

# Redefining Core Real Estate: Investing in the New Reality

*H. Michael Schwartz and R. Christian Sonne\**

**In this article, the authors suggest that investors seeking shelter from the recent economic storms would be wise to add self storage to their core real estate asset mix of essential building blocks for balanced and successful portfolios.**

In today's uncertain economic climate, many real estate investors are looking for low prices, consistent cash flow and a hedge against inflation. The consensus among most analysts is that a balanced portfolio of diversified "core" real estate assets offers these attributes. Traditionally, the core asset class has been narrowly defined as four basic property types: office, industrial, retail and multifamily housing. However, as the last few years of economic turmoil have demonstrated, these commercial assets are far from recession proof and more volatile than anticipated.

Perhaps it is time that investors begin to broaden their perspective on what qualifies as a core real estate investment in terms of real world performance. Based on the most common characteristic of this class, one of the first places they should look is the realm of self storage.

## **Self Storage Investing**

A relatively new industry in terms of investment, self storage has matured to the point that even the Federal Reserve has recognized

it as a core asset by allowing self storage properties to be leveraged in single sponsor, Term Asset Backed Securities Loan Facility ("TALF") eligible commercial mortgage backed securities ("CMBS") transactions. The asset class is defined by steady cash flows, a low break even point, minimal capital expenditures and no tenant improvements or leasing commissions. Even during the economic recession and capital markets depression, self storage market conditions remain fundamentally stable suggesting it is to a large degree recession resistant.

Like all real estate, self storage soared in value in the mid-2000s when money was easy and cheap. As the capital markets froze and capitalization rates started rising, the value of self storage properties declined along with other real estate investments. However, net operating income in the industry rose at a compound annual rate of 2.02 percent from 2001 to 2008.<sup>1</sup>

The resilience of self storage is not the only reason this property type should be considered a core real estate investment. By almost every measure that is used to define

\*H. Michael Schwartz is CEO and Chairman of the Board of Strategic Storage Trust, Inc.—a publicly registered nontraded REIT targeting the self storage market. R. Christian Sonne is Managing Director of the Self Storage Industry Group for Cushman & Wakefield.

core assets, self storage performs as well or better than most commercial real estate classes.

According to The National Council of Real Estate Investment Fiduciaries (“NCREIF”), the expectations of a core asset are as follows:

- Stability;
- Consistent cash flow;
- Potential for capital appreciation;
- Hedge against inflation;
- Solid returns (well above bonds); and
- Modest risk (well below stocks).

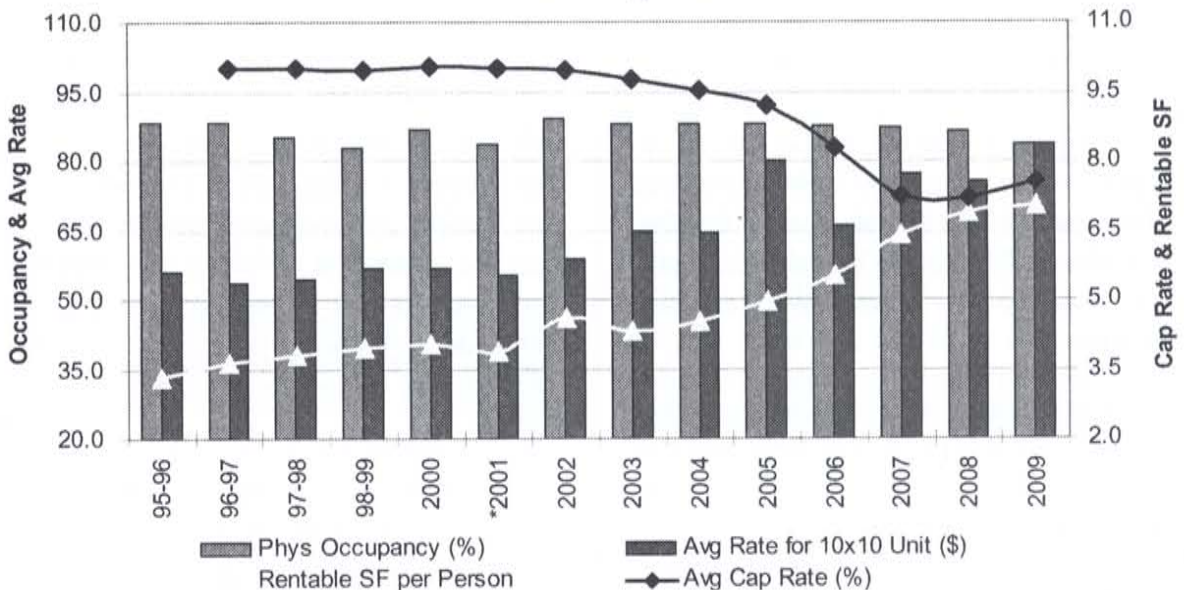
### Self Storage Industry History

The self storage industry has been the fastest growing sector of the U.S. commercial real estate industry over the last 30 years. According to the national Self Storage Association, it took the self storage industry

more than 25 years to build its first billion square feet of space; it added the second billion square feet in just eight years (1998–2005). In the last two years, however, self storage new construction has declined by an estimated 75 percent. Demand has obviously kept pace with the growth of supply (see graph).

Historically, self storage market conditions have remained fundamentally stable. The national trend data show some remarkable results that explain the rise of the asset class. Over the 14 year time frame, total supply more than doubled from 3.31 square feet of self storage space per person in 1995 to 7.03 square feet of self storage space per person in 2008—a compound rate of growth of 5.53 percent per year. Even while supply doubled, national occupancy ranged from 82.90 percent to 89.40 percent with an average of 86.72 percent. Moreover, the average monthly rental rate for a 10 × 10 storage unit went from \$56.02 in 1995 to \$83.54 in 2008, a compound rate of growth of 2.90 percent.

Annual Self-Storage Almanac



\* Recessionary Period

In summary, the supply more than doubled while vacancy remained relatively stable and rents increased. This suggests a resilient asset class. To test resiliency, a simple scoring model is analyzed that sums rent and occupancy to obtain a score for each year. The data indicates that in the 2001 recession year (U.S. economy), the score declined only 3.35 percent to 138.80 from a score of 143.61 in year 2000. The next year (2002) the score increased 6.76 percent to 148.18. This indicates the asset class is resistant to recession.

### Advantages of Self Storage Investing

Although not always evident, there is potential for capital appreciation of self storage properties, either through capital improvements or value added services. Examples of other sources of income include ancillary sales of various items (such as locks, boxes, tenant insurance services, etc), mail centers and rental trucks. Some properties can be expanded by adding more units thus creating additional value.

Self storage also provides an excellent inflation hedge. A report recently published by The Institutional Real Estate Letter said data shows that assets with shorter lease terms tend to provide the best inflation hedge. Although apartments typically rank high on this list, the average stay at self storage facilities is only 12 months and can be as low as three to six months for students or military personnel.

Rents are more easily marked to market than other asset classes because demand for self storage is a function of the local trade area, typically within a three mile radius. And because rents are fee simple and not leased, the owner can increase them at any time to reflect the impact of inflation. In fact, self stor-

age revenue enhancement programs are very successful at raising rent—so much that the rent for existing tenants is often higher than the quoted street rate to new tenants without a significant impact to vacancy.

According to the Self Storage Association Industry Fact Sheet, 83.9 percent of all U.S. counties (or 2,634 out of 3,141) have at least one primary self storage facility. Because of the relatively small property size and value, investments can easily be spread across self storage facilities nationwide, insulating your investment from local or regional economic forces. The tenant mix also can cover a broad range of sectors from small business to personal, including military and student—all of which demonstrate different lease characteristics which leads to a more orderly lease roll over such as length of stay and seasonal rollover rates.

Average returns for self storage assets are well above bonds. For example, annual dividends of self storage REITs currently range from 3.26 percent to 10.92 percent with a fourth quarter average (2009) of 5.70 percent. Comparatively, long term U.S. 30-Year Bonds were 4.19 percent and U.S. 10-Year Bonds were 3.39 percent as of October 2009 (Moody's Bond Record). Corporate Bonds (Baa) returns were 6.29 percent in the same period. If single self storage assets are considered, the overall capitalization rate (national average) is 8.75 percent. Moreover, credit risk for self storage is spread among hundreds of tenants, reducing the chance that the loss of one major tenant will affect income.

In addition, self storage properties have one of the lowest rates of delinquency among commercial real estate classes with just 2.39 percent currently in default nationwide. The delinquency rate is currently 7.06 percent for

multifamily, 4.4 percent for retail, 2.97 percent for industrial and 2.7 percent for office.<sup>2</sup> The number of CMBS loans that have been referred to special servicers (delinquent and defaulted loans as well as loans seeking extension or modification) is approaching nine percent currently.

Even in terms of asset characteristics, self storage fits the bill for a core asset. A recent study by a team of researchers from Lend Lease Real Estate Investment defined core real estate investment as minimizing risk under the characteristics of both the asset itself and the entire portfolio. Core assets were identified as investments with these qualities:

- Existing buildings;
- Substantially rented;
- Orderly lease roll over;
- High quality;
- Limited to just the four basic property types (office, retail, multifamily, industrial);
- Low leverage; and
- Limited anticipated capital expenditure.

Of these, the only characteristic that self storage lacks is that it does not fall into the so called “four basic property types”—which we argue is an outdated definition.

Self storage investors usually target existing facilities that are substantially rented. While recently constructed self storage may take as long as three years to reach stabilized occupancy, long run occupancy near 85 percent is typical. High quality is not much of a factor in this asset class; whether a storage facility rates as Class A or Class B is not as essential to tenants as it is in office or

retail properties, which rely on client impressions or customer traffic. Even older properties can produce an attractive cash flow.

Leverage, of course, is volatile. However, due to the stability of the self storage asset class, capital is available. For example, U-Stor-It Trust recapitalized significant debt (near \$100,000,000) in 2009—the revised balance sheet resulted in significant gains in their stock pricing. Currently, banks and life insurance companies are lending to self storage with continued institutional investment from retirement funds and Wall Street. Typical terms for self storage lending now are 65 percent loan to value at a 7.25 percent rate for five years with 25 year amortization for recourse loans. Other assets have challenges of tenancy and cash flow related to the economy making financing extremely difficult to obtain.

Another core characteristic that sets apart self storage from other assets is limited capital expenditure. Unlike office, there are no capital expenditures for tenant improvements or tenant leasing commission expenses and unlike apartments, there's no call for a cleaning deposit and repairs. All you need to do is sweep the floor before the unit is ready for a new rental.

At the heart of investing theory is the idea that you can generate more return with less risk by combining diversified assets in the portfolio. A core based portfolio is no different; the asset mix should be diversified both geographically and demographically. In no asset class is this more easily achieved than the self storage sector.

The last decade has seen the phenomenal growth of new self storage facilities, yet demand remains healthy with the exception of a few chronically over served trade areas.

Time and population growth are the biggest drivers for recovery of over served markets in self storage. New construction is at the lowest point in a decade and the nation's

population is expected to grow near 100 million over the next two generations, suggesting stability and growth for self storage in future years.

**Total Annual Returns by Property Sector**  
(Returns in Percent)

	Office	Industrial	Retail	Apartments	Self Storage
1994	2.86	18.67	2.98	2.19	8.90
1995	38.80	16.21	5.10	12.26	34.40
1996	51.80	37.22	34.60	28.93	42.84
1997	29.01	19.02	16.95	16.04	3.41
1998	-17.35	-11.74	-4.94	-8.77	-7.20
1999	4.25	3.90	-11.77	10.73	-8.04
2000	35.46	28.62	17.97	35.53	14.69
2001	6.65	7.42	30.42	8.66	43.24
2002	-6.82	17.32	21.07	-6.15	0.56
2003	34.01	33.14	46.77	25.49	38.14
2004	23.28	34.09	40.23	34.71	29.70
2005	13.11	15.42	11.80	14.65	26.55
2006	45.22	28.92	29.01	39.95	40.95
2007	-18.96	0.38	-15.77	-25.43	-24.82
2008	-41.07	-67.47	-48.36	-25.13	5.05
2009	35.55	12.17	27.17	30.40	8.37
<i>Source Data: NAREIT</i>					
<i>Analysis - Calculation Based on NAREIT Data</i>					
5 yr Avg. Return '05 - '09	6.77	-2.12	0.77	6.89	11.22
5 yr Standard Deviation	32.55	33.92	29.34	27.48	22.20
10 yr Avg. Return '00 - '09	12.64	11.00	16.03	13.27	18.24
10 yr Standard Deviation	26.41	28.28	26.90	23.41	20.46
15 yr Avg. Return '95 - '09	15.53	11.64	13.35	12.79	16.52
15 yr Standard Deviation	26.21	24.95	24.23	20.37	20.92

## Conclusion

Investors seeking shelter from the economic winds of change would be wise to add self storage to their core real estate asset mix of essential building blocks for balanced and successful portfolios. Based upon a statistical analysis of NAREIT's annual price in total average returns by property sector (see table), self storage has outperformed all sectors (office, retail, industrial and apartments) in a five year, 10 year and 15 year annual returns. In addition, self storage of-

ferred a lower standard deviation over all property types in five year and 10 year period. Therefore, institutional investors should embrace self storage as a core real estate asset class following the same path as Wall Street.

## NOTES:

<sup>1</sup>According to a survey by the Self Storage Industry Group at Cushman and Wakefield.

<sup>2</sup>September, 2009 by Trepp, Inc.