



While You Were Napping...

You may not have noticed the best three years in the self storage business!

What happened?

You didn’t have to raise any rents, lower any expenses or even increase your occupancy – and you made a **lot** of money over the last three years or so. In fact, it may have been so easy that many of you may not have even known that it actually happened. However, while you were busy tending to other things, the real estate market became incredibly hot and interest rates hit lows not seen in your business lifetime. Let your eye immediately be drawn to **Table 1**, which represents what has happened to a typical facility (see **Table 2**) over this period. Being very clever, you will note the increase in **value** and **equity** that this happy circumstance has created. The equity is, of course, the number that interests you most, because it represents the net value of your ownership. Notice a whopping **71%** increase - - especially nice since you didn’t have to do anything different to earn it!

TABLE 1			
	2001	2004	% Increase
Cap Rate	10.00	8.50	
VALUE	\$2,000,000	\$2,353,000	17.7%
Loan	\$1,500,000	\$1,500,000	
EQUITY	\$500,000	\$853,000	70.6%
NOI	\$200,000	\$200,000	
Debt Service 25 Years	\$144,000 (@ 8.5%)	\$110,000 (@ 5.5%)	
CASH FLOW	\$56,000	\$90,000	60.7%

Why did it happen?

Why did this extraordinary increase in value and equity occur? The really short story is that interest rates went down and real estate investors were willing to pay more for real estate to get returns that were better than they could get at the bank, in stocks or in bonds. The drop in Cap Rates, shown in the first line, generally equates to the total return an investor is willing to accept when they buy a real estate asset. When investors’ expected returns drop, prices will go up. It’s just simple math. For more details on how Cap Rates operate, read my recent article, “Cap Rates – A Little Mystery Unveiled”, which was published in the November 2004 issue of *Inside Self-Storage* magazine www.selfstorage.com/argus/articles/caprates_1104.pdf. It has also helped that, for the first time, Self Storage is now considered a full-fledged, certified real estate product by the major buyers and lenders.

TABLE 2	
Typical Facility	
SF	40,000
Rent	\$8.52 per SF
Occupancy	88%
Expenses	33%
Loan	75%
Class	A
NOI	\$200,000

What happened if I refinanced?

The good news never seems to end! Not only were things even better, if you refinanced, you also had a very pleasant choice to make. First, if you didn't want to increase your loan amount, you can see by the example that your cash flow would have gone up by **61%**. That is sure easier than raising rents! However, if you maximized the loan, you could have taken out **\$265,000** cash -- a little more than half of your original equity -- and still increased your cash flow by \$2,000! Oh, the wonders of financial leverage!

Will this continue? So, what's the bad news?

Interest rates have started up and Mr. Greenspan seems to be committed to continuing to keep moving them in an upward direction and his hand is on the lever. At the moment, there still are many eager buyers around. But as interest rates rise, buyers simply won't be able to pay as much for the same dollar of income, and prices will fall. There are also persistent rumors (probably a lot of truth too!) of overbuilding in the air. In the long run, maybe not so long, the law of gravity still applies: "what goes up, must come down!" The bad news is that the math that made the values rise, works the same way and in the same magnitudes in reverse. Whoops!

What can I do?

If you plan to keep your facility forever, refinance NOW! If you aren't absolutely sure if you should keep your facility for at least five more years, now is the time to think about selling. If your facility is not state-of-the-art and in a very good location, if you have competition coming on board, if your rates and occupancy are not rising, or if you have some personal issues that might require you to require selling in the next five years, NOW is the time to get serious, very serious, about making the decision to sell or not to sell. Don't let the valuation math "go into reverse" for your facility. Remember, you had no control when it went up and you won't have any control on the way down! Don't get caught napping!

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