

Cap Rates and Sales Prices

Facts, Fantasies, & Trends

by Michael L. McCune

In the business of buying and selling self storage facilities around the country, the discussion with both buyers and seller always ends with cap rates. Unfortunately, most people don't understand all of the ramifications of this simple sounding number. Hopefully, this summary and discussion will help clarify this mysterious, yet fundamental concept. I have invited Ray Wilson of Charles R. Wilson & Associates in Pasadena, CA, and Steve Hopper, an Argus affiliated broker with Whiteside Properties in Charlotte, NC, to help me with this. Both men have years of experience in self storage appraisal and sales. Additionally, I have asked some of our Argus Self Storage Sales Network affiliated brokers to comment on the application of cap rates in the market place and on trends they see developing in this crucial area.

What are Cap Rates and Why use them?

Real estate valuation is a very complex business with many variables that affect price. Over the years real estate people found that they needed a way to compare property values, essentially price, in a market using a shorthand method, thus capitalization rates or cap rates came into general use. In a way the cap rate tells you what investors expect to earn as a percentage of their investment. For example, a buyer who thinks a facility is worth a cap rate of 10.5, is saying that he wants a 10.5% return on his investment.

When the net operating income (NOI), subject to some assumptions to be discussed later, is divided by the cap rate, "Vola" you come up with a property value. This method is essentially a way to develop a price based on a stream of income. The net result is the lower the cap rate, the higher the price and the flip side being the higher the cap rate, the lower the price. This is only one of three methods used by appraisers to value a property, but it is the one most focused on by investors. It is primarily used because it does a very good job correlating property values and helps facilitate comparison between markets.

The Underlying Assumptions in Calculating NOI

As with any good rule of thumb there are certain assumptions that are implicit in the calculations of the NOI. Calculating NOI for self storage facilities is no different. As we see later when all of these assumptions are in line, the cap rate calculation produces very consistent results. For cap rates to be useful and comparable the NOI must be calculated on a consistent basis on all properties. The first assumption when calculating the NOI is that all revenues must result from reoccurring operations and not from any asset sale or insurance recovery. Secondly, depreciation and debt service should not be deducted from revenues to arrive at the NOI. Depreciation and financing do not reflect value, but merely

reflect tax issues and capital structure. These revenue assumptions are clearly defined and are almost universally applied.

However, assumptions related to expenses are less uniformly applied and result in significant misunderstanding, particularly among sellers. The assumptions should include; that the property is properly insured, is advertised in the yellow pages, and that property taxes reflect current assessments. Further, the expense numbers need to reflect that all labor costs necessary to operate the property are included in the NOI deductions even if the owner is currently doing the work for free. It is also assumed that the expenses include a management fee over and above the on-site management expenses, this will range between four and six percent, depending on the size of the property. Another assumption is that of a replacement reserve. This expense is roughly .05 to .15 cents psf depending on the age of the facility. If any of these assumptions are not included in the expenses, an adjustment must be made to the NOI.

Many owners will say that some of the assumptions don't apply to them for various reasons, but I can assure you that there are almost no exceptions in the marketplace of real sales. In the end, ignoring these assumptions is at best merely self-deception, and at worst, can have serious impacts on the financing or sale of a property.

Why Do Some Properties Have Higher or Lower Cap Rates?

Since all properties are not alike they can command different cap rates. The variations from normal cap rates (between 10 and 11) usually reflects the quality of the project and the risk to the investors. For example, a 40% vacant metal building project in a rural area would require a higher cap rate to reflect the increased risk and lesser quality. On the other hand, a large masonry project with full security, in a growing metropolitan area, with consistently increasing rents would command a premium cap rate, perhaps in the range of 9.5 to 10. Once again, while the cap rates may vary the underlying assumptions to the NOI do not. Property evaluations are somewhat subjective, but our collective experience would indicate that knowledgeable buyers and sellers agree on the quality of the NOI and with the risk variances that lie in a very narrow range of cap rates.

This chart (Exhibit 1) lists some quality and risk adjustments that will affect a property's value and the cap rate used to reflect that value. If you circle the applicable characteristics of your property and find that they dominate one column, the cap rate will likely be adjusted from the average in that direction. Obviously, the more the merrier, but don't cheat, the market won't. The chart is not intended to be scientific and should be used only as a guide since many other variables can impact the cap rate. If done accurately, this should give you a good perspective of where your project fits into the range of cap rates. In summary, it takes a great facility to merit a 9.5 cap rate and not too many flaws to find an 11 cap rate.

Cap Rate Adjustments (Exhibit 1)

Do Cap Rates Really Reflect the Market?

The answer is unequivocal; Yes!!! If cap rates did not reflect the marketplace accurately we would not be using them in so many ways. The chart (Exhibit 2) will give you an idea of the consistency of pricing in the market as well as how cap rates relate to pricing. Ray Wilson has been kind enough to share his collection of data with me and help create a very powerful visual representation of this point. The chart shows recent sales based on the sale price psf and the NOI psf. (Remember: to get the cap rate we took the NOI psf and divided it by the sale price psf.) We have drawn on the chart lines that represent the cap rates, 9.5, 10.5, and 11.5.

As you can see there is a real consistency of prices in this range with a convergence around 10.25. The few exceptions are almost exclusively for properties with a price psf above \$40. This would generally indicate a more exclusive and non-competitive market for the project. Often times additional expansion land distorts the calculation. This consistency in actual sale's cap rates tells us several things: 1) Our shorthand cap rate valuation method reflects the real selling price in the marketplace; 2) There are no "greater fools" in our experience, otherwise, there would be quite a few variances or sales that are "way out of line;" and 3) If a buyer or seller wants to participate in the market they must do so at market prices, i.e. market cap rates. It is clear from the chart that "greedy" sellers and "bottom feeding" buyers are not doing much business in the marketplace. As you can see, the consistency of the prices indicate that this is what economists would call, "an efficient market."

90 Self Storage Sales of 1996 (Exhibit 2)

Comments From our Experts.

Lets ask our experts to give us some thoughts on cap rates and trends.

Are cap rates declining?

"The market is very competitive for first rate projects and the cap rates might be a little better for these projects, but run of the mill good projects haven't gone down much." **Joan Lucus, Joan Lucus Real Estate Services, Denver, CO.**

"I think this is an excellent sellers market that has pushed the cap rates down about as far as they can go." **Stephen McKnight, Island Associates, West Islip, NY.**

What happens if interest rates take a jump?

“I don’t think I want to find out!” **Harold Helm, CAI, CCIM, RE/MAX Commercial, Louisville, KY.**

“Higher rates make financing more expensive and this squeezes the equity in a project. That means lower prices and higher cap rates. It also means its harder to build a new facility, which is good for existing properties.” **Joan Lucus.**

Do you ever see sales that don’t reflect prices that are not consistent with the cap rates we have talked about?

“I have buyers and sellers that really believe there is a greater fool out there, but I’ve never seen one close a deal.” **Harold Helm.**

“Almost never. While many sellers point to sales that appear to have lower cap rates, typically the seller is missing information. A good example of this would be the availability of excess land to expand, which the buyer reflected in the offering price. The contributory value of the excess land must be factored out in order to determine the true cap rate.” **Patrick A. Lemp, MAI, Self-Storage Consultants, Hartford, CT.**

Do buyers really look at the NOI adjustments we discussed earlier?

“We go to extensive length to verify sales, given that we are not only brokers, but MAI appraisers as well. In verifying sales with buyers, we have learned that these adjustments are made by most every buyer we encounter. **Patrick A. Lemp**

“Almost all self storage facilities are bought by other self storage owners. This group knows the business and doesn’t overlook the obvious.” **Stephen McKnight.**

Michael L. McCune is the President of Argus Real Estate, Inc. located in Denver, CO. Argus operates and manages the Argus Self Storage Sales Network, the nation’s only network of brokers dedicated to the buying and selling of self-storage facilities. For more information on cap rates, contact Mike 1-800-55-STORE.