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New England self storage market: A period of disconnect between sellers and buyers

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As I review the year 2007, so far, I looked back at my prognostications from the beginning of the year for the self-storage industry in New England. At that time I felt that interest rates would rise which would cause capitalization rates to increase. I also saw the trend of regional developers teaming up with institutional monies to acquire and or develop new storage facilities. These new teams were filling a void left by the relative inactivity of the self-storage REITs.

With the turmoil in the capital markets that has persisted since the summer, spreads have widened substantially since the spring of this year. Early this year I was amazed that a trophy self-storage asset that I was involved with the financing of, was able to obtain a rate of 105 basis points over the ten year treasury fixed for ten years. That deal was completed just before the re-pricing of risk which started with the collapse of the sub-prime markets. This has impacted all types of real estate as Wall St. has appeared to close the candy store while it sorts its problems out. While the pendulum may have swung back in the opposite direction as it's apt to do, I do not expect pricing to improve in the near to mid term.

How has this affected self-storage? In short, its full effects have not yet been felt. There is still a significant amount of capital in the market that is looking for a home and self-storage remains a viable product type. The problem is that most sellers have not yet grasped the changed market conditions. As most savvy real estate investors know, if the cost of debt increases, which it has, unless the equity return requirements diminish, the overall rate of return or capitalization rate must increase.

The days of class B storage properties, meaning facilities older than ten years, selling at sub 8% capitalization rates on a proforma basis are gone for now. This is a tough pill for owners to swallow given that over the past three years these properties were routinely trading in the 7% to 8% capitalization rate range. Buyers are no longer buying "blue sky," the idea that that rental rates will go up substantially and expenses can be contained. Even if the "blue sky" buyer could be found, it would be very difficult to get an aggressive transaction financed.

I have concluded that we have entered into a period of disconnect between what sellers want and what buyers are willing to pay. This should inevitably work itself out as it usually does. The problem is that it will take time. It should start with some transactions happening by year end as sellers feel compelled to close transactions for tax accounting purposes. These transactions will set the market in some respects.

Also, don't be surprised to see some lenders taking storage properties back or others going to auction. I don't foresee a huge waive of foreclosures and/or near foreclosures, but there is plenty of self-storage product that is suffering from high vacancy rates, weak locations and increased competition.

The new teams of self-storage owners, regional developers and institutional money, will continue to play an important role. The REITs will continue to only selectively invest in New England due primarily to a lack of population growth from which the region suffers. These new teams should fill a void but there will be plenty of room for astute investors to acquire self-storage properties at more reasonable pricing levels which take into account the levels of risk that are inherent in most forms of real estate.

This re-pricing of risk, while painful to many, is not necessarily a bad thing. Over the next 12 months it is my guess that this period of disconnect will begin to abate as pricing levels are adjusted to reflect the new economic realities.

Self-Storage Consultants provides brokerage, appraisal, feasibility and consulting services specifically to the self-storage industry throughout New England.

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