flows and strong re-leasing and retention rates. Also, self

storage cash flows are void of leasing commissions and tenant improvement allowances so cash flows are generally close to net operating incomes.

OVERALL CAP RATES

Initially, overall cap rates for the self-storage sector were forecast to flatten in the first half of 2014 with future changes directly linked to shifts in interest rates. However, continued momentum in acquisitions, as well as still-low interest rates, has continued the compression trend. As shown in Table DSS-1, the average overall cap rate slips 22 basis points over the past six months. This sector's average overall cap rate peaked in 2009 at 8.55%, indicating an average annual decline of 48 basis points over the past five years.

Investors are becoming more selective about the quality of the self-storage product they look to acquire with institutional and REIT investors

focusing on Class-A and Class-B assets in the top 50 MSAs. Even though there has been a surprising amount of activity across each segment, Class-A and Class-B products have captured the greatest volume of capital while Class-C product accounts for the highest number of sales.

A breakout of discount rates, overall cap rates, and residual cap rates by market segment is shown in Table DSS-2. At 5.50%, the average overall cap rate for the Class-A sector is the lowest, representing a 50-basis-point decrease from six months ago.

Even though the average overall cap rates for the Class-B and Class-C segments also declined over that time period, the decreases were a bit lower at 35 and 25 basis points, respectively.

CONCLUSION

Heading into 2015, investors remain upbeat about the investment prospects surrounding the self-storage industry. Both existing players, as well as new ones, will likely look to capitalize on this sector's favorable trends relating to robust fundamentals, steady cash flows, and limited additions to supply, keeping competition strong among buyers and downward pressure on overall cap rates. ♦

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Table DSS-2

DOMESTIC SELF-STORAGE MARKET

Key Indicators by Asset Class

	CLASS-A	CLASS-B	CLASS-C
SECOND HALF 2014			
DISCOUNT RATE (IRR)^a			
Range	8.00% – 9.00%	9.00% – 10.00%	10.00% – 11.00%
Average	8.55%	9.35%	10.30%
OVERALL CAP RATE (OAR)^a			
Range	5.00% – 6.00%	6.00% – 7.25%	7.25% – 8.50%
Average	5.50%	6.40%	7.50%
RESIDUAL CAP RATE			
Range	5.25% – 6.25%	6.25% – 7.25%	7.50% – 8.75%
Average	5.75%	6.60%	7.75%
FIRST HALF 2014 [AVERAGE ONLY]			
DISCOUNT RATE (IRR)^a			
Average	9.00%	9.75%	10.50%
OVERALL CAP RATE (OAR)^a			
Average	6.00%	6.75%	7.75%
RESIDUAL CAP RATE			
Average	6.25%	7.00%	8.00%
a. Rate on unleveraged, all-cash transactions			
Source: Cushman & Wakefield			