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The Two Telling Tools An Insight to Feasibility Studies

by Michael L. McCune

In the course of my 34-year real estate and development career, I have found that the two most useful tools in the developer's kit are: 1) a rational and critical feasibility analysis (RCFA) and 2) luck. My observations also indicate that, fortunately, good luck is more often found than a rational, critical feasibility analysis. While "Lady Luck" is immensely helpful, her presence is highly unpredictable, although there are some rumors that she tends to hang out with good feasibility analyses. However, while this correlation is suspected, the sightings of RCFA's are so rare, the relationship remains statistically obscure. My personal belief is that Lady Luck has some affinity (compassion?) for we Irish – maybe because the Irish never take credit for her work. In any event, my respect for this beautiful maiden obliges me not to speculate further on how to seduce her into our lives. Thus, I will stick to talking about the value and nature of RCFA's.

Because my space is limited, I am going to focus principally on taking a critical look at what should be included in a RCFA as to projected demand and pricing. This is not to say that cost and timing factors are not important, but only that they are usually somewhat less subjective. My experience is that, while mistakes in estimating project costs are certainly no fun, they are usually less frequent and not as life threatening as "missing the market."

THE PAST IS PAST

In the first generation of self storage, the demand for this new revolutionary product was so deep that it was often described as in the movie *Field of Dreams*: "Build it and they will come." A feasibility analysis was at best file fodder for an otherwise eager lender. Lady Luck also conspired to have our erstwhile self storage developer come of age in the right two or three decades of history. Times have now changed. Now, with some 40,000 facilities dotting our fair land, storage users have a far wider choice of amenities, locations and prices than at any time in the past.

Chris Sonne of Self Storage Economics just told me that his Annual Investor Survey revealed that the number one concern of all investors was "too many new units being built." **Ray Wilson** has also opined in several forums, including a recent Argus Teleconference, that the "unabsorbed demand" that characterized the past has found a self storage home in many, if not most, parts of the country. By Ray's calculations, there is an equivalent storage unit for every 10 households in America. Unfortunately, it appears that the new tag line for the business is likely to be "Build it and where will they come from?" Thus, a RCFA has become a very critical tool for the

developer considering a self storage project. Now the emphasis has switched from properly papering the loan application to finding out if the property will really work and accessing the downside risk. Please note the rational and critical words in my definition (redefinition?) of a RCFA --these words are intended to differentiate the nature of feasibility studies.

BUT I GOT FINANCING

Unfortunately, there are many developers who equate “getting the money” with having proved up the feasibility of a project. Many people suffer from two very serious misconceptions: 1) lenders know something about self storage; and 2) lenders are doing you a favor by lending you money. Only in the rarest circumstance is the first true and the second is never true – they love to rent money! Thus, the fact that you got “the money” doesn’t mean that the project is really feasible; it may just mean that your banker is a good salesman. Remember, lenders on new projects aren’t quite as particular because they have recourse to your other assets.

WHAT IS THE RIGHT ANSWER?

First and foremost, a feasibility analysis should be unbiased. Many people doing feasibility analyses are often listening to the desires of their clients and the report consequently reflects the client’s prejudice, not the actual market, and the project’s ability to compete in that market. Being human, people who write feasibility studies want to please their clients. Thus, the first thing you should do is ask the analyst how many of the last ten studies he has done were negative. I’m not sure what the right answer should be, but more than two or three in this market should bring credibility to the preparer. In my past life developing office buildings, I would tell analysts I would pay a 15% bonus for a negative report, sometimes it worked! You must remember that in feasibility studies there are two equally right answers, YES and NO, MAYBE is also a NO!

A WORD ABOUT NUMBERS

There are many “numbers” about self storage out there. Several groups publish reams of statistics about every dimension of self storage. The problem is that these are based on mail surveys of facilities that volunteer the information to the publishers. Unfortunately, because the sample sizes are relatively small the information is, at best, applicable only to *very* broad market characteristics. In addition, because of the “voluntary” source, the sample may not meet the standards of randomness considered necessary for accuracy. While the numbers look precise, the reality is that they are often “manufactured backwards.” For example, one source quotes total national square footage as 1.46 billion. That number is the average surveyed facility size of 37,590 SF multiplied by a purchased database of all facilities, 38,817 ($37,590 \times 38,817 = 1.46$ billion). While the numbers are mathematically correct and the average size appears reasonable for an urban area, I have always suspected that rural properties were underrepresented in the survey and therefore the total square footage may be significantly overstated. No one knows for sure, but it is food for thought. However, if the total square footage is overstated one should suspect that the national square footage of demand per person (4.94 SF per person) could also be overstated. Thus, if you are anticipating 4.94 SF per person of demand you may be overestimating.

Another problem with such statistics is that the samples are so small that the statistics are only marginally useful when looking at a small trade area. The characteristics of a trade area are quite variable, such as density, income levels, percent of renters, and prevalence of basements as to render comparisons to national or state information highly unreliable. I have reviewed some recent feasibility studies and find that extrapolations of the national square foot per person numbers are often used as the basis for projections of demand. If your feasibility report does this, you had better go find our pal Lady Luck because you are going to need her.

WHAT SHOULD A RCFA LOOK AT FOR DEMAND?

Clearly self storage is a local business and the trade area, barring unusual circumstances, is usually a three to four mile radius. Therefore, the demographic attributes that define this neighborhood will also define the demand. Some analysts use sophisticated regression analyses to help estimate demand. For example, they look at many similar trade areas and by mathematical algorithms can determine the variables that most affect the demand (actual absorption in the area) and in what proportion they affect demand. Not surprisingly, the studies show that population, number of renters, and income levels among others are important determinants of demand. However, the important information that a regression analysis provides is to assign a value to each variable and thus predict demand. It is a lot of work and requires some expert judgments to define the trade area.

The question is, is the “sophistication” worth it? In the past, it wasn’t worth it because the demand was overwhelming. Now I think it is foolish not to use the best tools at hand; the market supply and demand balances are just too treacherous. The next question, are the numbers created by these or other mathematical methods more correct? These are the same techniques used by the pollsters to predict elections. Pollsters rarely hit the actuals “right on the head,” but they usually get quite close – and occasionally really blow it. Your odds on being right are about the same for a correct prediction, except your timeframes are longer which introduces more risk. The right analogy is: would a pollster say that during the last election 46% voted democratic or would he use the math to project the situation from current data? Modern methods of predicting demand require complex math but are proven in many ways to improve your odds, but there are still a lot of variables. There is always a required element of experience, professional, intelligence and judgment necessary to complete the picture.

HOW TO BUY A FEASIBILITY STUDY

Many people bid the process out, and if you want the cheapest price, this is the way to do it. However, this is not a good idea for two reasons. First, good RCFA’s usually don’t cost much more than really bad ones, sometimes less, but the value is different by many magnitudes. Secondly, you are making a huge investment based on this information and you must be very comfortable with and sure of the analyst’s ability. The price of a good feasibility report only costs about two tenths of one percent of the cost of a \$2.5 million project, but to quote Robert Frost it “can make all the difference.” When you commission a RCFA you should get: Recommendations from people you know have used the analyst, get names of people that have used the analyst and that have completed their project and ask them how the projections worked out. Samples – ask for samples or “blacked out” reports to review and read them to see if they make sense or just present a lot of handy “on the Internet information.” Remember some analysts use the proven sales method “if you can’t dazzle them with brilliance, you baffle them

with volume.” Interviews – you should interview your candidate analysts. What they say should make sense. It is always good to keep in mind that you want a rational and critical analysis, not a glib sales job, so forgive the analyst if he is really into the details – he should be!

THE BACK STOP!

After you have bought a great RCFA and have the report in hand, there is one more very important thing you should do, verify it. Take the report to the building and planning departments and see if all the projects with permits or pending plans are shown on the report. The very last thing you need is an unsuspecting competitor. Then actually visit each of the competitors in the trade area and compare your proposed facility to the competitor in terms of visibility, location, traffic, amenities, pricing and occupancy. You can find a form at <http://www.selfstorage.com/argus/toolbox/checkup.htm> that will help you. If you find that the information you collect is different from what is contained in the report, a bell should go off. Things to also be alert to: Rents - if you must get higher rents than your competitors are actually getting, if rents have been declining or concessions increase; Occupancy - if occupancies have been declining or the average occupancies are below 85%. If you find problems in rents or occupancies, it is time to take a deep breath and rethink the project.

TAKE A PEEK AT THE DOWNSIDE

A very important step in the review of a feasibility report is to do a sensitivity analysis. You can do this easily by merely rerunning the income proforma and reducing the rent by 7% and the occupancy by 7% and see what happens to your NOI (net operating income), cash flow after debt service and recalculating the amount of debt the project will carry. Just as a preview, my guess is that change of such magnitude will cut the projected cash flow by between 50 and 60 %. These projects are very “sensitive” to changes in revenues. The analyst preparing the report should also be happy to provide this information as well. The issue that you are trying to resolve with this test is to see how much error in the estimate of demand and pricing you can tolerate and still think the project risk is acceptable. You may want to try some other variations, after you have seen the results of the first test. There is usually a lot leverage in a self storage project, both operating leverage and financial leverage, and it cuts both ways. At the end of the day, you must be comfortable that the projections of demand and pricing and their relative reliability comport with the margin of risk that you are willing to accept.

IN SUMMARY

These last two steps are the most critical (and most often skipped) because only you can ultimately judge your level of comfort with the proposed project. It should also be remembered that good RCFA’s are never perfect and even the very best rely largely on the analyst’s judgment. Lady Luck will still play a very large role in the success of your project, but a good RCFA will at least help her to be on your side. Remember, that sometimes *No* is a better answer than *Yes*! Good Luck!

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