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The Greatest Risks to Your Value Today and How to Overcome Them

by Ben Vestal

Forecasting economic trends, particularly in real estate, is risky business. However, not paying attention to economic trends such as interest rates, cap rates and overall real estate investor confidence is even riskier. I believe that self storage owners have made or lost more money because they are in the real estate business not the self storage business; even though your self storage business is an extremely reliable income stream. The value of your self storage property is greatly affected by the economic trends that impact the real estate business, more so than the operation of your self storage business. No matter what I tell you or what another real estate broker tells you, it is the real estate market that creates the value for your property - not the listing process!

Today, real estate investors not only have cap rate risk but also interest rate risk. The first thing to remember is that income creates the basis for value. In real estate, the relationship of income to value is called a cap rate. A cap rate is the rate of return an investor will expect on the invested equity without taking into consideration debt on the investment. If you think about the return on an investment, a low return or low cap rate usually implies a higher value for the same income. Conversely, high returns or a higher cap rate usually implies a lower value for the same income. This ratio, or cap rate, is set by the buyers and sellers of properties in the market. Overall market conditions also have a very dramatic effect on what an appropriate cap rate for a project may be. Together property-specific issues and market conditions work together to develop what buyers and sellers feel are appropriate cap rates for real estate investments. Often times buyers and sellers do not agree on the risk associated with what makes up an appropriate cap rate for an investment. Therefore it is important for you as self storage owners and real estate investors to understand the risks associated with your investment and what is affecting the value in the market today. If you do the math, making investment decisions to capitalize on market conditions will have a greater impact on the investment's IRR than simply renting more units and improving your project's operations.

The "TRUE" Cap Rate

First, it is very important to understand that a cap rate is a mysterious number and it changes from one property to the next. There is no standard cap rate! So remember when you hear someone saying they bought on a 10 cap or sold on a 7 cap that many things can come into play and affect what an appropriate cap rate is for an investment. The relationship of income to value changes from one property to the next and is affected by property specific and market conditions. Some examples of property specific questions that can cause the cap rate to go up or down are: Is the property on a land lease? Is the market over built? How difficult is it to develop a new project in the market? How many competitors are there in a 5 mile radius? Who are the competitors? Is the state considering a sales tax on self storage rentals and what is the quality of construction of the project? Market conditions may have an even bigger effect on the cap rate and may include such things as investor confidence, inflationary risk, interest rate risk and the availability of financing. As you can see, cap rates are affected by many factors and there is simply not a number that can be used to value every project. Each project is different in its own way and has its own set of risks.

Interest Rates: "What's Next?"

The effects of the continuing low interest rate environment have had a very dramatic impact on self storage investments over the last six to nine months. The most

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obvious and positive is that owners are able to sell their properties for close to historically high prices once again or refinance and keep a larger share of their hard earned income by paying less to their lenders in the form of interest. The reality of this is that buyers today are paying very high prices because they are able to borrow money somewhere between 5.25% and 6.0% and that is leaving plenty of spread between the cap rates and cost of borrowed money. As always, investors are looking to have the advantage of the arbitrage of what they can borrow money at and the return they are receiving on their investments. This tactic of arbitraging increases the rate of return on the equity an investor receives on the investment.

With these thoughts in mind, many investors wonder how long the current interest rate environment will last. With the liquidity crisis of 2008 still fresh in the minds of the Federal Reserve and the ever increasing concern of the prospects of inflation, the question is "when to jump?" We also wonder when the Fed and other political types will make it a priority to control inflation, i.e. raise interest rates. What we do know is that as interest rates go up, prices relative to income will go down. Buyers will not buy properties at cap rates that are less then the cost of borrowed money. Not even the best management can make that situation a profitable one.

Overcoming the Risks

When considering the cap rate and interest rate risk in the market today, I believe you can protect your investment by ensuring that you have plenty of time left on your existing loan and that the interest rate is locked or has a ceiling that you feel is reasonable. Also, as I commented on above, the ability of self storage owners to take advantage of the perceived current market conditions, such as selling when the market is improving, will have a greater impact on the investment's IRR than simply renting more units and improving the operations of their project. In order to be in position to execute on this strategy you must have a low or no prepayment penalty on your existing loan. As you know, it's not how you get into the deal, but how you get out of the deal that counts. Lastly, keeping your loan to value in line with the depth of your resources will enable the property to make you money and not the leverage; it is also just a good business practice.

There are many things that influence self storage values and I can't begin to address all of them or even do justice to the details as it relates to the relationship of cap rates and interest rates, but hopefully I have given you some insight as to the risks and opportunities that are very present in today's market.

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