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Self Storage Finally Gets Some Respect

by Michael L. McCune

During our rather brief history in the self-storage business the perceptions about the industry have changed dramatically. Wall Street has embraced some self-storage REITs and even the Wall Street conduit lenders are enamored with lending to self-storage at rates comparable to other trophy real estate. Finally self-storage is getting the respect it deserves.

In light of mainstream real estate investors now racing to the self-storage business I thought we might take a little time to explore the reasons for all of the excitement! I am prepared to make an argument that self-storage may well be the best type of investment you can make in the real estate world and really deserves its recently found respect. However, before I begin, I must warn you that my analysis only reflects certain attributes, such as: product demand growth, cash flow, return on equity, break even risk, additional capital costs, and other mundane "numbers" kinds of things. So for the balance of this article, I am going to make several arguments about the relative merits of self-storage investments compared to other types of real estate. Let's see how self-storage stacks up.

It is a Growth Industry

One significant factor makes self-storage a better bet in the long run than a lot of other real estate types - its market is growing faster than the population. First, many Americans have never used self-storage, and thus in many areas there is still pent up demand for the product. Secondly, after a period of time, perhaps five years, many self-storage facilities report that most of their business, say 80%, is from repeat customers. If you combine these two statements, it is clear that customers are not only discovering self-storage, but more importantly, they are also learning to use it again and again. The point is that this type of real estate's growth is not limited to just the population growth in a market, but gets a great boost from "moving up the learning curve" of the consumer.

There is another factor that impacts this formula for demand growth but is harder to quantify and that is the fact that self-storage doesn't require a "body" to make it useful. Hotels, apartments, offices, and homes all require human beings to occupy them or they are not very useful or profitable. On the other hand, self-storage doesn't need a person to physically occupy each unit in order to be successful. Rather, it thrives on our fast growing accumulation of "stuff" and our emotional attachment to it. The net result is that the demand for self-storage is growing rapidly and in excess of the rate of population growth, at least for the time being. We also know that fast growth in demand covers a lot of sins in real estate, but it also enhances our ability to earn greater returns on our self-storage investments than on other types of real estate. Despite the fact that the industry

built some 45,000 +/- facilities over the last 25 years, rents have continued to go up which certainly proves that the total demand has exceeded the supply and the population growth. Of course you may say that rents have gone up for all real estate types and that is generally true, but when you think of the relative amount of absorption of supply in such a short time the story is truly remarkable!

Cash Flow

I am now going to briefly explain five reasons why the cash flows on self-storage are higher and probably more secure than investments in other kinds of real estate. This translates to higher returns on your investment, less risk and possibly higher prices sometime in the future. All of my additional arguments, however, are based on the fact that a facility is in a good location, in a rational market (i.e. not overbuilt) and well maintained.

Zoning: We all know that getting zoning for self-storage is becoming harder in almost every community. It is not that self-storage is a bad civic citizen (actually it's among the best), but that self-storage is not glamorous, there are no sales taxes in most states and the real estate taxes are usually modest. This, of course, tends to restrict potential additional development and thus increase cash returns of existing facilities as demand builds. So, if you have a good facility, it is increasingly likely that the local zoning board will not jump through hoops to help developers build potential competition.

Cap Rates: Now readily recognized as great real estate, cap rates on most self-storage properties average between 1% and 2% above retail, apartment and office properties. Therefore, if an office or apartment project yields a 6.5% return, a self storage project might yield a 7.5% return. It may not sound like much, but it actually means that the cash flow is 15.4% per dollar of purchase price and about twice that increase if the property is leveraged with a loan.

Capital Risks: Investors for other types of real estate investments often overlook the requirement, and risk, for additional capital. Hotels always need new furnishing and redecorating, office buildings require massive amounts of tenant finish and commissions, apartments need everything and often. However, as one industry wag puts it, self-storage also has its own capital requirements to handle tenant replacements - a new broom about every three months! While this comment is somewhat facetious, the capital demands of a self-storage facility are very small, not only in relative terms to other real estate but also in absolute terms.

Operating Costs: Once again self-storage appears to have an advantage because the operating costs for self-storage usually have only a small exposure to currently high energy costs and labor. Many other real estate types have as much as 70% of their operating costs in energy and labor. Because of the lack of exposure to dramatic changes in these key expense components, the risk for self-storage is reduced and the consistency of income is improved.

One of the main reasons that self-storage is such a great real estate investment is both a blessing and a curse. The reason, of course, is the lack of glamour. It is a blessing because all of the return comes in the form of cash flow and not ego satisfaction. The curse, however, comes when you sell your facility. Buyers are seldom ever so smitten with a self-storage facility that they “fall in love” with a project and forget the numbers. The usual buyer of self-storage is someone just like you, in it for the money. In almost every case the buyer of a facility already owns a storage facility, knows the market cap rates, the operating costs, and refuses to over-pay for a facility.

It is easy to see why the former “ugly duckling” of the real estate industry now enjoys the respect of all types of investors. The potential for growth in self-storage, combined with the impressive cash flow that the business can produce has elevated this asset class to a whole new level – one that will rival the most glamorous of property types for years to come.

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