

BUSINESS BRIEFING SELF STORAGE



VALUATION & ADVISORY

A Cushman & Wakefield Valuation & Advisory Publication

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SOLID YEAR AHEAD IN SELF STORAGE

As we enter 2015, investors always ask about market expectations for the New Year. Market fundamentals remain robust for self storage, so new construction will rise. Cap rates compressed more in the second half of 2014, suggesting moderate compression to stabilization in some markets in the first half of this year. The long term superior performance of the sector has brought new players and capital to the asset class, and competition for product – both single assets and portfolios – is high. More CMBS debt will renew this year over last, suggesting rates may begin to stabilize (regardless of Fed policy). Overall, it will be a solid year for self storage.



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INVESTOR RESEARCH

The Self Storage Industry Group of Cushman & Wakefield publishes twice annually in the Price Waterhouse Coopers Investor Survey for self storage (Q4 2014). With permission from PwC, those results are summarized as follows:

SECOND HALF 2014 – SELF STORAGE KEY INDICATORS			
	2ND HALF – 2014	1ST HALF – 2014	2ND HALF – 2013
DISCOUNTED CASH FLOW			
Range:	8.00% – 11.00%	8.00% – 11.00%	8.25% – 11.00%
Average:	9.00%	9.15%	9.25%
Change (Basis Points):	-15	-10	-25
CAPITALIZATION RATE			
Range:	5.25% – 8.50%	5.25% – 8.50%	5.50% – 8.50%
Average:	5.90%	6.12%	6.25%
Change (Basis Points):	-22	-13	-30
RESIDUAL CAP RATE			
Range:	5.50% – 8.50%	5.50% – 8.50%	6.00% – 8.50%
Average:	6.15%	6.35%	6.50%
Change (Basis Points):	-20	-15	-25
MARKET RENT CHANGE RATE			
Range:	3.00% – 6.00%	3.00% – 6.00%	3.00% – 6.00%
Average:	3.50%	3.50%	3.25%
Change (Basis Points):	0	25	-25
EXPENSE CHANGE RATE			
Range:	2.00% – 5.00%	2.00% – 5.00%	2.00% – 5.00%
Average:	3.00%	3.00%	3.00%
Change (Basis Points):	-25	0	0
MARKETING TIME			
Range:	2 – 6	2 – 6	2 – 7
Average:	3.0	2.5	3.0
Change (Basis Points):	0.50	-0.50	0
Source: PwC Investor Survey, Q4 2014 and reprinted with permission			

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This Business Briefing includes an expanded survey such as market optimism, absorption time and other elements that characterize the current market conditions for the self storage asset class. The results of the survey, completed in Q4 2014 by over 50 respondents in investment, brokerage and other industry players, are detailed as follows:

Q4 2014 SELF STORAGE KEY INDICATORS										
TIME	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005
TRADE AREA										
Range:	1.00 – 5.00	1.00 – 5.00	1.00 – 5.00	1.00 – 5.00	1.00 – 5.00	2.00 – 5.00	2.00 – 5.50	2.00 – 5.00	1.00 – 5.00	1.00 – 5.00
Mode:	3	3	3	3	3	3	3	3	3	3
Average:	3.30	3.25	3.22	3.20	3.15	3.21	3.25	3.33	3.14	3.30
Change:	1.54%	0.93%	0.64%	1.59%	-1.87%	-1.20%	-2.40%	6.05%	-4.85%	17.86%
DEMAND (SF PER PERSON)										
Range:	1 – 8	1 – 8	1 – 8	1 – 8	1 – 8	1 – 8	1 – 10	3 – 10	2 – 10	3 – 12
Mode:	7	7	7	7	7	6.5	6	6	5	5
Average:	7.10	7.35	7.31	7.15	6.98	6.73	6.52	6.12	5.70	5.36
Change:	-3.40%	0.55%	2.24%	2.44%	3.71%	3.22%	6.54%	7.37%	6.34%	1.71%
CAPITALIZATION RATE										
Range:	5.25% – 8.50%	5.75% – 8.50%	6.50% – 8.50%	6.75% – 9.00%	6.50% – 9.00%	6.50% – 9.50%	6.00% – 9.00%	6.00% – 9.00%	6.00% – 9.00%	7.00% – 10.00%
Mode:	6.50%	6.90%	7.25%	7.75%	8.50%	8.50%	7.50%	7.25%	7.00%	8.50%
Average:	6.12%	6.55%	7.25%	7.50%	8.45%	8.55%	7.55%	7.19%	7.26%	8.28%
Change:	-43 Basis Points	-50 Basis Points	-25 Basis Points	-95 Basis Points	-10 Basis Points	+100 Basis Points	+36 Basis Points	-7 Basis Points	-91 Basis Points	-91 Basis Points
ABSORPTION TIME (MONTHS):										
Range:	18 – 36	18 – 36	20 – 40	24 – 40	24 – 48	24 – 48	20 – 40	18 – 36	18 – 43	12 – 44
Mode:	30	30	32	36	36	36	36	30	30	24
Average:	28	30	33	36	35	34	33	32	30	27
Change:	-2	-3	-3	+1	+1	+1	+1	+2	+3	+3
MARKETING TIME (MONTHS):										
Range:	1 – 12	1 – 12	1 – 12	1 – 12	1 – 12	1 – 12	1 – 12	1 – 12	1 – 6	1 – 12
Mode:	3	6	6	6	6	8	4	4	4	1
Average:	3	3	4	5	6.15	7.75	4.31	3.66	3.14	3.06
Change:	No Change	-1	-1	-1.15	-1.65	+3.44	+0.65	+0.52	+0.08	+0.17
PROFIT (ON COST ONLY)										
Range:	10.00% – 25.00%	10.00% – 25.00%	10.00% – 25.00%	10.00% – 20.00%	10.00% – 15.00%	10.00% – 20.00%	10.00% – 20.00%	10.00% – 25.00%	15.00% – 25.00%	10.00% – 30.00%
Mode:	20.00%	20.00%	18.00%	15.00%	12.00%	15.00%	15.00%	18.00%	20.00%	20.00%
Average:	21.00%	20.00%	17.50%	15.00%	12.50%	14.96%	15.86%	17.63%	20.13%	20.14%
Change:	5.00%	2.50%	2.50%	2.50%	-16.44%	-5.67%	-10.04%	-12.42%	–	17.78%
OPTIMISM INDEX (1 – 10)										
Range:	3.00 – 9.00	3.00 – 9.00	3.00 – 10.00	3.00 – 9.00	3.00 – 9.00	1.00 – 8.00	3.00 – 9.00	3.00 – 9.00	3.00 – 9.00	3.00 – 9.00
Mode:	8.00	7.50	7.25	7.00	6.00	5.00	6.00	6.00	7.00	6.50
Average:	8.10	7.50	7.25	7.00	6.15	5.50	6.00	6.25	6.50	6.65
Change:	8.00%	3.45%	3.57%	13.82%	11.82%	-8.33%	-4.00%	-3.85%	-2.26%	-3.62%
MARKET CONDITIONS										
Under-Supplied:	42%	25%	20%	15%	10%	10%	10%	6%	15%	15%
Over-Supplied:	20%	30%	40%	50%	60%	65%	63%	52%	50%	50%
Equilibrium:	38%	45%	40%	35%	30%	25%	27%	42%	35%	35%
STRATEGY										
Buy:	55%	52%	47%	43%	40%	20%	27%	15%	18%	20%
Sell:	20%	24%	35%	42%	45%	60%	55%	60%	50%	60%
Build:	25%	24%	18%	17%	15%	20%	18%	25%	32%	20%
DISCOUNTED CASH FLOW										
Usage:	70%	61%	52%	41%	33%	36%	33%			
DISCOUNT RATE (IRR)										
Range:	8.00% – 11.00%	10.00% – 12.00%	9.00% – 11.50%	9.50% – 11.50%	10.00% – 12.00%	10.00% – 12.00%	10.00% – 11.00%			
Average:	9.15%	10.00%	10.25%	10.50%	11.25%	11.50%	10.75%			
Change (Basis Points):	-.85	-.25	-.25	-.75	-.25	75.00	25.00			
Rental Growth Rate:	3.50%	3.50%	3.50%	3.00%	3.00%	2.00%	3.00%			
Expenses Growth Rate:	3.00% – 4.00%	3.00% – 4.00%	3.00% – 4.00%	3.00% – 4.00%	3.00% – 4.00%	3.00% – 4.00%	3.00% – 4.00%			
Terminal Cap Rate:	+25 bps	+25 bps	+25 bps	+35 bps	+50 bps	+50 bps	+50 bps			
Cost of Sales:	2%	2%	3%	3.5%	4%	4%	4%			
Holding Period:	10 Years	10 Years	10 Years	10 Years	10 Years	10 Years	10 Years			

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The survey is valuable because it includes 10 years of data in a time trend series. In summary, the data indicates cap and yield rate compression continues. In fact, cap rates are now at the lowest point in the 10-year series, and down 243 basis points (bps) from the Great Recession year of 2009. Demand per square foot per person has actually declined, a result of population growth rising faster than self storage new construction starts. Consequently, absorption and marketing times are down, while profit (on cost) and the Optimism Index are at all time highs.

Investors continue to be selective, demonstrated by segmentation among cap and yield rates by investment quality. For example, the average overall cap rate for a Class A facility (physical and investment quality) can be as much as 350 basis points lower than for a Class C facility. This does present interesting opportunities for smaller, more entrepreneurial investors to focus on secondary markets where yields are higher. Data regarding market segmentation from the Second Half 2014 PwC Investor Survey is summarized as follows:

-243 bps

Cap rates are now at the lowest point in the 10-year series, and down 243 basis points (bps) from the Great Recession year of 2009.

MARKET SEGMENTATION BY INVESTMENT QUALITY			
	CLASS A	CLASS B	CLASS C
DISCOUNT RATE (IRR)			
Range:	8.00% – 9.00%	9.00% – 10.00%	10.00% – 11.00%
Average:	9.55%	9.35%	10.30%
CAPITALIZATION RATE			
Range:	5.00% – 6.00%	6.00% – 7.25%	7.25% – 8.50%
Average:	5.50%	6.40%	7.50%
RESIDUAL CAP RATE			
Range:	5.25% – 6.25%	6.25% – 7.25%	7.50% – 8.75%
Average	5.75%	6.60%	7.75%

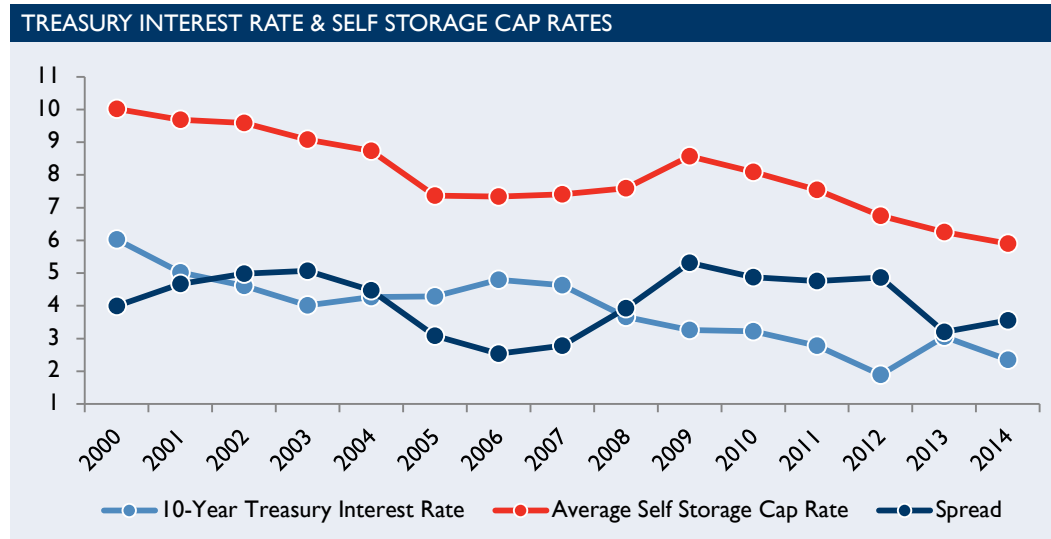
Source: Self Storage Industry Group of Cushman & Wakefield

WHY NOT TO WORRY ABOUT CAP RATE COMPRESSION – NOT YET

The average spread from cap rate to the 10-year Treasury has been 425 bps over the last 15 years. As of Q4 2014, the spread was 355 bps. While below the time series average, it remains 101 bps higher than the lowest spread of 254 bps at the peak of the last boom in 2006. This suggests greater discipline in the market with respect to cash flow. Investors are not solely relying on appreciation as an investment criterion, but are balancing cash flow and appreciation in cap and yield rate decisions. The great unknown is that investors are concerned about the Fed increasing the 10-year Treasury. When this happens, it will be interesting to see if investors continue with discipline shown by the spreads. A time series of cap rate spreads to 10-year Treasuries follows.

Investors are not solely relying on appreciation as an investment criterion, but are balancing cash flow and appreciation in cap and yield rate decisions.

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MARKET FUNDAMENTALS

Supply and demand factors are near equilibrium in self storage, resulting in rising operational characteristics and higher net operating income. Industry operating metrics in terms of occupancy and income demonstrate continued, positive momentum. The REITs show some anomalous results in terms of asking rents, but rental income is a more important metric because it more closely reflects cash flow. Data on same store sales show significant gains in “other” income categories such as tenant insurance revenue. In self storage, positive growth in physical occupancy tends to be followed by growth in economic occupancy suggesting momentum will be sustained.

Prudent management will enhance revenue by raising rents on existing tenants. Some management companies use complex algorithms to find the sweet spot between raising rents and losing tenants. This seems to translate into raising rents on existing tenants at month five and month nine. To keep occupancy growing, street or stated rents are lower. As a result, economic occupancy can be higher than physical occupancy. Monthly contracts mean rents can be increased at any time. REITs are particularly adept at revenue management resulting in superior operating performance over the long run.



In self storage, positive growth in physical occupancy tends to be followed by growth in economic occupancy suggesting momentum will be sustained.

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Operating data from the Self Storage Performance Quarterly (published by the Self Storage Industry Group of Cushman & Wakefield) Q3 14 is presented as follows:

PERFORMANCE AT-A-GLANCE THIRD QUARTER 2014 (Benchmark Ground Level 10x10 Non-Climate-Controlled Units)					
NATIONWIDE	QUARTERLY Q3 14 vs. Q2 14		SEASONAL Q3 14 vs. Q3 13		ANNUAL Current Four Quarters vs. Preceding Four Quarters ¹
Asking Rental Rate	↔	No Change 0.0%	↑	Up 2.3%	↑ Up 0.6%
Physical Occupancy Rate	↑	Up 1.0%	↓	Down -1.0%	↓ Down -0.2%
Rent per Available Sq Ft (Rental Income)	↑	Up 1.9%	↓	Down -0.6%	↓ Down -0.2%
REITS	QUARTERLY Q3 14 vs. Q2 14		SEASONAL Q3 14 vs. Q3 13		ANNUAL Current Four Quarters vs. Preceding Four Quarters ¹
Asking Rental Rate	↑	Up 2.8%	↑	Up 0.9%	↑ Up 0.2%
Physical Occupancy Rate	↑	Up 2.6%	↓	Down -0.3%	↓ Down -0.1%
Rent per Available Sq Ft (Rental Income)	↑	Up 6.3%	↑	Up 3.6%	↑ Up 0.9%

¹The Annual changes reflect the percent change in the moving average for the four quarters ended in the current quarter relative to the four quarters ended in the previous quarter

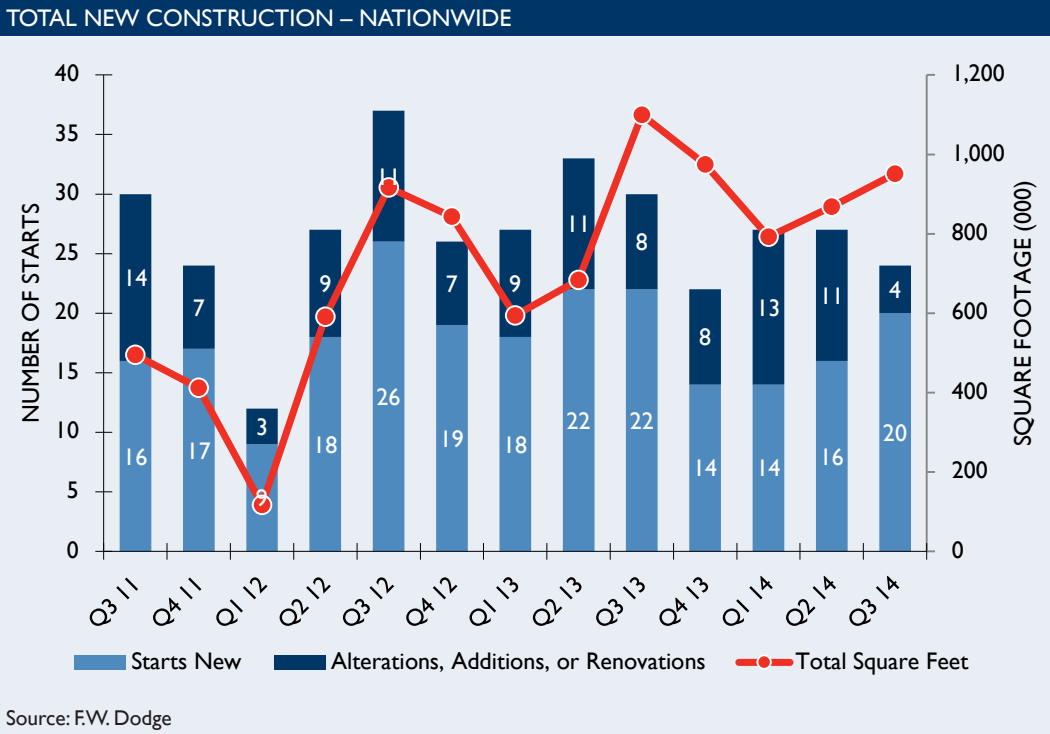
NEW CONSTRUCTION STARTS

The following graph illustrates the historical trend in the total number of new construction starts for self storage facilities including alterations, renovations and interior construction, both within and outside major metropolitan areas (source F.W. Dodge). Construction starts continue to be very low on a historical basis; however, we expect a surge in new construction in 2015 continuing through 2017, as long as financing remains available.

Developers are now building on speculation, hoping to sell to major operators once the Certificate of Occupancy is received. This strategy has served national operators well as an expansion tool. The underwriting is typically a stabilized pro forma value, less a 20 percent discount for absorption costs. However, the spread between buying an empty building and a stabilized building is getting squeezed as new players and old players compete for acquisitions.



We expect a surge in new construction in 2015 continuing through 2017, as long as financing remains available.

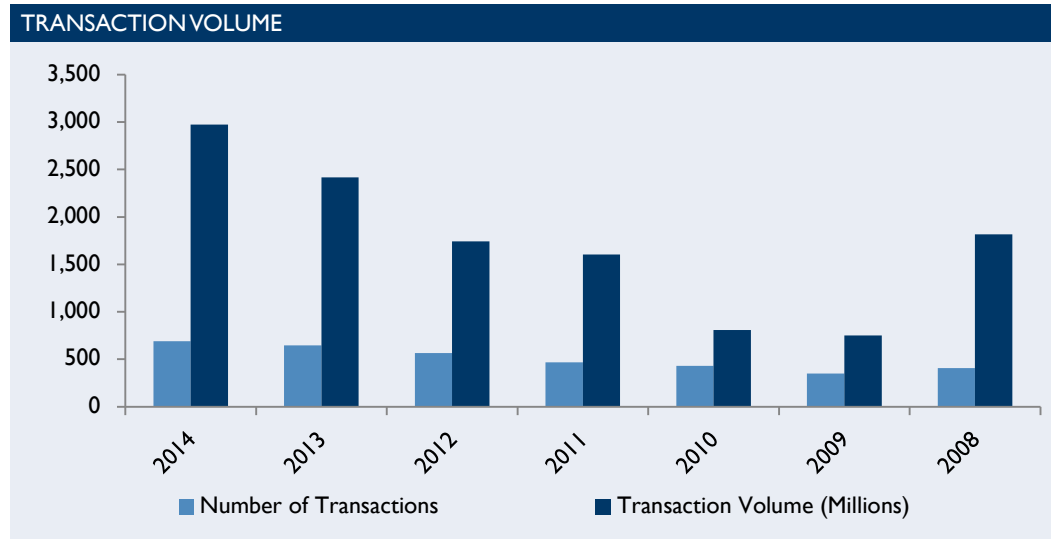


TRANSACTION VOLUME

Transaction volume is on pace to exceed \$3.0 billion for the asset class, the highest level since we have tracked this data beginning in 2007 and exceeding the average of \$1.73 billion over the last seven years. Portfolios continue to receive a premium because of the ability to place a large amount of capital into the sector, and the length of time it takes to build up a portfolio (through development or acquisitions of single assets). After several record years of portfolio acquisitions, it will be interesting to see if the robust pace continues. Our practice has observed that portfolios of lesser quality are receiving more attention than in past years, suggesting capital investors are searching for product. Data by number of transactions and volume are summarized in the following graph.

\$3.0 billion
Transaction volume is on pace to exceed \$3.0 billion for the asset class, the highest level since we have tracked this data beginning in 2007.

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SUMMARY

Market sentiment reflects the strong cash flow and market conditions for self storage, resulting in record amounts of capital seeking to store investments in this asset class. It appears 2015 will be another good year for self storage. Over the past 15 years, the performance of this sector has been remarkable based on the NAREIT index. Self storage is no longer a counter-herd investment, and many now consider the segment as CORE or CORE+. As a result, new capital sources continue to invest in self storage. Continued investment discipline, strong supply and demand characteristics and superior operating performance, support the investment market's confidence in storage.



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