The Worm Has Turned -- Let’s Just Hope It Is Slow!
By Michael L. McCune

As readers of the Market Monitor have come to know, I think that low interest rates have been the best friend a self storage owner could have over the last couple of years. It now appears that the long, downward trend in interest rates has turned and is now beginning to head upward. It was a great ride on the way down, and the relative value of today’s low rates remains, even today, by almost any historic standard, extraordinary. In the late spring and early summer, rates for real estate loans, including self storage, were literally at 45-year lows. Many real estate investors have gone through very long careers and never experienced these kinds of rates. While predicting the future of interest rates is not a high percentage game, I think it is safe to say that in the intermediate to long term, it would be reasonable for interest rates to trend up. Neal Gussis, our friend from Beacon Realty Capital, has provided some interesting statistics to confirm that change in the rates has a high probability. For example, Neal has found that the least interest rates have changed in any given year over the last 20 years is 1%. He also allows that the recent change in the 10-Year Treasury Note was the fastest change of that magnitude in 60 years, and that was during the Second World War. I just heard today as I was writing this article, the Federal Reserve Committee said they weren’t dropping rates but that they “expected low rates into the future.” Unfortunately, this was met in the real estate marketplace by rates going up, with long-term rates leading the way. So, you might ask, ”What do these actual and potential changes in interest rates mean for the average owner, buyer or seller?”

Impact on Owners

If you were fortunate enough to lock in a low fixed rate loan while interest rates were at their recent lows, it means you are pretty smart, take a bow! If on the other hand you have a variable rate loan, you have some difficult thinking ahead of you. The question is when, or if, you should switch to a fixed rate loan at a now higher rate. Several owners that I have talked to say they don’t have to worry about fixing the rate because short-term rates will always be lower than the long-term rates. Having lived through the Carter Administration with the Prime Rate at 18%, I would just add that while it may not occur often, it really is devastating when it does. There aren’t many real estate projects that work at those rates. There is a variety of solutions to the problem, including the purchase interest rate swaps, hedging in the commodities market, or getting a new loan. Each has its own pitfalls and benefits, but none will work unless you take the action to initiate them. Two things are very important and they are: 1) you need the best advice you possibly can find, and 2) make sure you really understand what your objectives are. We would be happy to recommend a mortgage broker in your area, and you can rest assured that we do not share in their compensation in any way.
Impact on Buyers

Clearly, higher interest rates make any new deal less attractive than with low interest rates. Let’s take out the old calculator and see how much difference a change in the rates can make on an investment’s return. To save you the effort, I have computed the cash on cash returns on a deal that cost $2,000,000 at a 10 Cap Rate, financed at 75%. The return with a 5.25% interest rate was a whopping 20% and with an 8.5% loan the cash on cash return fell to 12.6%. It is the difference between getting rich over night and getting rich in the long term. However, on the positive side, we may see more properties for sale as sellers recognize that buyers take advantage of the remaining low rates because the smart sellers and buyers both know that low interest rates “subsidize” both higher prices for the seller and higher returns for the buyer.

Impact on Sellers

Let me begin by saying that you should not sell just because interest rates are going up, but if you are thinking about selling in the next year or two, your sale could be more profitable and easier to do before interest rates go any higher. Combined with local areas of overbuilding that are occurring more frequently, this could be the right time to exit. What change can a potential seller expect for trends in the selling market as interest rates trend up? First, cap rates that have been trending down will now trend up. When cap rates go up, the value of the property goes down in relation to its income. See [www.selfstorage.com/argus/articles/valuation_0203.pdf](http://www.selfstorage.com/argus/articles/valuation_0203.pdf). This is the result of buyers trying to achieve higher cash on cash returns. A one point change in the cap rate roughly equals 10% of the value of the property. Secondly, buyers become more critical of a property because they are both less forgiving when the rate of return is 12.6% than at 20%, and they will likely have more options to choose from in the marketplace. The low interest rates have created a seller’s market that has lasted at least two years and continues today, albeit with some cracks beginning to appear. Real estate values tend to be very cyclical, and it will be no different in the future; the only uncertainties are the volatility and the duration of the cycle. Some cycles are mild and some very difficult, but few last less than three years and some many more. Thus, if you have personal reasons to sell, please don’t wait for the trends to make your task harder. The axiom to remember is: Higher interest rates never increase values! MM

Michael L. McCune, President of the Argus Self Storage Sales Network, can be reached at 303-785-6087 or via e-mail at mccune@argus-realestate.com.