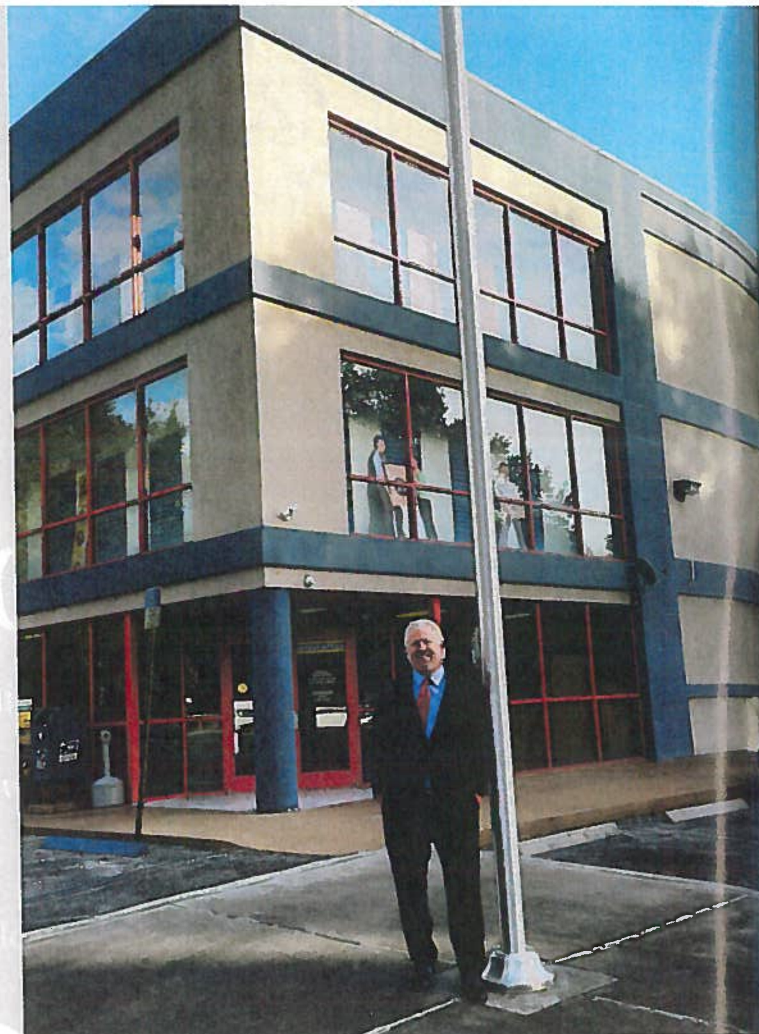
Summiting the Peak

Industry experts predict good times in 2016 but wonder how long it can last.

By Laura Williams-Tracy



Michael Mele of Marcus & Millichap expects the first wave of new stores to open in late 2016.

Everywhere in self storage the metrics are good, maybe even great. Occupancy and rents are high. Interest rates and cap rates are low. Builders and suppliers are busy. Investors are hungry for the sector.

The question looming for 2016: Is this as good as it gets?

"It seems like for a long time self storage has been the darling of commercial real estate and the REITs have been the darlings of Wall Street," said Mike Mele, a partner with Marcus & Millichap, a real estate investment services firm. "If that starts to fade, and rising interest rates affect values, then this could very well be the peak."

Heading into a new year, the thriving self storage sector faces more headwinds from outside the industry than within. Inside the industry, owners are enjoying high values, access to debt equity, abundant customers and the ability to push rents.

What's pushing against the industry is likely to come from a fully-anticipated interest rate hike triggered by the Federal Reserve, the unknowns of a presidential election, and potential shocks to the economy from terrorist activity or other unknowns.

With interest rates almost certain to rise and values reaching unheard of levels, there's a feeling among many owners who've watched their investment soar that this may be time to sell.

"We're priced to perfection," said Eric Snyder, a partner with Talonvest Capital. "Cap rates are really low. Interest rates are really low. Occupancy is high. Rents are high. New properties are coming online. That doesn't mean we won't continue with the current trajectory, but the wiggle room is limited."

2015 was a record year for many real estate advisory services firms like Talonvest and Marcus & Millichap. And the pipeline for deals set to close in the first half of 2016 remains just as strong. But five years of year-over-year growth means a change could come.

"If we are not at the peak we've got to be close to it," said Shawn Hill, principal of The BSC Group, LLC, in Chicago. "It just feels like a very aggressive time in the market, and at some point there's going to be a shakeup because historically there always has been one."

Higher Interest Rates

Bloomberg released an index of 65 published economic forecasts that indicates the 10-year Treasury note will increase to 2.9 percent, up from 2.3 percent in November, by the third quarter of 2016. If true, this increase may result in long-term fixed rates rising by at least half a percentage point by the middle of the year.

Cap rates for self storage continue to come down, but they are compressing at a lower rate than one and two years ago. If interest rates go up, the impact on cap rates isn't expected to be immediate, in part because of strong demand for self storage investment opportunities.

The greatest chance for a more meaningful hike in interest rates will happen if both the Treasury note and credit spreads increase.

"If both go up it could result in a significant increase in rates compared to what people have gotten used to," said Tom Sherlock, a partner with Talonvest Capital. "That said, we'd still likely be at historically attractive rates."

Higher interest rates will impact loan proceeds, which leaves buyers with less leverage, and that impacts the investment return and the corresponding offering price.

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Robust Development

More self storage facilities will break ground in 2016 than in 2015, but most industry watchers say there's not good data on exactly how much inventory is underway and whether it's enough to cause concern for current players. IBISWorld expects the number of self storage facilities to grow from 52,952 in 2015 to more than 60,152 in 2020, a 14 percent increase.

Jay Crotty, managing partner of BayView Advisors in Tampa, says even with an interest rate increase assured, the underlying fundamentals of the industry remain strong. Population growth, the boom in apartment building throughout the U.S., and the significant lack of new construction in self storage for almost five years after the recession means new construction doesn't come near to making up for the gap that was built in those lean years.

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>
> ~ Shawn Hill, The BSC Group

"Dallas has a lot of new construction as does South Florida," Crotty said. "We do not expect significant new supply nationwide. There's enormous, enormous demand for self storage."

Mele said he expects the first wave of new stores to open in late 2016 with more into 2017. The only places where an impact might be felt are localized submarkets that once had only one storage facility and now have three or four.

"At some point, new supply is going to factor in and impact the ability to grow rents and occupancy," said Jim Davies, a partner with Talonvest.

Davies said pressures will show up in certain markets sooner than others. And even in markets with aggressive development, the entitlement period prior to construction is prolonged and final construction costs are creeping higher.

"Development is clearly much more difficult in this cycle than the last," he added.

Investments and Financing

A normalized lending environment has helped brokers to their best year ever in 2015, and deal pace is expected to continue at least into the first half of 2016.

Though financing has been readily available, that could change with an interest rate hike. The CMBS market (commercial mortgage-backed securities) has been a key to the high prices that have been paid and relies heavily on people buying that debt in a secondary market. If that slows down it could hinder that activity.

Regulatory issues stemming from Dodd-Frank legislation that followed the economic meltdown of 2008 will be more fully implemented in 2016. Banks will be required to keep more capital on hand for a loss and have a bank officer sign personally for commitments related to bond offerings.

"Regulatory changes that came out of the recession are probably going to have some impact on pricing and how banks view risk, which ultimately may get passed along to the borrower," said Hill.

Crotty said he sees the industry being further fueled by crossover buyers—investors coming out of multifamily investments who want to defer taxes from the sale of an apartment complex. "They don't want to put their money back in multifamily, and they want to look at storage, which they view as easier management than multifamily," Crotty said. "They will pay up."

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New supply may cause vacancy rates to climb in some submarkets, but experts say there won't be enough to hit most markets.

"Vacancy rates are certainly the best they have been in several years," Mele said, adding that operators don't want to turn away customers, so they are raising rates when they reach 90 percent occupancy.

A continued good economy with high consumer confidence and potential storage renters living in smaller, high-amenity apartments bodes well for the industry.

"Overall I think the market is in a great spot," said Hill. "There's certainly plenty of debt to support transactions and an aggressive normalized lending environment. From a borrower's perspective it is absolutely the golden era, and they can achieve the highest values ever." ❖

Talonvest's Jim Davies (far left) said, "At some point, new supply is going to factor in and impact the ability to grow rents and occupancy."

2016 Economic Summit to be Held in Dallas

The SSA will address the most current economic issues facing the industry at the Self Storage Economic Summit, at the Hyatt Regency in Dallas, Texas. The Summit will coincide with the SSA Spring Conference & Trade Show, which runs March 30–April 1.

Talonvest Capital has signed on as lead sponsor and emcee for the event, which will showcase speakers and panels addressing such issues as operational strategies, recent sales, buyer acquisition strategies, changes in the capital markets and other key economic issues.

Visit **selfstorage.org** for details on how to join your fellow owners and investors at the 2016 SSA Economic Summit in Dallas.