UNDERSTANDING DEMAND

Tracking Tenant & Investor Needs

By Charles R. Wilson, MAI, CRE

In the best of times, self-storage tenants want what you have at any price. In the worst of times, tenants don't want what you have at any price.

In self-storage, we are concerned about the demand for space, or tenant demand, and the demand for facilities, or investor demand. The success of your self-storage business in the short term is tied to how well you manage your facility in the face of tenant demand. At the same time, your long-term investment yield is rooted in the capital markets and how they affect investor demand. Clearly, the self-storage industry is a tale of two markets in which timing is everything.

Demand, as the economists say, is the desire for an item matched with the purchasing power to affect an exchange. The strength of demand from both segments of the self-storage market has been strong and has generally continued to grow each year for the past 30-plus years. For a number of reasons, we see changes on the horizon for 2008—changes in both tenant demand and in investor demand.

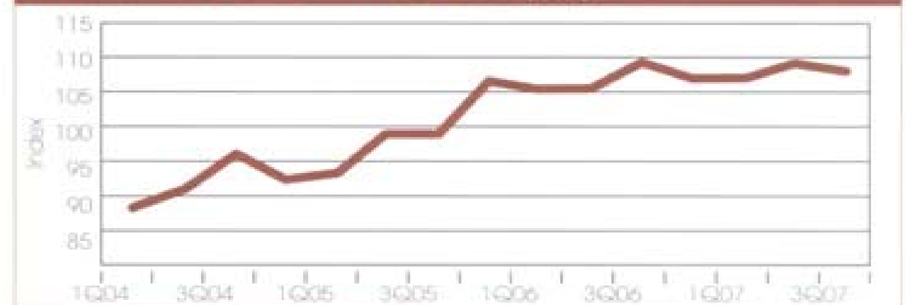
Tracking Demand

Customer Demand

The Self Storage Performance Index© (SSPI) measures the health of the industry based on key operating statistics on a quarterly basis. Among its components are asking rental rates, concessions, and occupancy statistics from thousands of facilities. We can track and measure changes in the level of tenant demand by looking at changes in the SSPI and its component indices over time. For example, as of the end of the third quarter 2007, the index stood at 108.1 (4Q03=100), down 1.2 percent from the prior quarter and down 1.4 percent from the same quarter last year. The index is based upon the operating performance of over 5,000 facilities nationwide.

An additional measure of current tenant demand is reflected in the level of facilities having to offer concessions to entice tenants to rent space. Physical occupancy is first a measure of utilization. Collected rents are the true measure of tenant demand at the facility level.

SELF-STORAGE PERFORMANCE INDEX (SSPI)



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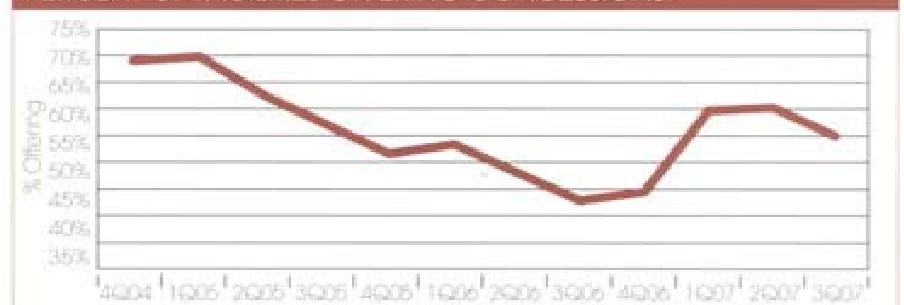
PERCENT OF FACILITIES OFFERING CONCESSIONS



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Many of today's owners are appropriately focused on the need to keep their facilities "economically" occupied. Economic occupancy is calculated by dividing collected rents by the amount of potential rents at a given facility.

Moreover, the interplay of asking rates and physical occupancy are linked by the level of concessions offered. Changes in the level of concessions are a leading indicator of trends in tenant demand. The need to offer concessions to attract and or retain tenants had been declining until the summer of 2006—about the same time that the SSPI peaked.

Given the supply of units from a maturing and increasing segmented array of facilities, tenants now have many more choices about where they wish to rent, what amenities they desire, and how much they are willing to pay for a unit with such attributes. Studying the segmented market helps us to stop thinking of tenants in terms of just households or business establishments. It is important to recognize that tenant demand varies by the neighborhood's demographics and by the various types of businesses within the neighborhood.

Measuring Tenant Demand

Past attempts to measure tenant demand have been very general. For example, the most common measure of tenant demand in a market is the number of square feet of occupied storage space per capita. However, measuring demand is much more complicated. To simply assume that because one neighborhood can accommodate four, six, or eight square feet of storage space per capita, all neighborhoods can do the same is potentially misleading. Why? Self-storage is market-specific.

Moreover, because looking solely at the number of square feet per capita does not give any consideration to the differences in neighborhood demographics, it could cause overbuilding. Even more important, the utilization of the existing unit mix in a market area needs to be studied before building a new facility; it is not uncommon for new facilities to include unit sizes for which there is little or no demand.

Market Penetration

While we know the importance of studying the number of households and the number of business establishments in relationship to the number of occupied self-storage units in a given market, in a word, it is the level of market "penetration" that matters. Market penetration can be calculated for a given market area by first determining the total number of occupied self-storage units in that market, then determining the split between consumer and commercial usage, and finally, dividing the number of consumer occupied units and commercially occupied units by the respective total number of households and business establishments.

According to ongoing research by Self Storage Data Services, Inc. (SSDS) in various markets across the U.S., the current average ratio of households to self-storage units (i.e., penetration) is about 10:1, meaning there are 10 household for every existing self-storage unit. Obviously, if there are more commercial tenants in a given market, the households ratio can be lower and the market will still have satisfactory tenant demand.

Market Segmentation

Generally speaking, all types of real estate compete with other real estate within the same class. For example, Class A offices compete with other Class A offices and, to a much lesser degree, with Class B office, but probably not at all with Class C offices.

The supply of self-storage facilities has reached the point that tenants can now choose the type of facility in which they rent a unit. The types range from Class A, state-of-the-art, multistory, climate-controlled facilities to single-story, first-generation facilities.

This means that to measure tenant demand, owners must look at the market segmentation to determine how many tenants seek Class A type facilities versus Class B or C. The tenant demand for each can be equally strong. In some markets, the tenant demand for Class C facilities could easily be stronger than either of the other two, depending upon the local demographics.

Market segmentation goes even further as each tenant group, whether it is those seeking high-end Class A facilities or those looking for the least expensive storage available, have their own criteria for the kind of facility in which they want to rent a unit. For example, factors affecting residential tenants could be short-term versus long-term stay; high-income families versus middle- or low-income families; married versus single, etc. Factors affecting commercial tenants could be large companies with many employees versus single proprietors. The type of business varies greatly as well, ranging from professional services to manufacturing. As competition increases, self-storage owners will need to have a clear understanding of the market segments their individual facilities appeal to, and they need to understand why tenants choose one facility over another.

Investor Demand

In Allen Greenspan's terminology, the "excessive exuberance" of the market participants over the past few years has subsided, thanks in part to the current capital market correction impacting all types of real estate. The self-storage markets have become more competitive and investors are recognizing the differences in the level of risk associated with different classes of facilities.

The REITs and other large private and institutional investors have largely stood on the sidelines as the recent sellers' market dictated that one cap rate seemed to fit all facilities. In the opinion of most investors, that cap rate was too low given the level of operating performance and the level of competition in most markets.

It is anticipated that investor demand will shift away from the smaller, regional, leveraged investors who depended on the now-tightening credit markets for acquisition capital to the public and private equity investors. This shift would seem to suggest a slowing in the number of Class B and C transactions. Class B and C facilities are the most numerous, and they represent the largest percentage of the total population of self-storage facilities. If Class B and C facilities are to continue to sell, then the investor demand will be dominated by equity-based investors who will look to price facilities on risk-based factors and on segmentation of tenant demand.

While the volume might not slow down, the length of time to complete deals may increase with the increased level of due diligence and tighter underwriting. There will be more use of the discounted cash flow analysis in facility valuations, and DCF analyses will use more conservative assumptions regarding the exit cap rate and revenue growth assumptions. This is especially true of those investors who lost sight of the fact that a cap rate is not intended as a rate of return on capital or as a full measure of investment performance.

Investor demand is also being influenced by the recent overall trend in operating performance. Based upon thousands of facilities monitored every 90 days by SSDS, the amount of rent collected per occupied square foot has been decreasing fairly steadily since it peaked in the third quarter 2006 as shown in the Change In Rent chart.

Now that capital costs to the leveraged buyers are higher and underwriting standards have tightened up, the REITs and other equity investors will return to the market again. Some may even take another look at deals they passed on before, which are still available as sellers reevaluate their pricing demands in the context of current market conditions.

The investment demand for Class A facilities remains strong. Given the amount of capital seeking Class A facilities and only a marginal increase in the cost of capital to these investors, cap rates, and therefore values for these facilities, should remain stable.

The investment market for Class B and C facilities is starting to shift from a seller's market to a buyer's market because leveraged investors are finding it more difficult to make deals pencil out. The level of investor demand coming from the leveraged buyers will be determined by their willingness to lower their yield expectations and the seller's willingness to lower their price expectations.

An Overall View Of Demand

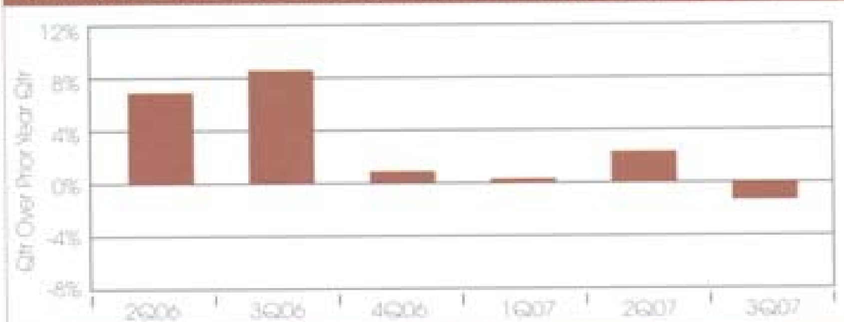
Tenant demand in 2008 should continue at strong levels assuming the country does not slip into a recession, which would adversely impact household disposable income. With leading indicators suggesting weakening tenant demand, most owners are well advised to focus on maintaining economic occupancies.

While household foreclosures have not had a major impact on performance thus far, owners are aware that the continued housing crisis could threaten to curb consumer confidence and, therefore, the consumer's propensity to spend disposable income on storage and on items that require storage.

In terms of investor demand, risk reassessment and the tightening credit markets may cause an increase in cap rates on Class B and C self-storage facilities as investors turn more cautious. Higher quality Class A facilities, however, will be less impacted, if at all, since the credit crunch will benefit equity investors. Given the Class A's current level of performance, the limited amount of new construction, and the barriers to entry these facilities enjoy, demand will remain strong.

Charles Ray Wilson, MAI, CRE is the founder Self Storage Data Services, Inc. (SSDS) an independent research firm that maintains a database of self-storage operating statistics. SSDS is now part of Integra Realty Resources.

CHANGE IN RENT COLLECTED PER OCCUPIED SQUARE FOOT*



* Seasonally Adjusted · Source: Self Storage Data Services, Inc. The Self-Storage Performance Quarterly. Copyright© 2007