

# BUSINESS BRIEFING SELF STORAGE



## VALUATION & ADVISORY

A Cushman & Wakefield Valuation & Advisory Publication

AUGUST 2013



## MOVING WITH CONFIDENCE IN SELF STORAGE

### Investors remain confident, despite recent volatility in interest rates

The impact of recent significant increases in 10-Year Treasuries indicate cap rates will remain flat until the bond market stabilizes. Over the long run, it appears the rapid compression in self storage cap rates is likely to flatten and stabilize. Operationally, the asset class remains robust. Year-over-year results show increases of 3.1 percent for physical occupancy and 4.8 percent for rental income, as of the first quarter of 2013, according to Self Storage Performance Quarterly published by Cushman & Wakefield.

Investors are increasingly being more selective, demonstrated by increasing segmentation among 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 275 basis points lower than for a Class-C facility. This presents interesting opportunities for smaller, more entrepreneurial investors to focus on secondary markets where yields are higher. Data from the Summer 2013 PwC Investor Survey for the domestic self storage market (authored by Cushman & Wakefield) is summarized on the following page.

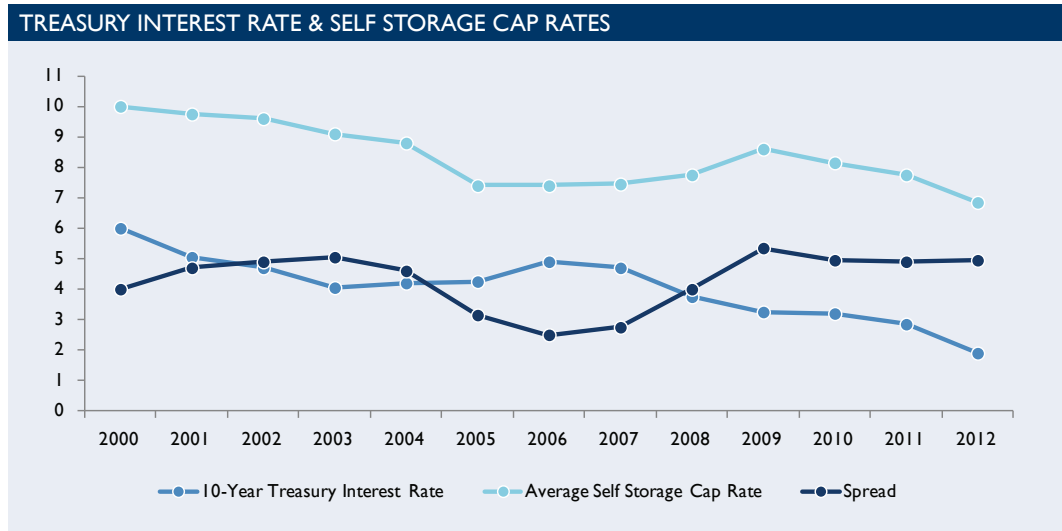
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| MARKET SEGMENTATION BY INVESTMENT QUALITY |               |                |                 |
|---|---------------|----------------|-----------------|
|   | CLASS A       | CLASS B        | CLASS C         |
| <b>DISCOUNT RATE (IRR)</b>                |               |                |                 |
| Range:                                    | 8.50% – 9.50% | 9.00% – 10.00% | 10.00% – 11.00% |
| Average:                                  | 9.00%         | 9.50%          | 10.50%          |
| <b>CAPITALIZATION RATE</b>                |               |                |                 |
| Range:                                    | 5.75% – 6.75% | 6.25% – 7.50%  | 7.50% – 8.50%   |
| Average:                                  | 6.55%         | 7.25%          | 8.00%           |
| <b>RESIDUAL CAP RATE</b>                  |               |                |                 |
| Range:                                    | 6.00% – 7.00% | 6.50% – 7.75%  | 7.75% – 8.75%   |
| Average:                                  | 6.75%         | 7.50%          | 8.25%           |

Source: Self Storage Industry Group of Cushman & Wakefield

INTEREST RATE VOLATILITY

Beginning in June 2013, the 10-Year Treasuries have spiked nearly 100 basis points from May to the current level of 2.63 percent (July 2013). Consequently, spreads to cap rates either must decline or cap rates will rise. The good news is the current Treasuries remain 291 basis points below the long term average of 5.4 percent (Source: Cushman & Wakefield Capital Markets). To analyze the long run impact, a time series of cap rate spreads to 10-Year Treasuries is shown below.



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From 2000 to 2012, the spread (from 10-Year Treasuries to Cap Rates) for self storage has averaged 425 basis points. Comparatively, the current spread is 392 basis points. At the end of 2012, the spread was 486 basis points indicating declining spreads as interest rates are rising. This is not surprising, because the spread at the end of 2012 was the third highest over the past 12 years. Currently, the 392 basis point spread is the fourth lowest since 2000. This indicates investors remain confident in the asset class and are willing to accept lower spreads, probably a function of strong operation characteristics indicated by rising occupancy and income.

### ONE SMALL STEP

The Fed's policy may have been one small step toward reductive involvement, but it was one giant step to market confusion. Fed Chairman Ben Bernanke seemed puzzled by market reaction that resulted in interest rates rising so quickly. The minutes from the Fed Open Market Committee meeting released July 10, caused Chairman Bernanke to clarify that the plan for tapering bond buying or quantitative easing this year. The Fed does not plan to shut down quantitative easing or raise the cost of funds until nationwide unemployment is below seven percent, not expected until next year. Nevertheless, the market sensitivity and resulting elasticity suggest that any movement by the Fed, either by quantitative easing or to interest rates, will result in an increase to cap rates. Given the Fed's opinion to raise interest rates when unemployment declines, it is likely self storage cap rates will begin to rise by the second quarter of 2014.

### MARKET FUNDAMENTALS

Supply and demand factors are near equilibrium in self storage, resulting in rising operational characteristics and higher net operating income. Industry operating metrics in terms of occupancy and income demonstrate continued, positive momentum. The REITs show some anomalous results in terms of asking rents, but rental income is a more important metric because it more closely reflects cash flow. In self storage, positive growth in physical occupancy tends to be followed by growth in economic occupancy suggesting momentum will be sustained.

Prudent management will enhance revenue by raising rents on existing tenants. Some management companies use complex modeling to find the sweet spot between raising rents and losing tenants. This seems to translate into raising rents on existing tenants at month five and month nine. To keep occupancy growing, street or stated rents are lower. As a result, economic occupancy can be higher than physical occupancy. Monthly contracts mean rents can be increased at any time. REITs are particularly adept at revenue management resulting in superior operating performance over the long run.



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Operating data from the Q1 2013 Self Storage Performance Quarterly is presented below:

| PERFORMANCE AT-A-GLANCE<br>FIRST QUARTER 2013<br>(Benchmark Ground Level 10X10 Non-Climate-Controlled Units) |                              |               |                             |                   |   |
|--|------------------------------|---------------|-----------------------------|-------------------|---|
| NATIONWIDE   | QUARTERLY<br>Q1 13 vs. Q4 12 |               | SEASONAL<br>Q1 13 vs. Q1 12 |                   | ANNUAL<br>Current Four Quarters vs.<br>Preceding Four Quarters <sup>1</sup> |
| Asking Rental Rate   | ↓                            | Down<br>-2.2% | ↔                           | No Change<br>0.0% | ↔ No Change<br>0.0%   |
| Physical Occupancy Rate  | ↓                            | Down<br>-1.5% | ↑                           | Up<br>3.1%        | ↑ Up<br>0.8%  |
| Rent per Available Sq Ft<br>(Rental Income)  | ↓                            | Down<br>-4.6% | ↑                           | Up<br>4.8%        | ↑ Up<br>1.1%  |
| REITS  | QUARTERLY<br>Q1 13 vs. Q4 12 |               | SEASONAL<br>Q1 13 vs. Q1 12 |                   | ANNUAL<br>Current Four Quarters vs.<br>Preceding Four Quarters <sup>1</sup> |
| Asking Rental Rate   | ↓                            | Down<br>-2.8% | ↓                           | Down<br>-1.9%     | ↓ Down<br>-0.5%   |
| Physical Occupancy Rate  | ↑                            | Up<br>0.3%    | ↑                           | Up<br>3.7%        | ↑ Up<br>0.9%  |
| Rent per Available Sq Ft<br>(Rental Income)  | ↓                            | Down<br>-2.3% | ↑                           | Up<br>6.3%        | ↑ Up<br>1.5%  |

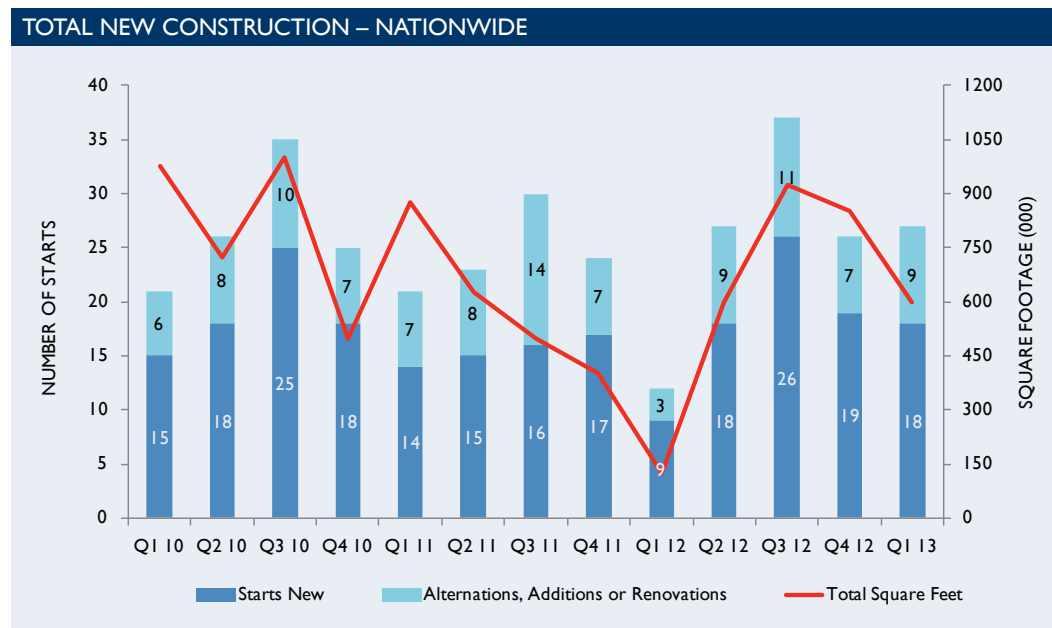
<sup>1</sup>The Annual changes reflect the percent change in the moving average for the four quarters ended in the current quarter relative to the four quarters ended in the previous quarter

## NEW CONSTRUCTION STARTS

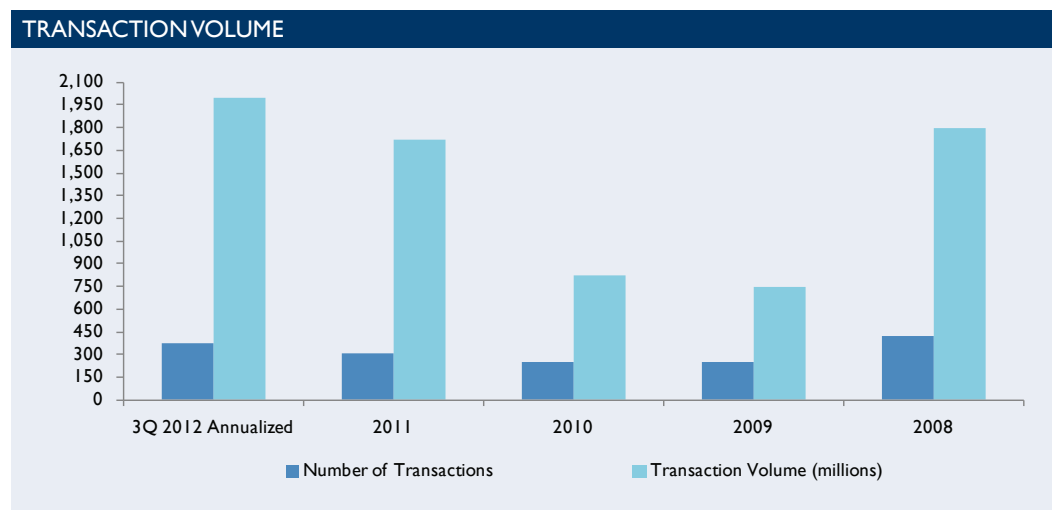
The graph on the next page illustrates the historical trend in the total number of new construction starts for self storage facilities including alterations, renovations and interior construction, both within and outside major metropolitan areas (Source: F.W. Dodge). Construction starts continue to be very low on a historical basis, however they are up 4 percent from last quarter, and up 125 percent from last year showing increased investor optimism as operating fundamentals continue to improve. Most large operators and a handful of regional operators have started actively searching for new development opportunities in most major metropolitan areas. The robust growth in rental rates and occupancies combined with the small amount of new construction in the pipeline are fueling this new construction growth. For the most part, the new developments are centered in major metropolitan markets with excellent supply/demand characteristics, and we anticipate these projects will see healthy absorption rates.

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TRANSACTION VOLUME



Cash flow performance in self storage has fueled a large investor appetite for acquisitions. Transaction volume is on pace to exceed \$2.5 billion for the asset class, the largest pace since 2007 and exceeding the average of \$1.5 billion over the last five years. The pace of acquisitions during 2012 represents a 20 percent increase over 2011. Consolidation of the asset class continues, as approximately 41 percent of all acquisitions over the past two years were portfolios. However, given the overall size of the sector, consolidation will remain a long term project. Data by number of transactions and volume are summarized in the following graph.



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Robust acquisitions are forecast to continue in the year ahead due to the strong performance history of self storage, expectations that the Fed will keep interest rates low until the end of the year, and higher yields in the sector.

### INVESTOR RESEARCH

The Self Storage Industry Group of Cushman & Wakefield publishes twice annually in the Price Waterhouse Coopers Investor Survey for self storage (Q2 2013). With permission from PwC, those results are summarized as follows:

| Q2 2013 SELF STORAGE KEY INDICATORS                                |                 |                 |                 |
|--|-----------------|-----------------|-----------------|
|  | 1ST HALF – 2013 | 2ND HALF – 2012 | 1ST HALF – 2012 |
| <b>DISCOUNTED CASH FLOW</b>  |                 |                 |                 |
| Range:   | 8.50% – 11.00%  | 8.50% – 11.00%  | 8.50% – 11.00%  |
| Average:   | 9.50%           | 9.75%           | 10.00%          |
| Change (Basis Points):   | -25             | -25             | -25             |
| <b>CAPITALIZATION RATE</b>   |                 |                 |                 |
| Range:   | 5.75% – 8.50%   | 6.25% – 8.50%   | 6.50% – 8.50%   |
| Average:   | 6.55%           | 6.75%           | 7.00%           |
| Change (Basis Points):   | -20             | -25             | -30             |
| <b>RESIDUAL CAP RATE</b>   |                 |                 |                 |
| Range:   | 6.25% – 8.75%   | 6.50% – 8.75%   | 6.75% – 8.75%   |
| Average:   | 6.75%           | 7.00%           | 7.25%           |
| Change (Basis Points):   | -25             | -25             | -25             |
| <b>MARKET RENT CHANGE RATE</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               | -25             |
| <b>EXPENSE CHANGE RATE</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             | 25              | –               |
| <b>MARKETING TIME</b>  |                 |                 |                 |
| Range:   | 2 – 7           | 3 – 6           | 3 – 6           |
| Average:   | 3.0             | 3.0             | 3.0             |
| Change (Basis Points):   | 0               | 0               | -1              |
| Source: PwC Investor Survey, Q2 2013 and reprinted with permission |                 |                 |                 |

This Business Briefing includes an expanded survey to include market optimism, absorption time and other elements that characterize the current market conditions for the self storage asset class. The results of the survey, completed in Summer 2013 by over 50 respondents in investment, brokerage and other industry players, are detailed on the following page.

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| SUMMER 2013 SELF STORAGE KEY INDICATORS |                  |                  |                  |                  |                   |                  |                 |                  |                  |                  |                |
|---|------------------|------------------|------------------|------------------|-------------------|------------------|-----------------|------------------|------------------|------------------|----------------|
| TIME                                    | 2013             | 2012             | 2011             | 2010             | 2009              | 2008             | 2007            | 2006             | 2005             | 2004             | 2003           |
| <b>TRADE AREA</b>                       |                  |                  |                  |                  |                   |                  |                 |                  |                  |                  |                |
| Range:                                  | 1.00 – 5.00      | 1.00 – 5.00      | 1.00 – 5.00      | 1.00 – 5.00      | 2.00 – 5.00       | 2.00 – 5.50      | 2.00 – 5.00     | 1.00 – 5.00      | 1.00 – 5.00      | 1.00 – 5.00      | 1.50 – 5.00    |
| Mode:                                   | 3                | 3                | 3                | 3                | 3                 | 3                | 3               | 3                | 3                | 1.50             | 1.50           |
| Average:                                | 3.25             | 3.22             | 3.20             | 3.15             | 3.21              | 3.25             | 3.33            | 3.14             | 3.30             | 2.80             | 2.82           |
| Change:                                 | 0.93%            | 0.64%            | 1.59%            | -1.87%           | -1.20%            | -2.40%           | 6.05%           | -4.85%           | 17.86%           | -0.71%           | --             |
| <b>DEMAND (SF PER PERSON)</b>           |                  |                  |                  |                  |                   |                  |                 |                  |                  |                  |                |
| Range:                                  | 1 – 8            | 1 – 8            | 1 – 8            | 1 – 8            | 1 – 8             | 1 – 10           | 3 – 10          | 2 – 10           | 3 – 12           | 2 – 12           | 2 – 8          |
| Mode:                                   | 7                | 7                | 7                | 7                | 6.50              | 6                | 6               | 5                | 5                | 4                | 4              |
| Average:                                | 7.35             | 7.31             | 7.15             | 6.98             | 6.73              | 6.52             | 6.12            | 5.7              | 5.36             | 5.27             | 4.87           |
| Change:                                 | 0.55%            | 2.24%            | 2.44%            | 3.71%            | 3.22%             | 6.54%            | 7.37%           | 6.34%            | 1.71%            | 8.21%            | --             |
| <b>CAPITALIZATION RATE</b>              |                  |                  |                  |                  |                   |                  |                 |                  |                  |                  |                |
| Range:                                  | 5.75% – 8.50%    | 6.50% – 8.50%    | 6.75% – 9.00%    | 6.50% – 9.00%    | 6.50% – 9.50%     | 6.00% – 9.00%    | 6.00% – 9.00%   | 6.00% – 9.00%    | 7.00% – 10.00%   | 7.50% – 11.00%   | 8.25% – 11.00% |
| Mode:                                   | 6.90%            | 7.25%            | 7.75%            | 8.50%            | 8.50%             | 7.50%            | 7.25%           | 7.00%            | 8.50%            | 9.00%            | 9.50%          |
| Average:                                | 6.55%            | 7.25%            | 7.50%            | 8.45%            | 8.55%             | 7.55%            | 7.19%           | 7.26%            | 8.28%            | 9.19%            | 9.52%          |
| Change:                                 | -50 Basis Points | -25 Basis Points | -95 Basis Points | -10 Basis Points | +100 Basis Points | +36 Basis Points | -7 Basis Points | -91 Basis Points | -91 Basis Points | -33 Basis Points | --             |
| <b>ABSORPTION TIME:</b>                 |                  |                  |                  |                  |                   |                  |                 |                  |                  |                  |                |
| Range:                                  | 18 – 36 Months   | 20 – 40 Months   | 24 – 40 Months   | 24 – 48 Months   | 24 – 48 Months    | 20 – 40 Months   | 18 – 36 Months  | 18 – 43 Months   | 12 – 44 Months   | 18 – 40 Months   | 18 – 36 Months |
| Mode:                                   | 30 Months        | 32 Months        | 36 Months        | 36 Months        | 36 Months         | 36 Months        | 30 Months       | 30 Months        | 24 Months        | 24 Months        | 24 Months      |
| Average:                                | 30 Months        | 33 Months        | 36 Months        | 35 Months        | 34 Months         | 33 Months        | 32 Months       | 30 Months        | 27 Months        | 24 Months        | 23 Months      |
| Change:                                 | -3 Months        | -3 Months        | +1 Month         | +1 Month         | +1 Month          | +1 Month         | +2 Months       | +3 Months        | +3 Months        | +1 Month         | --             |
| <b>MARKETING TIME:</b>                  |                  |                  |                  |                  |                   |                  |                 |                  |                  |                  |                |
| Range:                                  | 1 – 12 Months    | 1 – 12 Months    | 1 – 12 Months    | 1 – 12 Months    | 1 – 12 Months     | 1 – 12 Months    | 1 – 12 Months   | 1 – 6 Months     | 1 – 12 Months    | 1 – 6 Months     | 1 – 12 Months  |
| Mode:                                   | 6 Months         | 6 Months         | 6 Months         | 6 Months         | 8 Months          | 4 Months         | 4 Months        | 4 Months         | 1 Month          | 1 Month          | 1 Month        |
| Average:                                | 3 Months         | 4 Months         | 5 Months         | 6.15 Months      | 7.75 Months       | 4.31 Months      | 3.66 Months     | 3.14 Months      | 3.06 Months      | 2.89 Months      | 3.95 Months    |
| Change:                                 | -1 Month         | -1 Month         | -1.15 Months     | -1.65 Months     | +3.44 Months      | +0.65 Month      | +0.52 Month     | +0.08 Month      | +0.17 Month      | -1.06 Months     | --             |
| <b>PROFIT (ON COST ONLY)</b>            |                  |                  |                  |                  |                   |                  |                 |                  |                  |                  |                |
| Range:                                  | 10.00% – 25.00%  | 10.00% – 25.00%  | 10.00% – 20.00%  | 10.00% – 15.00%  | 10.00% – 20.00%   | 10.00% – 20.00%  | 10.00% – 25.00% | 15.00% – 25.00%  | 10.00% – 30.00%  | 8.00% – 25.00%   | 8.00% – 30.00% |
| Mode:                                   | 20.00%           | 18.00%           | 15.00%           | 12.00%           | 15.00%            | 15.00%           | 18.00%          | 20.00%           | 20.00%           | 20.00%           | 20.00%         |
| Average:                                | 20.00%           | 17.50%           | 15.00%           | 12.50%           | 14.96%            | 15.86%           | 17.63%          | 20.13%           | 20.14%           | 17.10%           | 14.34%         |
| Change:                                 | 2.50%            | 2.50%            | 2.50%            | -16.44%          | -5.67%            | -10.04%          | -12.42%         | -                | 17.78%           | 19.25%           | --             |
| <b>OPTIMISM INDEX (1 -10)</b>           |                  |                  |                  |                  |                   |                  |                 |                  |                  |                  |                |
| Range:                                  | 3.00 – 9.00      | 3.00 – 10.00     | 3.00 - 9.00      | 3.00 – 9.00      | 1.00 – 8.00       | 3.00 – 9.00      | 3.00 – 9.00     | 3.00 – 9.00      | 3.00 – 9.00      | 5.00 – 10.00     | 5.00 – 10.00   |
| Mode:                                   | 7.50             | 7.25             | 7.00             | 6.00             | 5.00              | 6.00             | 6.00            | 7.00             | 6.50             | 7.00             | 7.00           |
| Average:                                | 7.50             | 7.25             | 7.00             | 6.15             | 5.50              | 6.00             | 6.25            | 6.50             | 6.65             | 6.90             | 6.83           |
| Change:                                 | 3.45%            | 3.57%            | 13.82%           | 11.82%           | -8.33%            | -4.00%           | -3.85%          | -2.26%           | -3.62%           | 1.02%            | --             |
| <b>MARKET CONDITIONS</b>                |                  |                  |                  |                  |                   |                  |                 |                  |                  |                  |                |
| Under-Supplied:                         | 25%              | 20%              | 15%              | 10%              | 10%               | 10%              | 6%              | 15%              | 15%              | 3%               | 6%             |
| Over-Supplied:                          | 30%              | 40%              | 50%              | 60%              | 65%               | 63%              | 52%             | 50%              | 50%              | 54%              | 47%            |
| Equilibrium:                            | 45%              | 40%              | 35%              | 30%              | 25%               | 27%              | 42%             | 35%              | 35%              | 40%              | 47%            |
| <b>STRATEGY</b>                         |                  |                  |                  |                  |                   |                  |                 |                  |                  |                  |                |
| Buy:                                    | 52%              | 47%              | 43%              | 40%              | 20%               | 27%              | 15%             | 18%              | 20%              | 27%              | 28%            |
| Sell:                                   | 24%              | 35%              | 42%              | 45%              | 60%               | 55%              | 60%             | 50%              | 60%              | 46%              | 26%            |
| Build:                                  | 24%              | 18%              | 17%              | 15%              | 20%               | 18%              | 25%             | 32%              | 20%              | 27%              | 30%            |
| <b>DISCOUNTED CASH FLOW</b>             |                  |                  |                  |                  |                   |                  |                 |                  |                  |                  |                |
| Usage:                                  | 61%              | 52%              | 41%              | 33%              | 36%               | 33%              |                 |                  |                  |                  |                |
| <b>DISCOUNT RATE (IRR)</b>              |                  |                  |                  |                  |                   |                  |                 |                  |                  |                  |                |
| Range:                                  | 10.00% – 12.00%  | 9.00% – 11.50%   | 9.50% – 11.50%   | 10.00% – 12.00%  | 10.00% – 12.00%   | 10.00% – 12.00%  | 10.00% – 11.00% |                  |                  |                  |                |
| Average:                                | 10.00%           | 10.25%           | 10.50%           | 11.25%           | 11.50%            | 10.75%           |                 |                  |                  |                  |                |
| Change (Basis Points):                  | -25              | -25              | -75              | -25              | 75.00             | 25.00            |                 |                  |                  |                  |                |
| Rental Growth Rate:                     | 3.50%            | 3.50%            | 3%               | 3%               | 2%                | 3%               |                 |                  |                  |                  |                |
| Expenses Growth Rate:                   | 3-4%             | 3-4%             | 3-4%             | 3-4%             | 3-4%              | 3-4%             |                 |                  |                  |                  |                |
| Terminal Cap Rate:                      | +25 bp           | +25 bp           | +35 bp           | +50 bp           | +50 bp            | +50 bp           |                 |                  |                  |                  |                |
| Cost of Sales:                          | 2%               | 3%               | 3.5%             | 4%               | 4%                | 4%               |                 |                  |                  |                  |                |
| Holding Period:                         | 10 Years         | 10 Years         | 10 Years         | 10 Years         | 10 Years          | 10 Years         |                 |                  |                  |                  |                |

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As supply and demand fundamentals have become more balanced, total absorption time has decreased from an average of 33-36 months to an average of 30 months. Similarly, marketing times have decreased reflecting a continued, strong market allocation of investment to this sector. Over the last five years, the profit factor has ranged from 12.50 percent to the most recent of 20 percent, reflecting a rising trend for profit since 2010. Anecdotally, many respondents estimated indirect costs on top of direct costs in a range from 8 percent to 20 percent with the most common response of 10 percent. Several investors surveyed stated that they are looking for a 200 basis point spread in cap rates on development projects versus stabilized assets.

Measurements of market sentiment can be difficult to gauge, but our Optimism Index is at a 12 year high at 7.5 (ten highest). Similarly, more participants describe the market as either under-supplied or at equilibrium than in the history of the 12 year survey. Market sentiment can also be measured by strategy, with 52 percent of respondents saying now is the time to buy. Cumulatively, these characteristics of market sentiment reflect cash flow growth and value appreciation in the sector.



### TAKE AWAYS

Robust market conditions prevail in self storage. Supply and demand metrics are generally in balance, leading to significant gains in occupancy and income. At the same time, the cap rate trend over the past four years has been compression. With uncertainty in the cost of funds, we estimate stability into 2014 unless the Fed policies change. Market sentiment reflects these conditions with record amounts of capital seeking to store investments in this sector. Over the past three years, portfolio transactions have exceeded over \$2.5 billion for self storage. Institutional investors, some new to the asset class, are seeking to acquire equity interests or actual property. Portfolios trade at a premium with as much as a 100 basis point spread to cap rates. Yet, there remains discipline regarding new construction suggesting that increases in collected income will continue. Looking ahead, confidence in the fundamental strength and sustainability of cash flow is forecast for self storage.

For more information about the Self Storage industry, contact:

**R. Christian Sonne, MAI, MRICS**  
Executive Managing Director  
Valuation & Advisory  
+1 (949) 930 9241  
chris.sonne@cushwake.com

**Greg Wells**  
Director  
Capital Markets  
+1 (848) 558 5616  
greg.wells@cushwake.com

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Cushman & Wakefield, Inc.  
1290 Avenue of the Americas  
New York, NY 10019-6178