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The Self Storage Playbook | October 2014

In September, the REIT ascent halted as the market experienced a pullback. As measured by the MSCI US REIT Index (RMS), REITs posted a -6.0% total return for the month. Year to date (YTD), the RMS is up 14.0%, while the S&P 500 is up 8.3% after returning -1.4% for September. With REIT fundamentals remaining strong, we view the pullback as a buying opportunity.

Scouting the Competition

The self storage property, itself, may not be aesthetically pleasing, but the self storage business is as good as it gets. B. Wayne Hughes, the founder of Public Storage (NYSE: PSA) entered the self storage industry in 1972 with $58,000 and a partner. PSA became the 7th REIT to be included in the S&P 500, and Mr. Hughes made billions for himself from these metal and concrete boxes. Though the self storage business has been through rapid maturation over the past few years, the industry as a whole is still highly fragmented. Of the approximately 58,000 storage facilities in the United States, REITs own only about 10%, while about 30,800 facilities are owned and operated by single property mom and pop owners. With efficiencies of scale and internal revenue management systems, the REITs have been able to operate properties at profitability levels that would have been unimaginable just a few years ago.

Figure 1: Self Storage Quick Facts

	Number of Facilities*	Annual Same Store Rent per SF
CUBE	387	$13.76
EXR	807	$14.53
PSA	2,208	$14.52
SSS	478	$11.36
U.S. Self Storage		
Number of U.S. Facilities	58,000	
Avg. Number of Units	566 Units/Property	
Avg. Unit Size	100 Sq. Ft.	
Construction Cost	$100-$150/Sq. Ft.**	

Sources: Company Documents, Self Storage Association, Green Street Advisors, Statisticbrain.com. As of 6/30/2014.
*Number of facilities with an ownership interest
** Per Net Rentable Square Fooot

The REITs versus The Mom and Pops

The nature of the self storage business gives enormous benefits to operators who have size. This advantage for the REITs comes to fruition in marketing, revenue management, and customer service. Long gone are the days of using the Yellow Pages and local newspapers to advertise. The self storage REITs have moved the game to the internet. Internet advertising is much more than having a working website (which some mom and pop shops have). It is about being able to target the right person, at the right time, in the right place in order to fill specific vacancies at properties at the right price.

The REITs accomplish this feat by using paid searches, blogs, and social media engagement, along with mobile websites and marketing campaigns. This does not come cheap though; Public Storage paid $27.8 million for advertising and selling in 2013, which included TV commercials and its first ever Rose Bowl Parade float! However, the scale of the REITs allows them to distribute these costs over hundreds (or in PSA's case, thousands) of properties. It would be hard for a mom and pop owner to leverage the cost of an active online presence when only a few properties would receive the benefit.

Another advantage for REITs is their call center service. Sovran Self Storage's (NYSE:SSS) call centers employ 42 full-time employees, are open 14 hours per day, 361 days per year, and can reach a peak volume of 40,000 calls a month. They have a formal training program to ensure consistent call quality, which leads to over 98% of calls being answered and 45% of sales calls being closed. In comparison, small operators tend to only be available for calls during property operating hours and come with inconsistent call quality as they likely have many other roles. Sovran, which operates under the name Uncle Bob's, claims that this leads to only 60% of calls into mom and pop shops being answered.

Extra Space Storage's (NYSE: EXR) CEO, Spencer Kirk, has said that data is the single most valuable asset they own. Due to the REITs' large size and scale, they interact with thousands of customers per day. Every interaction is tracked as a data point, which is then used to develop an internal revenue management system. By transacting with customers in different markets through multiple cycles, the REITs have developed exquisite revenue management systems that have given them an advantage over their mom and pop peers. Of course, the mom and pops can purchase third party revenue management systems to make up for some of the lost ground. But the advantage still lies with the REITs as they have fine-tuned their systems from years of experience and customized them to fit their specific style of management. Also, revenue management does not matter if you cannot capture the tenant to begin with!

"Going Deep!"…into the Revenue Management Systems

The benefit of the internal revenue management systems comes from the detailed data the REITs input into the system daily. Sovran's pricing model illustrates the depth of detail used. Sovran's system takes into consideration six factors, as seen in **Figure 2**. The systems are developed to optimize pricing and occupancy down to a specific unit type. The REIT's call center, website, and pricing system all talk to each other. If the call center is receiving a high amount of calls, but not closing on deals, a message is sent to the revenue system and an adjustment is made in the price. The same scenario applies to clicks on unit types from the website. Without all three, it is more difficult for the mom and pop owners to compete.

Figure 2: Sovran's Pricing Model Factors

1. Forecasted Marked Supply
2. Forecasted Market Demand
3. Online Unit Requests
4. Phone Call Unit Requests
5. Current Unit Availability
6. Competitor's Rates and Specials

Source: Chilton Capital Management Research.

The REITs have the pricing game down to a science. Pricing differs depending on the source of contact. For example, pricing for walk up customers (which is currently about 35% of the total) is on average 10% more than the price on the internet. The REITs know pricing power is stronger when someone is already at their doorstep ready to unload their belongings.

"…pricing for walk up customers (which is currently about 35% of the total) is on average 10% more than the price on the internet."

Once the REITs have a tenant locked into a unit, the first price increase will be in 6-12 months for most customers (depending on the company) and then every 9-12 months thereafter. The decision of when and by how much to increase the rate on a customer is based on the likelihood of move out. The size of the unit (how easily the customer could pack up and leave), the current rate the tenant is paying versus market rates, and the wait list for the unit type all factor into the decision. Leasing in the self storage industry is typically on a month to month basis, so if those factors are favorable for them, quick adjustments in price can be made to maximize revenue.

The average length of stay is 13 months, though that number may be deceiving. The tenant type ultimately determines the length of stay with about 50% of tenants, mostly residential tenants, leaving within six months. The commercial tenants are on the other end of the spectrum with stays that last for years, which the REITs would prefer in an effort to lower turnover. The self storage REITs are acutely aware of the supply and demand dynamics for their units, and this gives them a significant moat against smaller, less sophisticated competitors.

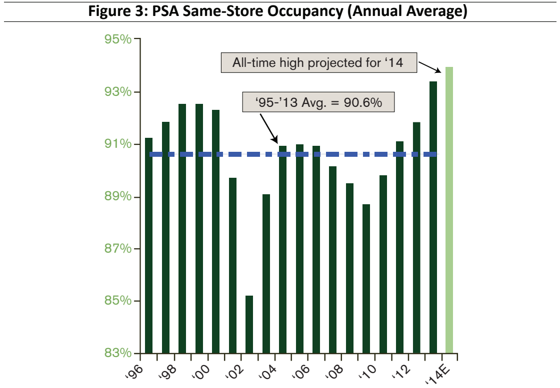
The mom and pops have tried to keep up with the REITs by installing third party revenue management systems, and as a result, the occupancy gap between the REITs and mom and pops has recently compressed. Then again, as self storage begins to enter into the historically slow part of leasing season, the spreads should widen as the REITs tend to gain market share when demand is slow.

All-American Performance

Investors may not be fully appreciating the cap-ex and NOI growth advantages that the self storage property type offers. Cushman & Wakefield and F.W. Dodge recently reported that 225 self storage projects are known to be under various stages of development across the U.S. That equates to less than 0.5% of existing supply! With new supply remaining relatively muted, it looks to be a landlord's market as same store NOI growth is expected to remain above historical levels for the foreseeable future. Green Street Advisors forecasts same store NOI growth for the sector of +4.9% in 2015 and +3.9% in 2016 versus historical same store NOI growth of +3.7% for self storage and +2.3% for the major REIT sectors (historical growth is a 15 year average). Importantly, their growth numbers are even more impressive given the minimal cap-ex required to maintain the properties. Self storage cap-ex is among the lowest of all property types at just 5% of NOI.

The REITs have three levers they can use to drive organic revenue growth: occupancy, rental rates, and concessions. Currently, the self storage REITs are experiencing record high occupancy rates in the low to mid 90's, as seen in **Figure 3** (PSA's performance is used as a representation for the self storage industry since historical data is limited). Future growth is likely to come from continued rental rate increases and decreased concessions as pricing power is increased by high occupancies and no immediate threat of new supply.

Figure 3: PSA Same-Store Occupancy (Annual Average)



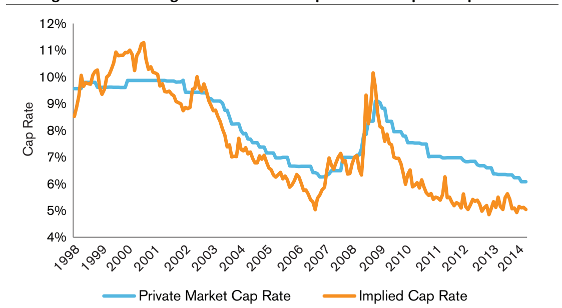
Sources: Company documents, Green Street Advisors.
*PSA's performance is used as a representation for the self storage industry since historical data is limited.

Lower operating expenses could also provide a boost to future NOI growth. Real estate taxes accounted for approximately 33% of self storage same store operating expenses in 2Q 2014 and increased 6.3% on average over the past year. Cities have recognized the value of self storage properties and accordingly reassessed their property values. As cities finish catching-up on their assessments, growth in real estate taxes should have less of an effect on expense growth.

Adding New Plays

Currently, private market cap rates are above public market implied rates **(Figure 4)** which has led to a period of active external growth for the storage REITs through portfolio acquisitions. Since 2012, the four public REITs have acquired over $5 billion worth of self storage properties. However, the environment may be changing as private market cap rates have come down 25 basis points (bps) since January 2014, and there is potential for a further decrease. Presently, there are a few REIT quality portfolios being marketed that could see sub-5% cap rates. REITs are usually able to grow yields by 40-50 bps annually over the first two years after acquisition due to superior revenue management. If private market cap rates fall to the point where acquisitions are too expensive, the idea of development could become enticing for those trying to achieve higher yields.

Figure 4: Self Storage Private Market Cap Rates vs. Implied Cap Rates



Source: Green Street Advisors.

However, there are countervailing forces that have kept development relatively at bay. The entitlement process can be challenging as storage developers usually receive push back from city municipalities. In the city's view, storage facilities are not as aesthetically pleasing as a strip center (or other use) and provide fewer jobs and sales tax income. Also, new lending restrictions and requirements on banks as a result of the financial crisis have made speculative construction loans, like storage development, too risky for banks to pursue. The entitlement, construction, and lease-up process can take 3-5 years to complete. As a result, a developer must be financially strong given the long period before cash flow is positive using typical deal structures.

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Instead of full-blown development, most of the storage REITs have taken up less risky Certificate of Occupancy (C/O) deals as a way to increase their yields on projects. In a C/O deal, the REIT agrees to purchase a newly built, unstabilized project from a developer. The deal eliminates two of the aforementioned development risks for the acquirer, leaving them only with lease-up risk. As a result, some of the potential dilution is avoided. These deals are becoming more common as would-be-developers know they must partner with a sophisticated, well financed operator in order to realize the highest potential return. It also guarantees them a quick exit. For taking on the additional risk, most REITs expect a stabilized yield near 9%, or a 300 basis point spread over prevailing acquisition cap rates. Upgrading existing sites is another way the REITs can boost yields. REITs can add additional units to already proven properties or add additional features, such as climate control, which receives up to a 25% rent premium over "dry" storage.

Though the opportunity to make billions on self storage may have passed years ago, investors in public self storage REITs can participate in the upside still available in this Super Bowl caliber property type. With a sizable operating advantage over most of their competitors, we expect the REITs to continue to consolidate the self storage space and reach returns unmatched by most other property types.

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Please feel free to forward this publication to interested parties and make introductions where appropriate.

Previous editions of the Chilton REIT Outlook are available at www.chiltoncapital.com/reit-outlook.html.