



SELF STORAGE SALES NETWORK

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Have You Found Your Chair Yet? by Michael L. McCune

For the last several months we have been talking about the uncertainty in the real estate markets. In this high-stakes game of musical chairs, **NOW** is the time to find a chair before the music stops, bringing to an end high real estate prices and easy financing. This is the time for serious analysis of your personal objectives and options because the real estate and credit markets are likely to severely limit your options and outcomes.

By most measures, the self storage rental business is reasonably steady, if not booming. According to Ray Wilson’s report on the first half of 2007 in the *Korpacz Real Estate Investor Survey*, increases in supply are becoming a consideration in some places. Rental rates are still going up, but at a more modest rate, and occupancies appear to be holding steady, often at the expense of more concessions.

However, the reality is that all self storage owners are also in the real estate business – and in a big way! Unfortunately, the term that we would use to describe the real estate aspects of self storage would not be “stable” and most real estate professionals would probably not use the term “positively inclined” for the foreseeable future. I am sure that there is no one on the planet that is not now aware of the debacle in the residential finance market, but I was somewhat surprised to find that self storage owners are aware of, and actually predicted, that many of the same things are happening in the commercial real estate market, including self storage. We recently asked 22,000 owners to share their opinions in a survey on what they saw happening in the future and got the following responses: 91% thought that cap rates would go up at least 1.5% by June of 2008; 73% thought interest rates would be up 1.5% by the same date and 50% thought that capital gains rates would increase by 10%. This survey was taken about two months ago, well before the “credit crunch” became a prime time headline. Interestingly, over half of the respondents also thought that they would have more competition and that there would be a recession by June of next year. The intuition of self storage owners proves to be both acute and predictive of future trends. For what it is worth, I think there is high probability that survey respondents are going to prove to be spot on regarding cap rates and interest rates.

What is the Big Question?

The real question is; what do rising interest rates and credit availability, as well as increasing capitalization rates mean for self storage owners and the value of their properties? In other words, how do changes in the macro economy and the credit markets impact the value of self storage properties and the owners’ flexibility.

By way of background, capitalization rates (the way self storage and other commercial real estate is valued) and interest rates are inexorably linked. If interest rates go up, cap rates will ultimately go up as well, and vice versa. However, due to various market conditions, the link between the two is somewhat flexible as to timing and magnitude. Think about the relationship between the two rates as being tied

together by a short, strong rubber band that allows the relationship to expand and contract somewhat, but the overall relationship remains very strong and closely related.

What is Happening to My Value?

The short, but honest, answer is that the value is probably going down if it is a stabilized property. That is the bad news, but the good news is that it is still worth more than at any time in the last 25 years, except for the last nine months! Cap rates have slightly moved up not only because increased interest rates but also because of more perceived risk, but remain at historically low levels (low cap rates mean high values).

An example may help to explain the mechanics of the numbers. Assume that we have a property that generates a Net Operating Income of \$200,000, at recent cap rates for high quality properties the value would be about \$2,670,000, if cap rates go up on 1.5% as suggested by the owners in our survey, the new value would be \$2,200,000, or a 21% decline in total value. However, if the property were financed at 75% of the first value the equity in the property would decrease 70%.

If you would like to “test” the sensitivity of your own project you can go to www.selfstorage.com/argus/sensitivity.pdf and print out a worksheet that will help you understand the pricing model and definitions as well evaluating the impact on your property.

What About Refinancing?

While interest rates, loan availability and loan amounts have become less certain in recent weeks, the rates are still in the lower end of the spectrum of historic rates and loans for stable properties are available. If you are holding the property for the long term it is a very good time to make sure that you have a fixed rate mortgage with a term of at least three years and preferably not less than five years. Having a remaining term on a good loan is insurance against difficult credit and high interest rate market periods. The results of having to refinance during times of credit stress can be very costly and even catastrophic in serious credit “crunches” such as occurred in the 1980’s. Steve Clifford of NorthMarq Capital is available (303-225-2100) to discuss financing with you.

To carry our musical chairs analogy a little farther, if your objectives are to hold your facility for the long run, it appears one potential opportunity would be the refinance “chair.” It is essential that you make sure you have financing that has a significant remaining term and a fixed interest rate that your operations can support. If, on the other hand, you have any thoughts about selling in the next three to five years, or if significant competition is entering your market, you may want to find a “chair” that accommodates accelerating your selling decision to avoid rising cap rates and a lower price. Whichever chair you chose, make sure it is comfortable for you and your objectives because the music is about to stop for awhile.