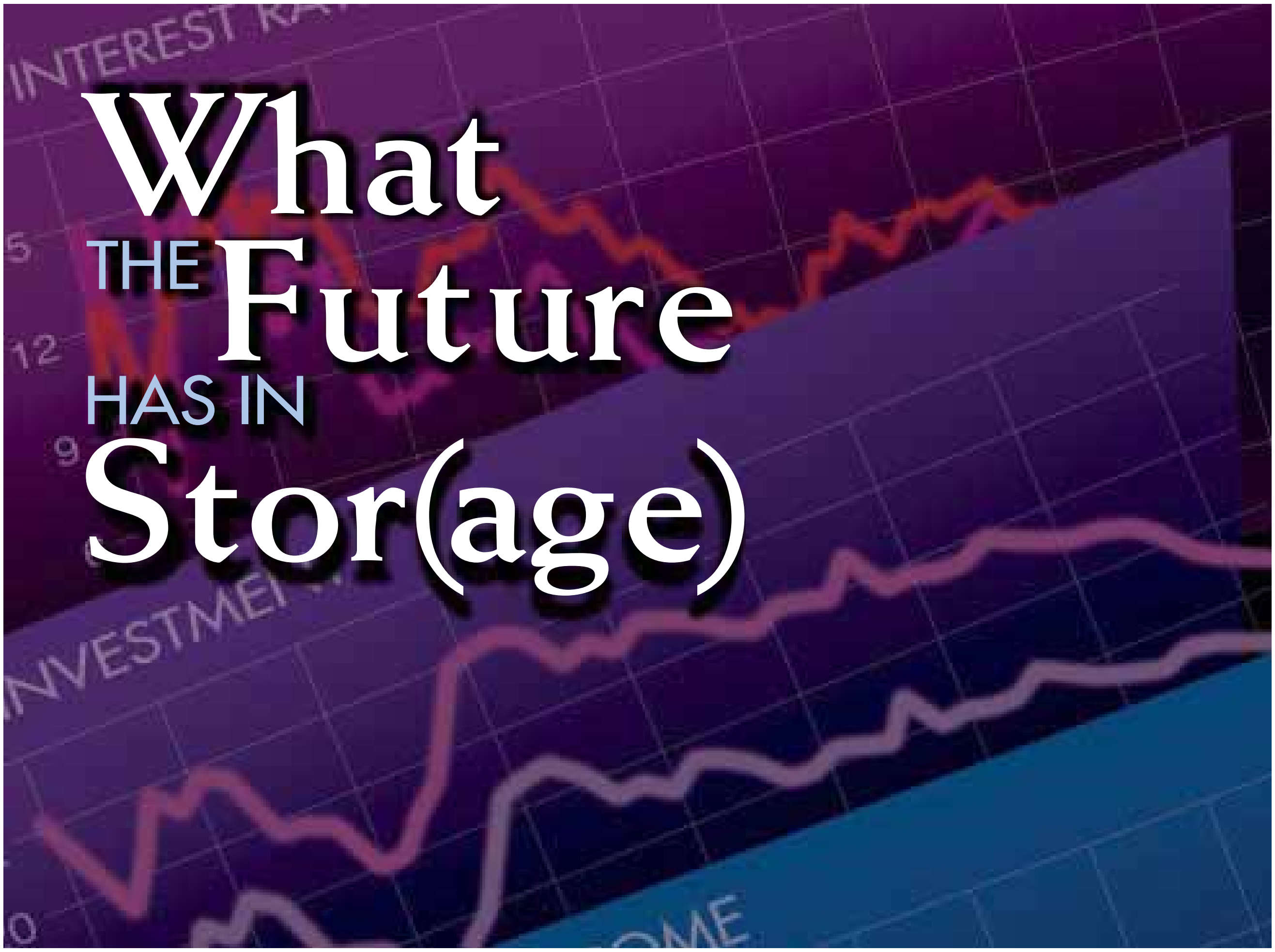
Mini-Storage Messenger
www.ministoragemessenger.com
Your Online Resource for Self-Storage Information
January, 2006



Predictions For The Next Decade

By Aaron A. Swerdlin

Today, the self-storage industry looks much different than it did 10 years ago. Just reflect for a moment upon the advancements in software for both management and security, the profile of the average owner, the skills of on-site personnel, the appearance of a typical facility, and the amenities now considered necessities that used to be considered state-of-the-art, just to name a few. The list goes on. But what will the self-storage industry look like 10 years from now?

Operational Enhancements

As with most sectors of commercial real estate, for any asset that serves a function, there will always be improvements over a measured period of time. Within the world of self-storage, it is expected that buildings will continue to be better engineered both for cost and function. The typical self-storage facility will also look nicer, on average, than most of what is in the market today. The location of the average facility will continue to move its way to the forefront of the major thoroughfare in any given submarket. Additionally, the average size of a facility will increase by five to 10 percent over that of today's average because of growing product awareness and customer base.

Software and hardware systems will evolve with technology and the applications for these products will expand. Renting a storage unit at a kiosk outside a self-storage facility or at a shopping mall is a trend that will most likely take hold, as well as other options such as improved online reservations and even the electronic signing of leases.

One of the most measurable changes within the last 10 years is with on-site personnel. The days of having someone working in the office (for two-times minimum wage) to collect rent checks and fill out a lease every now and then are gone forever. There is no such thing as a caretaker anymore. Today, on-site personnel needs to be proficient on the phone, knowledgeable on the computer, and motivated to market outside the office. Those skills will become even more important over the next several years as the industry continues the move into mainstream. Undeniably, operational enhancements will necessitate a more educated on-site manager so that the capabilities of new technology can be maximized. On-site personnel, in addition to being technologically savvy, will also need to be better marketers. Marketing and advertising in mediums other than *Yellow Pages* will be critical to accessing new customers.

Once a customer uses self-storage for the first time, they are more often than not a user for life—not necessarily keeping a unit for the rest of their life, but using self-storage without hesitation every time the need for storage arises.

Usage And Growth Trends

Other property types within the investment/commercial real estate world analyze growth and development within a very tight range of variables; job growth, population growth, and pricing sensitivities and demographics. A main attraction to self-storage is that, in addition to the standard variables, it has a customer base that is growing faster than rates of population growth and job growth.

The number of first-time users grows every month. Once a customer uses self-storage for the first time, they are more often than not a user for life—not necessarily keeping a unit for the rest of their life, but using self-storage without hesitation every time the need for storage arises. And because of product familiarity, they will use it more often than they otherwise would have. Plus, self-storage is working its way into the mainstream American culture, especially in big cities, to the point where some people do rent a storage unit with the intention of keeping it for an unlimited amount of time.

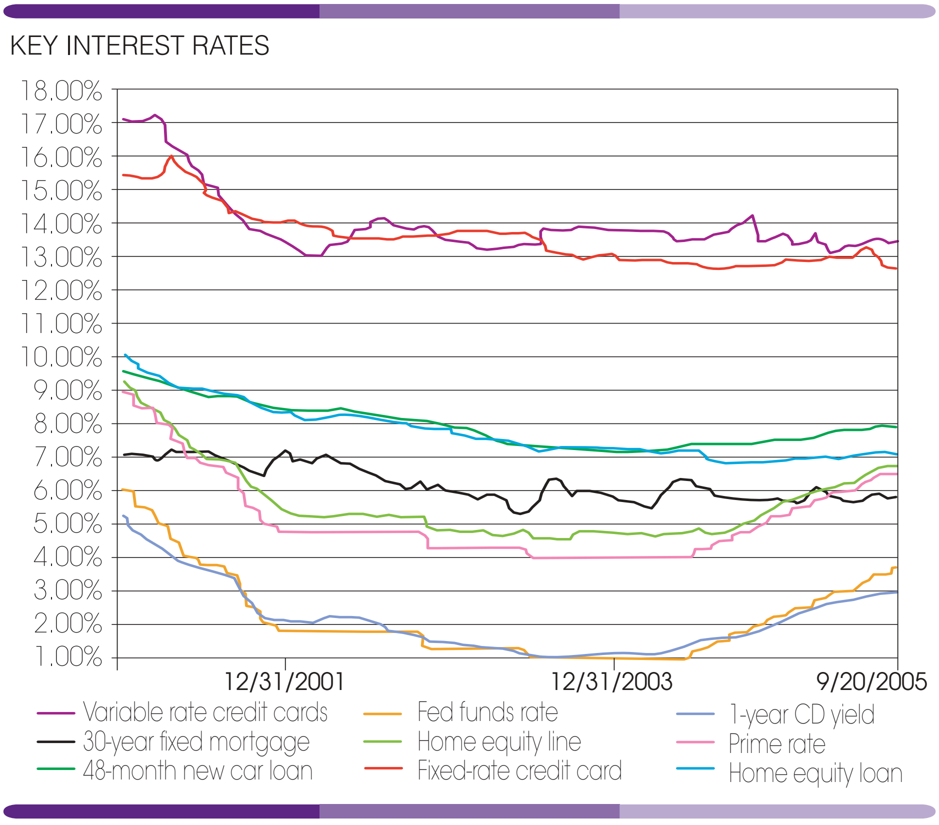
Many people dismissed this tendency a few years ago when companies began reporting it in markets such as metro New York, San Francisco, and other high-density markets. But the trend is real and it is very easy to understand when compared to the cell phone. The cell phone industry in the early 1980s had a market share of barely a single digit percentage of the population. Today, there are over 100,000,000 cell phones in the United States alone. Product familiarity and better technology have expanded the cell phone's potential market beyond that of any other product introduced in the last 20 years. The likelihood that one-third of the population will use self-storage in the next 10 years might be lower; however the characteristics of the potential market are very similar.

The Driving Force Of Capital

Understanding and even forecasting advancements in technology and operations are very obvious predictions that carry with them very little risk. Of course there will be advancements and improvements. The real driver behind the changes in the industry during the last 10 years is the same thing that will control the changes and growth in the next years: capital.

The reason the industry has made such progress is that there has never been this much capital looking for deals in the self-storage industry. Real estate in general has benefited from the condition of the capital markets. But self-storage especially has seen the laws of supply and demand work in its favor within the investment community.

A lot of focus is placed on the Federal Reserve's actions related to interest rates. An important point to keep in mind is that the interest rate the Federal Reserve manages is simply the interest rate banks are charged to borrow money



overnight to maintain required balances. The interest rate that a borrower of commercial real estate debt pays is an interest rate set by a supply and demand economy. While the Federal Reserve's actions are not completely benign to the effect on commercial interest rates, the effect is more reactionary than substantive. The reactionary element is that the institutional world looks to the moves the Federal Reserve makes to signal broader indications of the direction and strength of the United States economy.

The institutional world tries to predict the Federal Reserve's moves before they happen and build that prediction into the various markets. Unless the institutional world makes an incorrect prediction, the Federal Reserve moving rates up or down will have little if any effect on commercial interest rates beyond that which is assumed into the market by way of prediction. This does not mean that interest rates cannot or will not go up or down. It simply means that although lately the Federal Reserve has raised the overnight rate, interest rates for Commercial Mortgage-Backed Securities (CMBS) loans and life insurance loans have remained steady.

This is important because much is made of the fear that values of self-storage facilities have reached their highs and that the market only can go down; and will start going down soon. Values for self-storage facilities today have, on average, never been higher; however, low interest rates and low cap rates are not the sole reason for today's values. First, there are more buyers for self-storage facilities today than at any time in the past. This demand for product alone has compressed the price that the market will pay for a quality asset. Secondly, self-storage was an ignored asset-class until about 11 years ago. It was ignored largely due to a lack of information and knowledge about the property type. Counter to all other types of investment real estate, a self-storage facility is not pre-leased before it is built; stabilized occupancy does not occur until the second, third, or even fourth year after construction. And once it is stabilized the facility is occupied by tenants that could all move out next month because the leases are month-to-month. This was a way of operating that took non-storage investors a long time to get comfortable with.

Once the market understood the property type, it also understood that month-to-month leases were what made frequent rent increases possible. Unlike office real estate or retail, when a self-storage operator raises rates five percent, the results are much different than for office leases. To the average self-storage tenant, this equates to a $5 per month increase; to an office tenant that increase could easily equate to $500 per month or more. The expense structure for self-storage also is attractive because there is not a tenant improvement allowance, there are no common areas to maintain, and no leasing costs beyond the on-site personnel. Moreover, the likelihood of expense increases is also minimal, with the exception of real estate taxes.

Once the institutional community began to understand that the very things that have kept them away from self-storage were the very ones that made self-storage so attractive, they jumped in with both feet—and it appears that they are not looking back. In fact, more institutional investors enter the industry every month. This is important to note because institutional investors provide much needed patience in the self-storage industry—with the hundreds of millions of dollars the institutional community has invested, they will be very calculating of their actions and will provide value-stability by way of their patience.

Looking At The Numbers

In general, there is a lack of quality product on the market; at least relative to demand. This factor is keeping cap rates down in the high six to mid-seven range for quality assets. Although most investors do not price self-storage assets on cap rate alone (most use a combination of internal rate of return (IRR), cap rate, stabilized yield, and initial yield) the capitalization rate is a good barometer for the market to use to gauge itself against the debt market.

Strong indications that there is a lack of quality product in the market are the mega-deals that have closed during the last 12 months. Not only have two companies gone public (Salt Lake City, Utah-based Extra Space and Cleveland, Ohio-based U-Store-It) but there have been multiple 10-plus property portfolios sold to Public Storage, U-Store-It, or Extra Space. In addition, Shurgard recently announced that it has hired advisors to explore strategic options, among which most likely will include the sale of the company. The consolidation among industry leaders is a sign that the single-property and small portfolio opportunities are not plentiful enough to feed the acquisition appetite.

If the hypothesis is that the self-storage industry will have another 10-year run of operational, economic, and market growth, then the proof will manifest intwo tiers.

The first tier is the economic and capital component. Cap rates and core interest rates are going to fluctuate. However, overall asset value should continue to grow at a rate of at least three to five percent per year. The derivation of this forecast is that if cap rates increase, that is a direct indication that interest rates have increased. Interest rates do not rise without cause and with the current state of the economy; the single biggest contributor to interest rate pressure is inflation. But, if inflation is present, the ability to raise rents will increase and revenues (and thus value) will increase. The theory is that the loss of value from increasing cap rates will be offset by increased revenues (from the inflationary increase in rents), and the overall value of the asset will stay level (and most likely increase three to five percent). Interest rates also increase when there becomes a greater number of borrower's than lenders, and thus it becomes a lender's market.

Inflation however, will replace an increase in the cap rate as rental rate growth will be more easily applied, thus increasing net operating income (NOI). Although the cap rate that is applied to the NOI is higher, the NOI itself is higher and in a controlled inflationary market the increase in NOI should lead to overall asset value-growth. Plus, cap rates are not going to increase at a one-to-one ratio with interest rates. Although there might be three-to-six month periods of adjustment when the NOI growth is minimal and the cap rate growth is more measurable; in any 12-month period, the overall asset value will trend upward.

There is another place to put pressure on value in a changing capital environment; the spread the lender places on debt. Most commercial debt today is priced based on U.S. T-Bills or LIBOR rates. The lender simply charges the borrower a spread over the underlying benchmark. During the last 18 months, lenders have narrowed the average spread by more than 100 basis points and there is probably another 15 to 20 basis points worth of spread that will compress over the next 18 months or as rates rise.

Another benefit of today's debt environment is that if interest rates increase substantially, properties with existing CMBS debt will have a commodity attached to it that is not available elsewhere. Most CMBS debt is assumable. And if the interest rate on the debt is more than 150 basis points lower than the then current market-interest rate, the debt itself has value over and above the value of the unleveraged cash flow (provided there are five to seven years remaining on the debt and that the loan amount is not less than 65 percent of the purchase price of the property).

Provided the capital side of the equation remains solid, the continued progress in technology is inevitable.

The second tier needed for continued growth is simply the technological advancements in the software, hardware, building systems, and ancillaries along with continuing to augment the skills of on-site personnel and the approach to the marketing of the business. Provided the capital side of the equation remains solid, the continued progress in technology is inevitable.

The Formula For Longevity

Steady, measured growth is the formula for longevity. A healthy volume of transactions at a steady pace will keep property values stable. Interest rates and cap rates are going to fluctuate up and down; sometimes in the favor of sellers and sometimes in the favor of buyers. Taking a 12-month approach to reacting to changes in cap rates and interest rates, rather than reacting immediately, also will contribute to maintaining property value stability.

The self-storage industry is poised for another 10 years of progress and growth both from the investment perspective and, more importantly, from the standpoint of the customer.

Aaron A. Swerdlin is the Director and Senior Vice President of the Self-Storage Advisory Group, a nationwide practice solely focused on the brokerage and financing needs of the self-storage industry.