



SELF STORAGE SALES NETWORK

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Overbuilding – Is It Happening to You?

by Michael L. McCune

Overbuilding is a critical issue facing the self storage industry today and we hope this article will help you recognize the potential consequences of overbuilding in your market and the steps you can take to protect your business. Let's begin our discussion by defining what we mean by "overbuilding." Overbuilding is a market condition where self storage supply exceeds demand (renters) at any given time. Using this definition I would suggest that almost all markets are overbuilt to some degree if there is more than a nominal vacancy in the market. For example, a stabilized market that averages 88% occupancy could really mean that it is overbuilt by 12%. While 88% occupancy is not necessarily economically life threatening, it does indicate that excess demand is simply not there – otherwise they would be renting units.

Demand

A quick review about what we know about demand might be useful. The quick answer is not much. We know the SSA is trying to quantify and predict demand, but the task is complex and the results are at best inconclusive, but it is at least a start. We also know that for the last 30 years no one worried about demand for self storage because there was so much pent up demand for the new product. However, as Ray Wilson of Charles R. Wilson & Associates pointed out in the SSA Globe in December of 2003, this unlimited demand era is likely drawing to a close. Ray also pointed out in this same article that in studying a large national portfolio the number of households in a market only averaged 4.8 for each storage unit (varied between 3.0 and 7.7). One study has also revealed that 40% of the demand comes from the facility's own ZIP code, 20% from the adjacent two ZIP codes and virtually all demand within four miles. We also know that the population and household incomes are important in creating demand, but we are not sure just how. Thus, we can be reasonably certain that if demand is to increase, there has to be more people and hopefully with high incomes.

Supply

What do we know about supply? The first thing we know about a lot of new projects is that they are more driven by the availability of cheap money than a careful analysis of demand. It is clear that there is plenty of money available for a credit-worthy builder if he wants to build and someone will give him a positive feasibility study. We additionally know that the new builder in the market is the least likely to know much about it and that the new guy will not bring any renters with him when he comes. He will probably have higher costs, but then his expectations will also be higher. We also know, thanks again to the SSA Globe, that 86.7% of existing facilities compete with three or more facilities and almost 60% compete with six or more in their market.

The Impact of Overbuilding

Occupancies: Table I below shows the impact of one new facility on a hypothetical typical market with an 88% occupancy level. Study it closely, because over time the existing occupancy will roll over and the general occupancy will level out among all of the competitors, depending on their competitive merits. If the new competitor has a “better mouse trap,” more marketing, lower rents, etc., they might actually get a larger (maybe a lot larger) share of the market. Remember, the one thing we know for certain is that the new competitor does not create demand; he can only steal it from someone! As can be seen in Table I, this one project can drop the market’s average demand from 88% to 70%, which will cause serious economic hardship on all parties if there isn’t quick growth in demand.

Table I: Analysis of a Typical Market

Facilities	Number	SF	Total SF	Occp. %	Actual Demand
Existing Market	6	40,000	240,000	88%	211,200 SF
New	1	60,000	60,000	0%	0
New Total	7		300,000	70.3%	211,200 SF

Cash Flow: An example to illustrate the economic impact of “spreading” the demand is shown in a hypothetical project in Table II. These numbers assume that the rental rates don’t decline as occupancies fall. It is highly likely that rates (concessions) in such a market could easily cause gross rents to fall by another 5-10%. The numbers show that overbuilding can have a very dramatic impact on cash flow and value. It only takes one new facility to create this impact in a market that is not growing.

Table II: Impact on a Typical Project

Occupancy	100%	88%	70%
Rent	\$450,000	\$396,000	\$315,000
Expenses	\$150,000	\$150,000	\$150,000
Operating Income	\$300,000	\$246,000	\$165,000
Debt Service*	\$145,000	\$145,000	\$145,000
Cash Flow	\$155,000	\$101,000	\$20,000
Value**	\$3,300,000	\$2,730,000	\$1,833,000

* \$2,500,000 value, 75% LTV, 6% interest, 25 yr. amortization
** Based on a 9% Capitalization Rate

Growing Out of the Problem

Assuming that the “pent up” demand is nearly exhausted (the stabilized 88% occupancy would indicate that may be the case), how long would it take to grow out of our problem? In our little market, assuming that there were unlimited opportunities for growth and no

more new competitors, the demand has to grow by 25.1% to get back to the average 88% occupancy. The average American city has an annual population growth of 1.3% and the fastest growing city is at 3.7% annually. Dividing the occupancy deficit by the annual growth rates shows it could take 16.6 years for the market to return to 88% occupancy and the absolute best case scenario shows 7 years.

Another way to look at this problem is by using Ray Wilson's average of about 5 households per storage unit, an average household of 2.6 people, and 100 SF/unit. To get the market back to 88% occupancy ($60,000 \text{ sf} \div 100 \text{ sf/unit} \times 88\% = 528 \text{ units}$), we need to rent 528 units to new customers. Thus, we need 2,640 new households ($528 \text{ units} \times 5$) each with 2.6 people per household for a population growth of about 6,864 people **in our market area!** Many areas are already largely built out and are unlikely to ever grow that much. Planners tell me in a suburban metropolitan area it takes about $\frac{3}{4}$ acre for each household when roads, schools and commercial uses are considered. Therefore, in order to grow by 2,640 households this market would require about 2,000 acres be available for development – once again in just this market area!

Clearly, each market is different and requires different projections. Thus, our rough calculations should only be used to get a perspective on the potential magnitude of the consequences of overbuilding. Even with major “adjustments” the problem can be very serious and impact owners significantly. The most deceiving part is that overbuilding doesn't have to be a citywide or nationwide phenomenon, but it can affect just one small market. A careful analysis of your market is in order to see where you and your facility stand. You can find a useful format that can help you evaluate your market on our website at www.selfstorage.com/Argus/toolbox/checkup.htm.

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