ARGUS
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Are We Back at the Top Again?
Only if you have the right property
by Ben Vestal

As we settle in to 2011, it is clear that self-storage values are rebounding along with the values of all other commercial real estate. In 2010, large MSAs like New York, Boston, Los Angeles, Chicago, San Francisco, Houston, and Washington saw the beginning of a rapid recovery in commercial real estate values, much to my surprise. A combination of big portfolio sales and solid returns during the downturn has led both small and large investors back to self-storage as a preferred investment. We have already seen upticks in investor interest in the second tier markets such as Denver, Kansas City, Colorado Springs and Charlotte as the REITs and private equity reach for higher-hanging fruit, and we anticipate this to continue through 2011.

Large investors are reentering the market and as a result, the bifurcation between institutional quality assets and the rest of the market that existed in 2010 is still a factor in 2011 and may even be growing bigger. For the first time in recent history we are seeing investors differentiate between Class A properties and the rest of the market. This has caused cap rates for Class A properties to fall and values to rise for well-located, well-managed and stabilized properties. If you have a Class A property in a good market the only thing better is to have two or three. We are seeing cap rates for Class A properties at or near all-time lows. Historically, investors have not recognized the differences in the quality of the asset and have simply relied on the asset's NOI to assess the value. The self-storage industry has now reached a point were investors are making a distinction between the classes of self-storage properties. This has left small owners and operators frustrated and wondering "what is my property worth?" The investment demand for Class B and C properties is decreasing and shifting further away from the strong investment demand for Class A properties. This is because leveraged buyers are finding it more difficult to make smaller deals work as the smaller investors' cost of capital is rising faster than the large institutional buyers'.

It has occurred to me that it might be insightful to consider an opportunity the market appears to be ignoring. With the cost of debt still in the range of 5.5% to 6.5% for smaller deals and cap rates still hovering around 8.5% for Class B and C properties, it may be worth your time to do a little math! In Chart 1, I have outlined very basic cash on cash analysis that may be worth considering.

Chart 1: Cash on Cash Comparison

Property Class	Class A	Class B/C
Revenue	$500,000	$500,000
Expenses	$200,000	$200,000
NOI	**$300,000**	**$300,000**
Cap Rate	7.50%	8.50%
Value	$4,000,000	$3,529,000
Debt Service	$231,948	$204,636
Cash Flow	**$68,052**	**$95,364**
Loan Amount*	$3,000,000	$2,646,750
Equity	$1,000,000	$882,250
Cash on Cash Return	**6.80%**	**10.80%**

*Loan Assumptions: 75% LTV, 6% interest, 25 year amortization

By way of example, prices are higher per dollar of NOI (lower cap rates) on Class A properties then they are on Class B and C properties. As indicated in the chart above the Class B/C property has a 10.8% cash on cash return which is a 58% greater return than the Class A property with a 6.8% cash on cash return. While there may be many reasons for the difference, most will likely relate to the number of buyers and sellers in the market rather than some intrinsic valuation issue with the property. When we remember that a self-storage market is measured by a five mile radius (approximately) around each property, the difference between a Class A property and a Class B or C property is less important than many other things when evaluating the income of a facility. In other words, an excellent project in a stabilized market such a Madison, WI or Greensboro, NC is probably equal to a comparable, excellent project in Thousand Oaks, CA or Montclair, NJ as it relates to generating a stable and growing income.

Clearly, there is value in understanding what affects cap rates in self-storage and other real estate. The rewards are obvious and make the game worth playing, but the trick is to make sure the difference is really in the price and not the market or quality of the project! How long will these opportunities remain in the market? Your guess is as good as mine; the old saying you make money in the real estate business when you buy the property may be more true today than ever! MM

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