Determining Self-Storage Value in Europe

Self-storage is increasingly considered an investment-grade sub-sector in the European market, thanks to industry growth and the success of the major operators. The business is fundamentally a retail operation that is closely aligned to the real estate from which it operates. This relationship has been recognized by the broad range of investors who have tried to gain access to the self-storage market in the last 12 months, seeking to align themselves with more profitable operator income vs. conventional property returns.

Recent evidence has shown that storage operators are prepared to pay more for a well- located site than traditional investors and developers of industrial real estate. This demonstrates an ability to achieve a sufficient return on capital to cover costs. Any over- payment for land is made on the presumption that a storage operation will generate greater cash flow than conventional businesses, particularly once occupancy has stabilized and created a greater value as a real estate investment.

Performance

In recent years, property has delivered strong investment performance against other asset classes. The occupational basis of the storage business means its performance is linked to that of the wider real estate market. Total returns in the U.K. property sector have slowed in 2007, but previously, there had been continual downward pressure on yields. For self- storage businesses and investors, this meant a higher entry price and greater competition for well-located properties.

In recent years, we've seen significant capital flowing into the U.K. commercial real estate market from local and foreign investors. This has served to increase competition for assets and further depress yields. It was not until investors began to question forecast returns early in 2007 that this changed, compounding the recent turmoil in the U.S. sub-prime mortgage market and ensuing "credit crunch" and, as a result, re-pricing.

The U.K. self-storage market should not be affected by the slowdown in the real estate market (though falling real estate prices will be welcomed by operators). Over recent years, storage properties have outperformed others and sustained returns. Management teams have been able to actively manage assets to achieve maximum occupancy and rental rates.

Management

The result of the growing awareness of self-storage is it is gaining momentum with investors. Where traditional real estate assets have re-priced against void risk, self-storage businesses continue to thrive, benefiting from the opportunity and cash flow generated by risk management.

But because storage is a retail business, the importance of the management team increases in line with the risk related to sales/leasing. In this way, the quality, experience and capability of a facility's managers act as a "guarantee" for an investor that can't rely on traditional real estate returns.

Real estate investments traditionally rely on long-dated leases with term-specific rent reviews to lower a property's periodic cash flow; when the economics of divesting the property become more attractive, the property is sold. By contrast, self-storage operators can actively and periodically manage rental rates. Yield management combined with the physical management of space is why self-storage easily outperforms traditional real estate.

The Issue of Valuation

As a property-centric retail business, self-storage is unique, and surveyors have tried to assess facility value using standard property-valuation methods. But because storage businesses are operational platforms, it can be argued that corporate-valuation techniques are more appropriate, even for a single site.

Perhaps the most widely adopted valuation method is discounted cash flow (DCF) analysis, which is used to value all types of assets. Both surveyors and mainstream investors seem comfortable with this technique.

However, the inputs are open to manipulation to produce the desired result. Most influential is the discount rate applied to future cash-flow receipts, which provides the present cash-flow value. The discount rate estimates the required return of an incoming investor; typically, this is a function of the weighted average cost of the buyer's capital (i.e., the weighted average of debt and equity finance). Perhaps the more controversial component is the value of the property at the end of the investment period, or the terminal value.

The discount rate is comprised of three elements: the risk-free rate of return, the risk premium and implied revenue growth. The risk-free rate of return is typically a long-dated government bond (30-year term) and relatively easy to quantify, fluctuating with the bond market and strength of the national government where the property is located.

The risk premium is the most difficult and subjective component to estimate, as each investor will have a different return requirement depending on an investment's perceived risk. Therefore, it is only by comparing the relative returns produced by other investment classes that an investor/surveyor can deduce the risk premium. In addition, most forecast cash flows will include an allowance for the risk surrounding cash-flow growth and the resulting terminal value. Similarly, this risk can prove difficult to quantify.

This is for two reasons: First, the terminal value is predominately calculated on the final period's revenue, which is potentially an inaccurate forecast depending on the length of the investment horizon (it could be 10 years away). Second is the use of a discount rate to derive the terminal value (commonly the discount rate less the anticipated long-term growth rate). The capitalization rate could be unduly reduced by a high growth rate, increasing the terminal value. The rule of thumb in calculating the long-term growth rate is it should not exceed the average of the final few years nor any individual year leading up to the end period of the investment.

EV/EBITDA

A simpler and sometimes more appropriate valuation method often overlooked by property professionals involves comparing a self-storage business to recently sold peer companies or existing businesses, based on the readily comparable public/private ratio of EV (enterprise value) as a multiple of EBITDA (earnings before interest, tax, depreciation and amortization). This is a standard methodology used to value businesses across industries. It measures the EBITDA produced relative to the adjudged EV. While more suitable at a corporate level, each property is essentially a satellite business producing its own revenue, so the multiple measure could be applied (with some adjustment) to individual properties.

Two issues must be considered with the EV/EBITDA method: the calculation of EBITDA and the ability to draw on good comparable evidence. Accounting practices standardize the calculation of EBITDA, but the actual principles employed by companies can differ. Therefore, to accurately evaluate the multiple, the accounting method used by each company should be clear.

In self-storage, market information is difficult to obtain, and comparable analysis can be limited to larger public operators. The accuracy of the data can also be a problem.

Practical Examples

Recent U.K. self-storage transactions, including the Safestore IPO (initial public offering) and the private sale of Space Maker, prove investors recognize the superior returns produced by quality self-storage businesses. Both transactions involved strong pricing, affirming the cash-generative ability, risk spread and growth potential of the industry.

As of August 2007, stock-market turmoil and credit-market difficulties had pushed Safestore's share prices to approximately 25 percent below listing price. But both Safestore and Big Yellow, another significant U.K. operator, were given "buy" status by City analysts, demonstrating how robust and attractive their free cash flow should be to investors.

Space Maker is one of the top 10 operators in the United Kingdom, operating predominately in South and Southeast England. The business offers a strong platform for growth. **Its value was assessed using various methods, but centered on the DCF approach. The company sold for an EV/EBITDA multiple approaching 18, suggesting that investor sentiment for U.K. self-storage storage remains healthy.**

This level compares favorably with Safestore's EV/EBITDA multiple of 18.2. Interestingly, Big Yellow trades on a higher multiple, indicating the market attaches significant value to the development pipeline and land bank of the company, which offers significant and secure growth potential.

The U.K. self-storage industry is more than likely set for a general consolidation in the next few years. The acquisition of Space Maker by Babcock & Brown, the Australian investment fund, could be the first step toward global consolidation of inter-country or inter-region brands. There are indications that a number of smaller operators are considering exit opportunities, which will be welcome news to those players seeking secure geographical dominance and expansion.

The consolidators see the value in existing operational businesses and are able to apply appropriate valuation methods. Consolidation and organic expansion will become increasingly important, and the accretive value of good operators to the larger players will fuel the growth of this exciting sector.

Tim Edghill and Chris Stevens are with Jones Lang LaSalle Corporate Finance, which provides comprehensive mergers and acquisitions, restructuring and financial-advisory service across real estate sectors. Mr. Edghill has more than 15 years of experience in real estate and finance, and can be reached at tim.edghill@eu.jll.com. Prior to joining the company, Mr. Stevens was a property finance account manager with a New Zealand bank. He can be reached at chris.stevens@eu.jll.com. For more information about the company,

visit www.joneslanglasalle.eu/corporate-finance.