



SELF STORAGE SALES NETWORK

# Market Monitor

"America's Premier Self Storage Brokers"

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## **Self Storage Real Estate: A View From My Perch** by Michael L. McCune

The first month of 2008 has been beset by significant financial and political "rock and roll." If you are like me, much of it doesn't seem to fit into a neat package that helps to clarify what the rest of the year will bring. However, if you will indulge me, I will give you two thoughts on the self storage real estate market that will hopefully provide some perspective for you to consider.

### **The Credit Crunch:**

The subprime residential loan debacle has caused problems in the commercial real estate world as well. It was clear to most everyone involved that the commercial underwriting standards (how lenders value properties and how much they lend) were quite loose by most historic patterns in late 2006 and early 2007. It was a great time to get a real estate loan, rates were low and loan proceeds were high. In the later part of 2007 the rating agencies began to really tighten up on the underwriting. The largest source of funds for commercial mortgages was from Wall Street firms that created commercial mortgage backed securities (CMBS) loans that were repackaged and sold on to investors. In late summer 2007 the underwriters of the loans decided that commercial loans were too generous in terms of loan proceeds and that the values were being overestimated. Sound familiar? At present, the problem is not nearly as serious as the residential situation, but no one is certain what will happen if the credit crisis becomes worse. This situation has also affected values of commercial real estate as cap rates have generally increased by about 1% (say, from 7% to 8%, depending on the area of the country).

With the change in underwriting trends and the general concern about mortgage backed securities, the CMBS market for funds has now become dramatically less available to real estate borrowers. Life insurance companies and many banks have stayed in the lending game for commercial properties, but they are being very conservative about valuations, projections and loan amounts. The good news is that on balance, loan interest rates haven't changed much since the "good old days" of early 2007. This is because a lot of money has been invested for safety reasons in US Treasury securities and the Fed is lowering the discount rate which has driven down rates on the benchmark 10 year Treasury bond. The dark side of the situation is that the risk spreads (the amount that lenders add on to the T-Bill rate to get the loan interest rate) have gone up dramatically. Over

the last year the spreads have gone from about 1.2% to about 3.0% as this is written.

My opinion is that the take-home message from this is: If there is evidence of potential inflation, the 10 year Treasury rate will rise and if there is a liquidity problem in the credit markets the spreads will also increase. What this means for you is that while loan rates are still low, by any historic measure (say 6.5%), it might be a very good time to lock in financing for the long haul. These times appear to be very volatile and the future cost and availability of financing may be quite uncertain, you might sleep better with a loan locked in for 10 years!

### **The Market for Facilities**

The uncertainty in the economy has also had an impact on the marketability of self storage facilities. However, unlike the changes in finance availability, the changes have been more moderate and rational. Prices of self storage facilities (per dollar of net operating income) hit absolute all time highs in about mid-2007. Buyers would accept the validity of just about any projection and would finance the project to the maximum allowed. The market of early 2008 has seemed to find equilibrium at a level that is about five to ten percent below the historic highs. The reality is that many of those sales at higher values were made by investors with OPM (other people's money) which may have meant they were not as discriminating as someone with experience in the business might have been. However, since the majority of self storage projects are bought by current owners, the fact that prices have seemed to stabilize is a good sign that serious, experienced buyers recognize good value at the slightly lower prices.

The current market equilibrium may not prove to be very durable for the longer term for several reasons. For example, if the financing market becomes either less liquid or more expensive, the prices for a facility will fall. The math is simple, if you pay the lender more, you can not pay the seller more and if you put in a larger investment you need a larger return. Additionally, the current concern about a possible recession could cause the potential buyers to be more concerned about future revenues. A 10 percent decline in revenue equates to a drop in value (at an 8 cap rate) of about 15 percent, and if the property is leveraged at 75 percent of value the equity would drop about 60 percent. Clearly, any of these events could have a material impact on an owner's investment if the investment horizon short term, say less than three years. Thus if you are planning sell sometime in the not too distant future, you may want to give some thought to accelerating the process and putting your equity into T-Bills. **MM**