ARGUS
SELF STORAGE SALES NETWORK

Market Monitor

"America's Premier Self Storage Brokers" **Issue VIII-2011**

What's Next for Self-Storage?

by Ben Vestal

The economic and political roller coaster of the last month has been devastating not only to the stock market but also to the overall investment market, including commercial real estate. The fear and greed that motivates investors to take positions either to protect their investments in uncertain times or capitalize on what they perceive as opportunity has been frozen by the overall volatility in the market over the last month. The distinct difference between fear and greed is that fear hits you like a runaway train and is almost instant, whereas greed is slow moving and takes hold over a period of time. Given the extreme volatility of the market over the last several weeks, it would be more appropriate to put an exact date and time on this article as we are receiving conflicting information that is pulling the investment climate in several different directions, but the analysis below is our best estimation of the current and future prospects for self-storage.

Self-storage investment activity has increased so far this year, but the lending market is beginning to stall. As banks, CMBS lenders and life insurance companies struggle to pinpoint spreads, i.e. interest rates, we are seeing floating rate deals in the 5% to 6% range with fixed rate deals surging higher. Self-storage is getting more attention from conventional lending sources as the industry's performance has held up nicely and in most cases improved over the last six months. This is most evident as the four major self-storage REITs have reported same-store revenue growth over the second quarter of 2010 ranging from 3.5% to 7.2%. However, recent operating history and loan to value is critical to the underwriting process today. The ability to borrow money accompanied by the investor's desire to seek stability will help stabilize the self-storage investment activity through the end of the year. The real question is how long will this last? And it is only a matter of time before the volatility of Wall Street trickles down to Main Street.

Cap Rates and Near Term Outlook

With the recent volatility in the stock market and low interest rates, cap rates will continue to remain low and at compelling levels for owners who are considering selling through the end of the year, barring any major financial disaster.We have observed cap rates in the 7.0% to 8.5% range on properties that have defensible operating history and are located in major markets, and second and third-tier markets are seeing cap rates in the range of 8.0% to 11%. In some cases cap rates are well ahead of the levels accepted by lenders, whose internal thresholds are 50 to 200 basis points higher than the market today. The disciplined loan underwriting standards, implemented after the last financial meltdown, seem to be intensifying after being triggered by the recent volatility in the market and we anticipate this to continue for the remainder of the year.

The emergence of the CMBS market over the past year has certainly helped sales velocity and self-storage values. Although over the last few weeks we have seen a cloud of skepticism hanging over the CMBS market that could slow the overall velocity of CMBS loans and the availability of this loan product.

The Big Picture

The ten-year US Treasury yields are currently hovering around 2.25% which reflects a 100 basis point or greater drop since the beginning of May 2011 when they were closer to the low 3% range. This volatility has left the banks and investors skittish and unwilling to commit. The ongoing debate in Washington regarding the debt ceiling, debt reduction and taxes has shone a bright light on the uncertainty of the U.S.'s monetary policy. This was reinforced by Standard and Poor's lowering of the U.S. credit rating. This was due to the direct and indirect obligations of the U.S. Government which have been pegged in excess of $100 trillion, taking into account the bank bailouts, Fannie Mae, Freddie Mac and the other entitlement programs. Despite the downgrade, the U.S. Treasuries are still seen as a safe investment.

The fundamentals of the storage business seem to be holding strong. The four major storage REITs all posted growth in same store revenue in the second quarter 2011 over the second quarter 2010, along with operating expense reductions or very moderate increases. This, along with three of the four major REITs also posting an increase in occupancy in the second quarter 2011 over the same quarter last year leads me to believe that the storage market fundamentals are strong and will continue to be strong for the foreseeable future.

The majority of self-storage assets around the country continue to outperform other property types, resulting in a growing reputation as the most stable asset class in commercial real estate. This reputation, along with the recent results, leads me to believe that the current market conditions of low interest rates and proven results have created a perfect equilibrium for buyers and sellers alike. For self-storage owners and investors looking to buy or sell a property, now may be the time to act while conditions are favorable. MM

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