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WHAT'S GOING ON OUT THERE?

by John E. Barry

Over the past 10 years, you would read industry newsletters about what a fantastic investment self storage is, and thus, more and more investors joined the party. There were only 26,000 self storage facilities developed in the country from the 1970s through 2001, and now there are over 53,000. You would also read newsletters concerning how to optimize the operations at your facility or about the excellent valuations in the marketplace for selling, as owners sold their properties at fantastic profits! With the economic recession we are all living through together, the subject that is most topical for self storage is the market, valuations, and how to survive in these unique times.



John E. Barry
Vice President

The total number of transactions involving self storage facilities decreased year over year, there is no question about it. Valuations are off their peaks seen in 2006; however, on a relative basis, the multiples at which self storage facilities trade are still near all time highs, even though they are off about 20% from the top. Comparing this to the stock market, which topped around 14,000 for the Dow Jones, if you would have sold all your stocks when they were off 20% or at 11,200, you might feel very satisfied today, given that the Dow Jones now stands at 8,500.

We are glad to offer our forecast for the next few years, although predicting the future is a difficult task, at best. What we can do is present a number of facts and logical assumptions about the future so that you can make an informed decision about what do with your self storage investment. Remember, your self storage facility is an investment, and as Warren Buffet always says, "if the reasons you initially acquired the investment are the same now, then by all means, hold on to it." He believes that the stock market will be significantly higher 5 years from now. On the other hand, if factors in your market have changed from your original assumptions, then moving on to another investment may be a wise move, as it is very likely that valuations on self storage will fall over the next 2-3 years.

As with all real estate, location is paramount. Has new competition come into your market? Are you experiencing increased discounting just to get rentals? Is the current lending environment to refinance your maturing loan requiring an equity contribution just to keep things rolling? With the non recourse financial market essentially closed or the terms too unattractive, we have seen properties that are performing wonderfully on a cash flow basis difficult to refinance with the terms banks are now offering on recourse terms. Is the risk of holding it too high?

All buyers are not vultures. There are still buyers seeking the steady returns that self storage offers, and valuations are not too far off the peak; however, with the recession at hand, more buyers are changing their future assumptions of cash flow. For example, buyers would typically assume an increase in annual rents of 5% and 3% for operating expenses. Many large operators have recently cut their rents by as much as 25%, and many

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buyers are reluctant to forecast a significant increase in rents. At the same time, buyers can expect an increase in property taxes, insurance, utilities, and other operating costs.

What about the future of interest rates that are currently near all-time lows? Logically, between the printing of trillions of dollars for the bailout, along with increasing federal, state and local deficits, we can expect to see higher borrowing rates, definitely higher tax rates, higher cap rates on self storage, and lower valuations for real estate, including self storage. If Class A properties today garner an 8% cap or first year return, a 9% cap rate, which is closer to the long-term average, is quite likely in a couple of years.

If you take a self storage facility with a net operating income today of \$300,000 at an 8% cap rate, it would be worth \$3,750,000. If for the next 3 years, you could not raise rents due to a lack of discretionary income from customers or increased competition but you see an increase in operating expenses of 3% and the market cap adjusts to 9%, that same self storage facility would be worth \$3,127,000 or \$623,000 less than today!

The other piece of the puzzle is the potential volume of sales coming to the market in the next couple years. Several buyers acquired numerous properties prior to and during the market peak, and they will be forced to sell due to poor operating performance or refinancing issues. This will exert downward price pressure on the market.

It is clear that the US and world economies enjoyed the “party for the ages” over the past 10 years and will suffer through the “strongest hangover for the ages.” Long term holders will be just fine as the lack of financing and development will allow some additional absorption of market demand. On the other hand, if you have thoughts of selling in the next three years and want to maximize the value of your self storage facility, then today may, in fact, be the day to sell.

John Barry is Vice President of the Brokerage Division. Call John with any questions regarding the valuation of your property.



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