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Extraordinary Times - How Long Will They Last?

by Ben Vestal

During the relatively brief history of the self-storage business (35 to 40 years) the perception about the industry has changed dramatically. Wall Street has now embraced the industry and life insurance companies and conduit lenders have come back to the market, enamored once again with lending on self-storage properties with terms similar to core asset classes such as office, retail and industrial. Along with the respect that the self-storage industry has earned over the years comes an increase in competition. Operators are now realizing that sophisticated operations and economies of scale are imperative to survival in the business. This is more apparent today than ever before as we are seeing large operators winning business away from smaller operators whether by pricing, advertising or property amenities. I would also note that in general, the large operators are able to get a rent premium over the small operators that have similar properties in the same market. This leads me to believe that the self-storage industry has reached a crossroads and operators need to make the necessary adjustments in order to compete as the industry continues to mature.

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 obvious and positive result is that owners are able sell their properties at close to historically high prices once again (reflecting back on 2006-2007) or refinance and keep a larger share of their hard-eared income by paying less to the lenders. Let's not forget just 12 to 18 months ago the general consensus in the commercial real estate industry, including self storage, was that many owners would be facing maturity defaults as values had fallen as much as 40% and there were very few lenders willing to commit to new loans. We are now seeing values rebound faster then anyone thought possible. Low-leverage refinancing deals are once again able to achieve non-recourse loans with terms very similar to the peak of the market. Higher-leveraged deals also seem to be finding a home, albeit at higher interest rates and with strong personal guarantees. This is not to say that ill-conceived projects or properties that were bought with unrealistic expectations during the boom of the mid 2000s are not still struggling. I would expect these projects to continue to struggle and slowly work their way through the system. As they say, time cures almost anything; this seems to be also true about the real estate business.

The other noticeable impact of low interest rates has been on the pricing of self-storage facilities in relation to their income. This is of course in recognition that the new buyers will be able to obtain financing at lower rates and achieve higher returns. In essence, each dollar of income becomes worth more to a buyer. Using typical market rates (we call them Cap Rates in the real estate business) for computing this increase in value, on average a project would have gone up about 15% in value over the last year or so, with no increase in net operating income, largely because of the compression in Cap Rates over the last six to nine months. However, it is important to note that as the self-storage industry continues to mature, the sophisticated capital and operators who are able to pay the highest prices are now drawing a line in the sand between institutional grade properties and non-institutional grade properties. This has led many small operators to wonder why they can't achieve the same low cap rates as other properties in the market. This bifurcation in value, between large and small properties and large and small markets, will continue and many of the smaller operators will be faced with a difficult decision as the self-storage industry continues to mature. Maybe the most important indicator of where the market is headed is investor confidence. According to PriceWaterhouseCoopers' first quarter 2011 Real Estate survey, investor confidence is on the rise. Clearly there has been an improvement in the national economy, which has translated into an increase in investor confidence and commercial real estate fundamentals in general. I believe the real question is will this continue and how long will the recovery last? The current low interest rate environment and investor confidence has created an almost perfect atmosphere for anyone thinking about buying, selling or refinancing! Now, I know that this sounds like a broker talking, but let's briefly examine each action and see if you agree.

Buyers: Buyers today can purchase good properties and achieve cash on cash returns not seen in the last few years because of low interest rates. They also have the strategic advantage of understanding how a property has performed during the worst downturn in the last 40 years.

Sellers: Sellers today can enjoy near-historically high prices which are also being fueled by the low interest rates and increase in investor confidence, all while enjoying some of the lowest capital gains taxes in history.

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Refinancing: After the last few years, if an owner does not understand the importance of locking in a loan at a low interest rate for as long as possible, then he needs more help than simply a new loan.

With these thoughts in mind, the next logical question is will this improvement continue and if so, at what pace? Pursuant to the liquidity crisis of 2008 and the subsequent quantitative easing programs by the Federal Reserve, investors have become increasingly concerned about the prospect of inflation, particularly in light of the rapid rise in oil and global food prices. The question, of course, is when to jump into action. Since we have discovered the dramatic impact of interest rates, it might be helpful to review the history of interest rates. The chart that is provided below is the 48 year history of U.S. ten-year Treasury Bonds. Interest rates on this bond, plus a "spread" are most often used to set the pricing on self storage loans. The spread has ranged in the last 20 years from 1.15% to 5%, so a chart of self storage loans would be even more exaggerated in its swings. As a general rule, all spreads increase as interest rates increase and money tightens.

As you can see, interest rates can be very volatile, changing as much as 2% to 4% in just a few years. I have made a few observations below that may cause you to think that the risk of inaction may far outweigh the probability of improving your position by hoping for lower interest rates.

1.There have only been 5 years in the last 49 years were the ten year treasury bonds have been consistently below 4%; 1963, 2008, 2009, 2010 and now 2011.

2. In addition, rates over the last 49 years were 3.5 times as likely to be in the 6% to 8% range as where they are today and equally likely to be in the 12% to 14% range.

3. A 2% increase in the interest rate on a normal loan (6%, 25 year amortization) has the same impact on cash flow after debt service as raising your operating cost 23%.

These extraordinary times have created opportunity if you are considering buying, selling or refinancing. It all comes down to your objectives and the actions you must take to reach them. Now is a great time to make a move, if not now…when? MM

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Chart I: 10-Year US Treasury Bonds 1962-2010