



SELF STORAGE SALES NETWORK

## Preliminary Estimate of Value

The following worksheet provides a step-by-step process for estimating the value of your self storage facility. Please be sure to read through the entire package before completing your calculations as there are many variables and factors that need to be considered. To use this worksheet, follow the steps below:

1. Read the article "Cap Rates and Value, a Little Mystery Unveiled."
2. Complete the Cap Rate Adjustment chart to arrive at an appropriate Cap Rate for your facility.
3. Complete the Preliminary Estimate of Value chart to determine your property's NOI and apply the appropriate Cap Rate to learn the value.
4. If you have questions or would like to review your results with a real estate professional, call us at 1-800-55-STORE and we will put you in touch with your local Argus Broker Affiliate.

\*A Preliminary Estimate of Value is intended only as a general approximate guide to value and should not be relied upon for purchase, sale or financing of a project. A complete Broker's Opinion of Value requires a more thorough review of financials, market conditions, physical consideration, sale comparables and other tangible and intangible characteristics of the property and should be completed by an experienced real estate professional.



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## Cap Rates and Value - A Little Mystery Unveiled!

By Michael L. McCune

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If you are buying, selling or refinancing a self storage property, it is almost impossible to have a conversation without the term “Cap Rates” coming up. Everyone acts like they know what they are talking about, a few really do know, many more think they know, and some don’t want to admit they don’t know. Clearly not a scenario meant to provide much mutual understanding. Hopefully the next few paragraphs will provide a little insight and clarification on this area of confusion.

**What are Cap Rates?** The term is an abbreviation for *Capitalization Rate*. Without the more confusing details, it is simply the rate of return that an unfinanced property would return to an owner at a specific value. For example, if you had \$250,000 of income from a property and wanted to earn a 10% return you could pay \$2,500,000 for the property ( $\$250,000 \text{ Income} \div .10 \text{ Cap Rate} = \$2,500,000 \text{ Price}$ ).

The Cap Rate represents the relationship of value (price) to the income the property produces. Since Value and Cap Rates are directly related, real estate folks like to talk about Cap Rates instead of Value. The reason is that they can compare “Values” stated as Cap Rates of very different properties or property types. In other words, if someone says that one property with a \$100,000 income and another property with a \$1,000,000 income are both a “9 Cap,” they are saying that the income from both properties would produce a 9% income on the respective prices. So, what they are saying is that the properties are being valued the same based on the relative income. However, if one property was valued at an 11 Cap Rate and other at a 9 Cap Rate, the first property would be worth much less than the second property because the price would have to be lower to generate the higher return. Thus, if you know the Cap Rate and the income, you know the value, right? Well, now it gets tricky. Let’s start to refine our understanding a little more.

**What do you mean by Income?** First of all, the “stabilized income” used in the calculation does not mean what you put in the bank or report to the Government. The first step is to add back to your net income depreciation, amortization of the loan and interest payments. Also, take out of expenses any purely personal expenses, but add back to the expenses a fair rate for your time spent on the property. If your miscellaneous revenue exceeds 5% of your gross revenues, you should get some advice because it may be treated differently. These are just some of the adjustments that are made to the income. There is a technical name given to this adjusted income and that is Net Operating Income (NOI). Cash Flow is yet a different term; it is what you put in the bank after you pay the loan but before you pay Federal and State taxes. Cash Flow After Taxes means, for once, just what it says.

**What does the word “Stabilized” mean in relation to Income?** Good question, more caveats in the formula! When you are considering value, i.e. a sale purchase, or refinance, the income that “produces” the value must be “stabilized.” A couple of examples will show you why this is important. Perhaps the Olympics came to town and the contractors rented all your units at twice your normal rate. That year would not be normal or “stabilized.” Alternatively, a year in which a fire destroyed half of your units and it took six months to get them back in service would not be stabilized. Each situation does not represent the stabilized income of the property. A more usual situation in many markets today would be that your facility is 93% occupied and the other facilities in the market are 78% occupied on average. What is “stabilized” income in these cases? It may depend on other factors such as access, location, pricing or management. What is clear, however, is

that the issue of “stability” of income introduces a large dose of subjectivity into the otherwise simple formula for determining value.

While “stabilization” is not easy and is subjective, it is an important part of the valuation process. There are some short cuts that some people take in developing values for self storage (and other real estate for that matter). The most common and prevalent in the market is the “Trailing Twelve Months” Cap Rate. This merely substitutes the last twelve month’s NOI for a “stabilized” NOI. The assumption, of course, is that nothing in the facility or the market will change in the future. Sometimes this is not true, but it is a good guide barring any evidence to the contrary.

**What is the right Cap Rate?** You have probably heard people talking about Cap Rates going down, or someone saying “I sold on a 9 Cap Rate,” or “Cap Rates are lower in California.” What does all this mean? Remember that Cap Rates are just another way of talking about prices, prices in relation to income! But because of the way the math works, lower Cap Rates mean that values are higher. So when someone says Cap Rates are down, they mean prices (values) are higher. Confusing, but necessary to learn.

As we have learned, when a buyer purchases a property at a certain price, he is also estimating the return that he will get on the property on an unfinanced basis, and he must be willing to accept that return. That return is the Cap Rate! Let’s revisit some numbers again: A 10% return on a \$2,500,000 (price) property is \$250,000 (NOI) per year – the Cap Rate is 10. If he only needs a 9% return, he could pay \$2,777,777 for the property, and 9 would be the Cap Rate ( $\$250,000 \div .09 = \$2,777,777$ ).

When we compare sales in the market, we find that properties tend to sell on similar Cap Rates for similar quality properties. So when someone says that a market is a “10 Cap market,” they mean that sellers and buyers are tending to agree on prices that yield the buyer 10% on the price. Some properties will be less desirable and may sell at an 11 Cap Rate (lower price) and others that have the 100% high visibility location might sell at a 9 Cap Rate (higher price).

The reason for all this agreement between buyers and sellers is that they are always looking at alternative investments and evaluating self storage against them. If corporate bonds are yielding 11%, people will be more likely to invest in the bonds than in self storage facilities. However, if the bonds are returning only 6%, investors may decide that the extra risk of self storage makes a facility at a 9% return (Cap Rate) look good. Thus Cap Rates in general tend to rise and fall with the returns on competitive investments and interest rates. The General (some would call it Average) Cap Rate is then adapted to the specific property based on a number of factors. In the last ten years, Cap Rates have ranges from the extreme (and rare) 6% to 12% depending on the location, interest rates and characteristics of the specific facility.

I have attempted to summarize some of the characteristics that self storage facilities would have that would fall into various Cap Rate levels in today’s general market. There may be arguments and different opinions on some of the specific characteristics and their placement, but you will get a broad idea of some of the property-specific attributes that create and diminish value. The general investment market will rise and fall with alternative investments, but the relationships on the chart have tended to remain important as the general levels change. As you look at the chart, note that the Cap Rates on the top are on a continuum and are not specific numbers, and the descriptions are representative and not hard, fast rules.

## Cap Rate Adjustment

The market Cap Rates for self storage in this summary are illustrative only and may not represent the current market. The relationships in the chart are not empirical numbers, but rather are rough approximations of their impact on the ultimate Cap Rate. To compute the Cap Rate Adjustments for your property, place a check mark next to the description that **best** matches your property for each of the items below. Then total your results for each column to determine the adjustment factor for your property.

### Cap Rate Adjustment Worksheet

ITEM	Cap Rate Range		
	← "9%-ish"	"10%-ish"	"11%-ish" →
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Occupancy (last 2 yrs.)	95% - 100%	90% - 95%	< 90%
Rates (last 2 yrs.)	Continuous Rise	Steady	Falling
Size	> 45,000 SF	30,000 SF to 45,000 SF	< 30,000 SF
Competitors (3 mile radius)	One	One to Three	More than Three
Competitors' Occupancy	95% - 100%	Low 90s%	High 80s%
Surrounding Area	Growing Metro	Large City	Rural
Population (5 mile radius)	> 200,000	70,000 to 200,000	< 70,000
Traffic Counts	> 35,000	10,000 to 35,000	< 10,000
Median Household Income	Above Average	Average	Below Average
Manager	Full-time, Resident	Full-Time, On Site	Other
Records	Computerized and Professionally Audited	Computerized	Other
Computer System	Self Storage Software	Computers	None
Construction	Concrete or Brick	Combination Brick/Metal	Metal
Maintenance	Pristine	Little Deferred Maintenance	Some Deferred Maintenance
Security	Gated, Electronic Access, Security Cameras	Gated, Security Cameras	Other
Access	Direct	Clear, but not Direct	Difficult
Visibility	Sign and Facility Visible	Sign and Entrance Visible	Only Sign Visible
Drives	Concrete	Asphalt	Gravel
<b>Total</b>	<b>Column 1:</b>	<b>Column 2:</b>	<b>Column 3:</b>

Next, total the number of check marks you placed in each column and then use the chart below to multiply each number by the designated amounts to calculate the Net Cap Rate Adjustment. Check marks that were placed in Column 2 indicate an average response for the market, so no adjustment is needed. An example of the calculation is provided, along with a blank form to fill in your own results. Remember that a negative adjustment lowers the cap rate, thus increasing the value.

Adjustment Example:

	Check Marks	Multiplier	Adjustment Factor
Column 1	8	-0.05	-0.40
Column 2	6	No Adjustment Necessary	
Column 3	4	0.05	0.20
Net Cap Rate Adjustment			-0.20

Blank Adjustment Form:

	Check Marks	Multiplier	Adjustment Factor
Column 1		-0.05	
Column 2		No Adjustment Necessary	
Column 3		0.05	
Net Cap Rate Adjustment			

**Net Operating Income Calculation**

Next, fill out the table below to calculate the Net Operating Income (NOI) of your facility. Be sure to fill out all applicable items as thoroughly as possible to achieve an accurate result.

<u>Revenues</u>	<u>Actual</u>	<u>Comments</u>
Last 12 Months Actual Rentals	\$ _____	_____
Miscellaneous Income	\$ _____	_____
Other Revenues	\$ _____	_____
Gross Revenues	\$ _____	_____
<b><u>Operating Expenses</u></b>		
Real Estate Taxes	\$ _____	See notes below
Salaries & Benefits	\$ _____	_____
Insurance	\$ _____	_____
Utilities	\$ _____	_____
Maintenance & Repairs	\$ _____	_____
Capital Reserves	\$ _____	\$0.10/SF
Management Fees	\$ _____	5% of Gross Revenue
Marketing & Advertising	\$ _____	_____
Office Expenses	\$ _____	_____
Miscellaneous	\$ _____	_____
Depreciation	~ NOT APPLICABLE ~	
Interest	~ NOT APPLICABLE ~	
Total Expenses	\$ _____	_____
<b>Net Operating Income (NOI)</b> <i>(Income minus Expenses)</i>	\$ _____	_____

## Value Calculation

Now that you have completed all of the preliminary calculations, you are ready to arrive at the value estimate for your property. First determine your adjusted Cap Rate by adding the Cap Rate Adjustment number to the average cap rate of 10%. (For example,  $-0.20 + 10 = 9.8$  Cap Rate). Next, divide the NOI by the Cap Rate (remember to convert the percentage to decimal points,  $9.8\% = 0.098$ ). The result is the value of the property. To get a sense of the market, you should complete the calculation with values at both ends of the cap rate range to learn the possible high and low values for your property. An example of the calculation is provided below for reference, and you can use the blank chart below to complete your calculations.

### Value Calculation Example:

Net Operating Income (NOI)	\$200,000
Divide by Adjusted Cap Rate	0.098
<b>Estimated Value</b>	<b>\$2,040,816</b>
Estimated Value at 11% Cap Rate	\$1,818,181
Estimated Value at 9% Cap Rate	\$2,222,222

### Value Calculation Form:

Net Operating Income (NOI)	\$
Divide by Adjusted Cap Rate	
<b>Estimated Value</b>	<b>\$</b>
Estimated Value at 11% Cap Rate	\$
Estimated Value at 9% Cap Rate	\$

Finally, words of caution: This Estimate of Value should only be used to help you develop a range of possible values. An appropriate selling price should be developed in consultation with a qualified self storage broker or appraiser. The Estimate of Value Worksheet **may not** provide a realistic estimate of value if any of the following conditions exist for your property. You should consult with your Argus Broker Affiliate or a qualified appraiser if any of these conditions are present:

- The property is on a ground lease
- The loan has a prepayment lockout or defeasance clause
- Vacancies exceed 25% or occupancies have varied by more than 20% in the last three years
- There are any unusual easements or mineral rights on the property
- Major or chronic deferred maintenance
- Environmental problems
- The property is a non-conforming use under the zoning code
- There is extra land to be developed
- There are large self storage projects being built within three miles