Risk Management Insights

Understanding the Self-Storage Industry: A Primer for Lenders and Appraisers
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In the early days, long before self-storage was ever thought of as an industry, facilities were more often referred to as mini-warehouses or mini-storages. They were located well off the beaten path, often in industrial areas or on the outskirts of town, and were primarily mom-and-pop operations seen as an opportunity to bring in some extra income until another use provided a better return. Undeniably, things have changed. According to the *Self Storage Almanac 2010,* the industry now consists of 2.58 billion square feet in nearly 49,000 facilities nationwide, an average of 378 units per facility and 52,885 square feet per facility. Facilities are now located in upscale commercial areas with high visibility or even within or proximate to master planned communities. Today's facilities are equipped with state-of-the-art security and management technology.

The *Self Storage Almanac 2010* identifies some characteristics about the industry. Climate control is a feature in nearly half of the facilities nationwide. The Southeast region is well above the average with 73 percent of their facilities having climate control. The larger and newer facilities tend to have climate controlled units more often than smaller and older facilities. Research on the age of self-storage facilities nationwide reveals that 80.4 percent have been built since 1985. Self-storage facility construction boomed in the decade between 1996 and 2005 when 53 percent of the existing facilities were constructed. In terms of amenities, the rate of electronic facility automation over 2008 has grown for security, accounting/bookkeeping and kiosks, but shrunk for access control, lights and computerized rent payment. Most automated or electronic features increased in prevalence with more units and newer facilities. Physical security is a minimum expectation customers have of their self-storage providers, but keeping their belongings safe is another matter. Customer surveys show that the perception of adequate security is one of the three leading characteristics that attract new renters to a self-storage facility (curb appeal and convenience being the other two).

Industry Ownership Structure

Over the past 10 years, there have been three very distinct groups of owners: the self-storage REITs, which currently consist of the industry's top non-public companies — Public Storage, Extra Space Storage, U-Store-It Trust and Sovran Self-storage —and the smaller mom-and-pop operators. According to the *Self Storage Almanac 2010,* the top 100 self-storage operators own 16.3 percent of the facilities and 22.2 percent of the square footage. Thus, despite the predominance of public companies in terms of size, smaller operators still tend to own a lion's share of the industry. With REITs having over 15 years of reporting to the public market and a five-year history of good returns, self-storage has become a trusted investment for developers and investors from other real estate sectors. The historical returns can match and many times better those of most other industries.

Economic Drivers

The various brokers and developers of self-storage that we interviewed shared one common theme about self-storage. It is a market driven by life change events. The last two years have been especially difficult for self-storage as the struggling national economy has led to double-digit unemployment, the crash of the real estate market and thousands of home foreclosures. People have been riddled with fear, and this fear has led to stagnation, creating less demand for self-storage. As referenced by the *2010 Self Storage Almanac,* about half of the storage operators and owners describe their primary competitive market as oversupplied.

Analysis of existing competitors in a primary competitive market is key to a successful self-storage facility. Self-storage renters generally hail from within a three- to five-mile radius of a storage site. Renters also prefer to use facilities that they can access in the normal course of their life routines. The *Self Storage Almanac* uses a five-mile primary competitive market radius, but each local market can vary. Demand for a market area can be measured by the rentable square feet per person, and the *Self Storage Almanac 2010* states that the national average square footage per person for 2009 is 7.26, marking a modest increase of 3.27 percent from 2008.

Some investors consider a market undersupplied if occupancy of all competitors is over 90 percent, at market equilibrium if occupancy is 80 percent–90 percent, and oversupplied if occupancy is less than 80 percent. In general, operators will not allow the occupancy levels to increase above 90 percent as this is an indicator that rental rates are too low. In addition, full occupancy potentially drives away new customers.

Occupancy can be measured in a physical or economic nature. Physical occupancy is the number of units occupied, but economic occupancy is the number of units renting at maximum income levels. In other words, if 50 percent of the units are rented at a steep discount, then this is the equivalent of 25 percent of the units not generating any income at all. Thus, a 100 percent occupied facility (physically) is 75 percent economically occupied. Economic occupancy gives a better indicator of the bottom line performance. The goal of increasing economic occupancy is to maximize revenue and thus profits.

According to the *Self Storage Almanac 2010,* historically, high vacancy rates have been around 15 percent, but in 2009, vacancy rates climbed up to 30 percent. Economic and physical occupancy have been declining since that time. Unlike in the past when occupancy decreases were caused by a significant amount of new development as in the early part of this decade, current declines are due more to demand reductions fueled by the economic environment.

A residential real estate recovery will directly boost the self-storage market. Ultimately, the recovery of the real estate sector is contingent on the return of credit flows to enable transaction volume to increase, prices to bottom-out and stabilize, and refinancing to occur.

Self-storage customers pull from fairly well-defined market segments in small, local market areas. Knowing a facility's market enables owners and managers to focus effectively on the advertising, sales and planning aspects of facility management. According to the *Self Storage Almanac 2010,* typically, 75 percent of facility customers are residential, with the next largest group being commercial representing about 10 percent to 20 percent. Depending on the proximity to military installations and college campuses, military and student customers typically make up 5 percent of renters in total.

Industry Outlook

Physical occupancy is expected to increase over the next few years, but economic occupancy will lag behind, according to Adam Wides, of the Mele Group. His primary reasoning is the increase in purchasing by the large institutional investors, primarily REITs. Since new construction is expected to be almost non-existent, more consolidations and portfolio-expansion campaigns will occur, and the larger industry players, especially the REITs, will be able to operate a portfolio from one national call center, use sophisticated management systems, and reduce operating costs. In turn, occupancy will increase with more aggressive discounts and other sales strategies, which will be more feasible with lower operating expenses. The main goal will be increasing physical occupancy. Over time, as economic conditions improve and a sense of demand is created, the discounts will be less necessary, resulting in a closing of the gap between economic and physical occupancy.

One of the newer major players in the industry is the Flagship Investment Group, who is backed by the traditional Wall Street firm Kane Anderson Group. In our conversations with CEO Chip Headley, he is also optimistic about the future of self-storage. He is encouraged by the increase in consumer spending during the 2010 Christmas season compared to the two previous years. Looking forward, in areas where job and population growth occur, he sees opportunity as he feels Americans have a short memory when it comes to past struggles, and they will be more likely to use storage when they feel more secure in their jobs again and their disposable income increases.

In Chip Headley's opinion, the industry has returned to more of a "blocking and tackling" mindset. As self-storage gained popularity, ancillary sales tactics such as renting wine storage, combining self-storage with RV storage and other trends were seen popping up. He described his group's philosophy as buying facilities "with a story." Chip Headley sees a back-to-the basics approach. Flagship Investment Group targets poorly managed facilities— ones that are not taking advantage of technology, specifically the Internet, in creating value-add opportunities.

They bought 11 facilities in the fourth quarter of 2010 and currently have 20 facilities under contract. In addition, they are looking at several other deals on a national basis. Their vision for the future is to buy and maximize return, and not to construct new. They see self-storage as a mature industry, not the growth industry it once was. Jerry Hart of Hart Storage Realty also agreed with the back-to-the-basics approach, and as Jerry stated, “Real estate always has been about location and storage is no different.” Jerry added that in addition to location, understanding one’s submarket and having good marketing, and management are the keys to the industry because as simple as it sounds, a lot of facilities do not have strong management and marketing.

Credit Availability

The various industry players with whom we spoke indicated that availability of credit has loosened somewhat. Lenders currently are typically looking to meet debt coverage ratios of 1.30 to 1.40 with the highest end buyers being considered at 1.25. The loan-to-value ratios are 65 percent–75 percent on stabilized properties. Interest rates are 5.50 percent –6.00 percent on Class A properties trading at over $5 million. Properties at values of $1 million–$5 million are offered interest rates around 6.25 percent for a 10-year loan and 5.90 percent for a five-year loan. An asset must be performing in order to even be considered. A new SBA (Small Business Association) loan program was introduced in October 2010 for properties under $5 million. A minimum of 10 percent equity is required, a personal guaranty, up to 25-year terms, and the loan must be a refinance or adding to an existing facility. Adam Wides of the Mele Group noted the new program and said it is too early to see how this will affect the industry. However, all financing decisions will undergo strict underwriting with stringent review of a facility’s operating history.

With more opportunity for credit, an increased number of distressed properties, and bank short sales, the institutional buyers will have many options, but the focus of their buying, according to Adam Wides, will be in core markets, such as Miami, Tampa and Orlando in Florida, and in those markets in which they already own other assets.

Valuing Self-Storage Facilities

In order to value self-storage facilities, the income approach is most critical. A stabilized property will be valued using a direct capitalization approach as a capitalization rate is applied to the net operating income. Currently, in the best markets nationally rates are 7.0 percent–7.5 percent, 8.0 percent–8.5 percent in the core markets, and higher in secondary and tertiary markets. On a facility in lease-up, a discounted cash flow analysis is best used with a holding period between five and 10 years with discount rates between 10 percent and 12 percent according to the *Korpacz Investor Survey,* Fourth Quarter 2010. Adam Wides indicated that a target leveraged IRR is approximately 20 percent for many of the buyers with whom they work. Lastly, an analysis of the comparables sales provides a secondary layer of analysis. Many of the recent comparables in the Florida market range from $40 to $60 per rentable square foot.

Summary

Overall, economic performance is beginning to move from turmoil to stability, but growth is not here yet, and when it comes, it will likely be slow. Tight credit markets will continue to slowly recover in residential and commercial real estate markets. Housing transactions, which drive over half of the self-storage market, will need to stabilize to give a significant boost to the industry. Unemployment must decrease to increase consumer confidence and the availability of discretionary income, which gives people the perception of storage as more of a necessity. Different regions will see economic recovery at different rates, based on population trends and the underlying strength of their respective economies.

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