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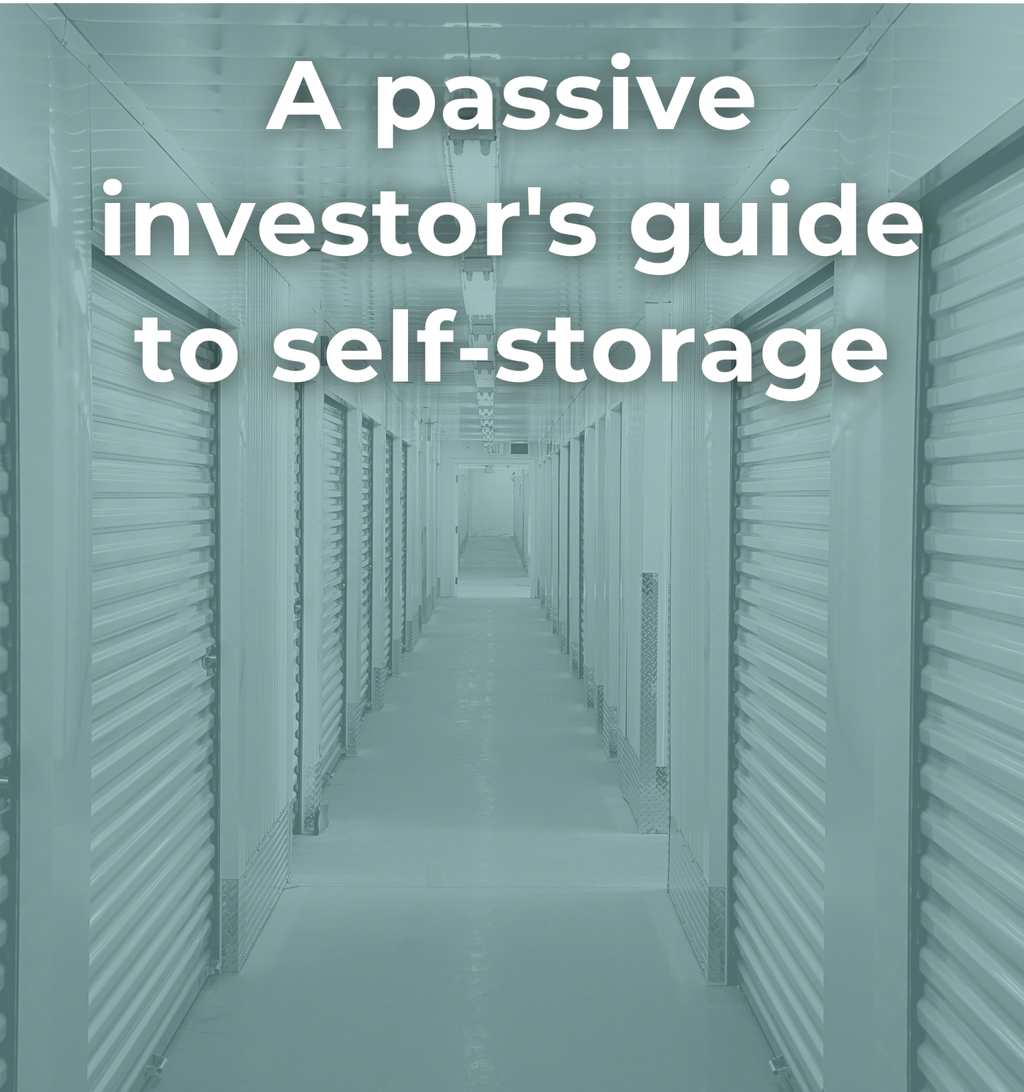
Little Boxes Big Profits

Kahseim Tucker

A passive investor's guide to self-storage



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Chapter 1 - Intro

Due to the recent upsurge in the popularity of crowdfunding, an increasing number of individuals are getting access to investments in the commercial real estate market. Overall, this trend is incredibly positive. Here's why: Previously, only ultra-high-net-worth individuals were able to diversify their portfolios into these types of investments because of the high ($5M-$20M) purchase price of quality commercial real estate. Interest in this asset class was further limited by the massive marketing advantage mutual funds have over alternative investment structures, as well as the extensive legal restrictions on marketing for securities. Crowdfunding opened the space up to a wider distribution of investors, creating a more open and accessible market.

Chapter 1 - Intro

The crowdfunding space has drastically changed since its beginning around 2012 due to the implementation of the JOBS Act, which allows public solicitation of investors for syndicated commercial real estate opportunities. Simultaneously, people are becoming more comfortable investing in real estate through online platforms, especially as younger generations, who have grown up with the internet, acquire the financial means to invest.

However, with this increased interest in the crowdfunding space has come the concern that investors are allocating their hard-earned capital into asset classes they may not fully understand during economic conditions they may not have thoroughly analyzed.

The vast majority of online crowdfunded opportunities focus on the following real estate assets...

- Multi-family
- Retail shopping centers
- Office
- Single-family loan pools

Chapter 1 - Intro

Despite the diversification potentially available online, the bulk of the online crowdfunded opportunities caters to an audience that wants to invest exclusively in multi-family or retail shopping centers. Amongst many reasons, investors are more emotionally comfortable with these asset classes, because they are more common investments, and have the potential to generate a lucrative return. In fact, the author of this eBook has invested in many properties of these two asset classes throughout his career and will continue to do so when a particularly desirable opportunity presents itself. However, when a vast number of investors are exclusively focused in the same direction, there opens an opportunity to make money in other areas.

The goal of this eBook is to shed some light on the state of the economy and what this tells us about where we should be investing. Then, we will go on to provide some education on the most under-represented asset classes in the crowdfunding space: self-storage.

Chapter 2 - Active vs Passive

Before getting into the details of self-storage, it is important to establish the perspective from which this eBook is written.

One of the main choices investors must make when beginning to pursue alternative real estate investments is whether they want to be active or passive. There are certainly strengths and weaknesses to both strategies, but the distinctions are very important, especially when it comes to self-storage.

Chapter 2 - Active vs Passive

Active Investments

Active investments are those in which the investor plays a significant, hands-on role in the performance of the investment, whether it is the identification, acquisition, management, or sale of the property. A typical example of an active investment would be an opportunity in which an investor acquires, rehabs, and rents a single-family property. Each month the tenant pays rent to the investor with whom they have direct correspondence. In this scenario, even if the tenant pays rent to a property management company, we would still consider it an "active investment" because the property management company interfaces directly with the investor.

Chapter 2 - Active vs Passive

Passive Investments

Before getting into the details of self-storage, it is important to establish the perspective from which this eBook is written.

One of the main choices investors must make when beginning to pursue alternative real estate investments is whether they want to be active or passive. There are certainly strengths and weaknesses to both strategies, but the distinctions are very important, especially when it comes to self-storage.

Chapter 2 - Active vs Passive

Benefits of Being a Passive Investor

There are many benefits to being a passive investor, but the most important is that the passive structure allows investors to be able to profit from an extremely experienced sponsor’s time, expertise, credit, and assumption of liability. Also, this structure allows investors to avoid being hyper-specialized in order to reap the benefits of portfolio diversification.

Chapter 2 - Active vs Passive

Benefits of Being a Passive Investor

- Time – When you are a passive investor, once you fund your investment, the extent of your time commitment is essentially cashing your quarterly distributions. It may sound too good to be true, but this is a reality for many passive investors in the U.S.

- Expertise – Many of the top-tier sponsors in commercial real estate have been involved in their particular asset class for decades and have proven their strategies over dozens of properties. Passive investors receive the benefits of the sponsor's industry knowledge by leveraging their capital with the sponsor's experience.

- Credit – It is quite common for real estate sponsors to obtain $10,000,000+ loans when investing in commercial real estate. The reason they have access to these types of loans is due to their track record and expertise, as well as relationships that they have developed throughout their career.

Chapter 2 - Active vs Passive

Benefits of Being a Passive Investor

- Liability – Because passive investors are investing in passive ownership shares of an LLC, which does not grant them decision-making power, their liability exposure is usually completely eliminated.*

- Diversification – Because passive investors leverage other people's time and expertise, they are able to diversify into multiple different asset classes, without being over-allocated in one particular investment class or geographic location. This is incredibly important for financial planning, as well as risk mitigation.

Chapter 2 - Active vs Passive

Benefits of Being a Passive Investor

This eBook is written from the perspective of a passive investor since that is the preferred investment strategy of the author and because self-storage is particularly profitable as a passive investment due to the intricacies of the asset class, which will be covered shortly. However, this eBook also caters to those who are interested in pursuing active investments in self-storage, as it outlines many important industry-specific management strategies of the asset class.

** CFC is not a law firm and does not provide legal, business, or tax advice. Always consult with a professional when considering an investment decision.*

Chapter 3 - Economic Indicators

Employment and Income

Despite claims of a robust economic recovery since the Great Recession, even a casual look into the details of the government's own figures shows a very different story. Most importantly, the vast number of jobs gained since 2009 have been low-paying jobs. In fact, 51% of wage earners in the U.S. are making less than $30,000 annually and 38% of wage earners in the U.S. are making less than $25,000 annually.

Jobs in such fields as construction, energy and mining, manufacturing, finance, insurance, real estate, business management, information technology, and trade/distribution account for only 50% of all non-farm payroll positions. They pay close to $50,000 per year, and on average, account for more than 66% of total wage and salary disbursements.

Chapter 3 - Economic Indicators

Employment and Income

The reality is these "breadwinner jobs" are the backbone of any strong economy. Unfortunately, despite overly simplistic unemployment figures and rosy monthly employment reports, the gross number of breadwinner jobs has not yet recovered to the level of its last peak in 2007. In addition, please keep in mind, that this is the gross number of jobs and doesn't factor in population growth.

Despite the fact that unemployment numbers seem rather low, many of those counted as "employed" in the jobs reports are only part-time employees. In fact, the Labor Department reports that more than 18% of those employed in the U.S. are working fewer than 35 hours per week.

Chapter 3 - Economic Indicators

Aging Population

Another economic indicator that paints a very interesting picture of where we are headed is the demographic changes that are taking place in the U.S. There are more than 10,000 baby boomers entering the age of retirement on a daily basis in the U.S., and a significant number of these retirees have little or no savings, leaving them primarily reliant on social security as a source of income.

This strategy, however, is not financially sustainable: the average social security check is $1,341 per month and the average two-bedroom apartment rents for almost $1,200 per month.

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Chapter 3 - Economic Indicators

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Aging Population

Because of the aging population and greater numbers of people hitting retirement with very little savings, there is a contraction of spending capacity taking place in the older generations. Many people in this category who were previously planning on living off their retirement are now being forced to downsize into smaller living quarters in order to live out their golden years without going broke.

Chapter 3 - Economic Indicators

Student Debt

One of the economic indicators that have received considerable press recently is the amount of student loan debt that is overburdening more than 44 million Americans. The U.S. population owes more than $1.3 trillion in student loans, a number that surpasses both credit card debt and auto loans. Keep in mind, unlike these other types of consumer debt; student loan debt causes an even larger burden because it cannot be wiped out in the event of bankruptcy.

Due to the combination of these onerous student loans and the sluggish economy, close to 50% of all college graduates move home with their parents temporarily after college, hence the term “Boomerang Generation.”

Student Debt

It is true that many young people live with their parents continuously, regardless of whether or not they go to college, but those adult children who leave and come back relatively unexpectedly create an interesting data point specifically relevant to the self-storage asset class.

Furthermore, when graduates enter the workforce and are disappointed with their opportunities, many of them choose to go back to school to pursue a higher degree and may incur even more debt, in hopes that employment opportunities will be more advantageous when they return to the workforce. Based on the economic indicators explained above, the risk that they will not secure a desirable job is perhaps more significant than they may realize.

What This Means as an Investor

Despite the fact that these data points suggest little or slow economic growth, there are still considerable investment opportunities out there in the commercial real estate space. Given these economic realities, now is not the time to focus on speculative investments that rely on appreciation, but it is an exciting time to pursue recession-resistant assets that perform well during all stages of the economic cycle.

The reality is that all types of commercial real estate should perform well when the economy is booming and the capital markets are loose. However, there are only certain types of assets that perform well during recessions or sluggish stages of the economic cycle.

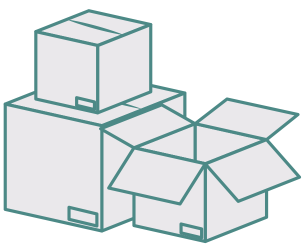
What This Means as an Investor

In fact, there are a few investment classes whose demand can actually be inversely correlated with the economic cycle, meaning the demand increases when the economy is sluggish, or even in a recession. Self-storage has one of the strongest inverse correlations with the overall economy out of all commercial real estate asset classes that exist.

Chapter 4 - Why Self-Storage?

Self-storage facilities provide an inexpensive place to store non-perishable items consumers don't need immediately but can't seem to part with. During the last sixty years, the industry has exploded into a $28.2 billion industry with more than 50,000 facilities all over the U.S. Despite the fact that investing in self-storage only really became popular in the mid-to-late 90s, there are now about the same number of self-storage facilities as all the Starbucks, McDonald's, and Subways combined.

Due to the unique facets of self-storage that we will uncover shortly, this asset class has the potential to produce years of lucrative cash flow and forced appreciation through the addition of ancillary income, optimizing of operations, and leveraging of strategic relationships with related businesses. Hence, the massive expansion.

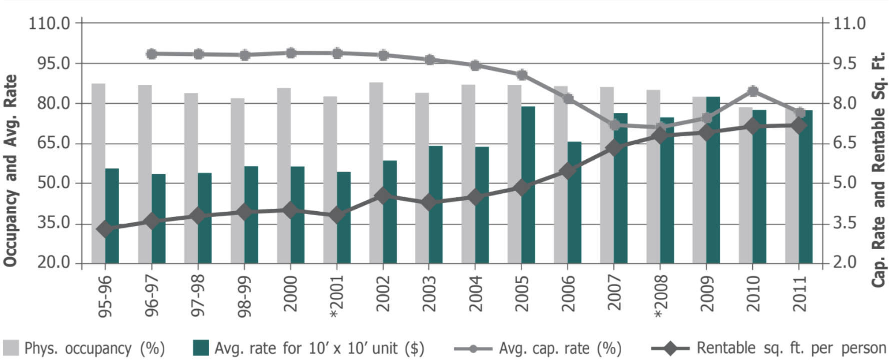


Chapter 4 - Why Self-Storage?

The most compelling reason for considering investing in self-storage is its ability to weather economic downturns.

Take note of Figure #1 below which tracks the occupancy and average rental rates from 1995-2011. As you can see, during the 2001 recession, both occupancy and rental rates remained relatively unchanged. The same is also true for the recession of 2008, which was the most significant real estate collapse in the history of the U.S. Another metric to consider when analyzing the Figure 1 chart is that from 1995-2011, the number of self-storage facilities more than doubled, while occupancy and rental rates continued to increase.

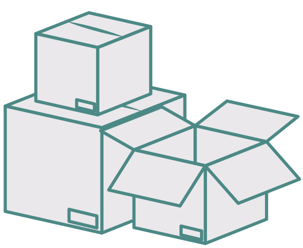
National Self-Storage Operational Trends



*Recessionary period

Source: *2011 Self-Storage Almanac*

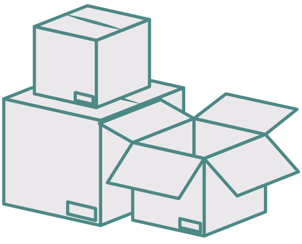
The reason for the asset's stability is that there often is increased demand for the product during economic recessions. For example: during the 2008-2009 correction, many individuals and households needed to downgrade to smaller living quarters but didn't want to sell their possessions. The downsizing resulted in high demand for self-storage, even though many other areas of the economy were struggling. This trend is also typical of previous recessions, as the majority of self-storage tenants are going through some kind of transitional period, often due to foreclosures, layoffs, or kids from college moving back home unexpectedly, all of which are common during economic downturns.



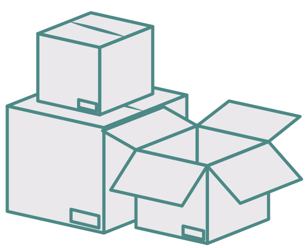
Chapter 4 - Why Self-Storage?

Another reason self-storage can produce very lucrative returns for investors is that the tenants are not as price sensitive to rental increases as other commercial real estate asset classes.

Because rental rates for self-storage facilities are relatively inexpensive from a gross dollar perspective, especially when compared to housing rental rates, tenants tend to be more forgiving of a rate increase. Therefore, it is possible to raise rents much more aggressively compared to other investments.



For example: in a typical multi-family investment, a 3-4% rental increase can be achieved in a solid, healthy market. For the average two-bedroom apartment which rents for $1,200/month, this represents a $35-$50/month increase in the tenant's rental rate. Comparatively, an experienced self-storage operator might raise rents by 6%, but this change may only result in the tenant's monthly rates increasing from $150 to $159. The reality is very few tenants will go through the trouble and costs associated with leasing a rental truck, packing up their belongings, and moving to a nearby self-storage facility (where rental rates are likely to rise soon anyway) over such a negligible increase from a gross dollars perspective. The math just doesn't make sense. However, for investors, these types of annual rental increases can result in very lucrative cash-on-cash returns, especially when implemented over the long term.



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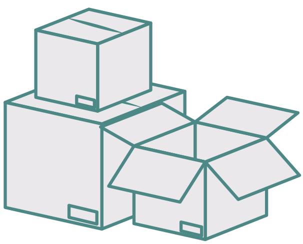
Chapter 4 - Why Self-Storage?

One of the major value-add potentials created by the self-storage space is that there is a tremendous amount of mismanaged facilities in the U.S.

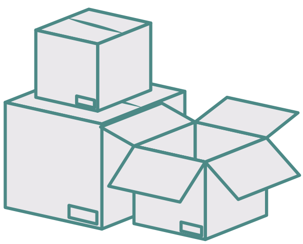
This is due to the fact that there is a pervasive misconception among both potential investors and existing self-storage owners that these facilities are a hands-off asset class. Nothing could be further from the truth. The reality is that the top-tier operators in the U.S. have developed strategies and systems to fully optimize every aspect of a fully functioning self-storage business and the discrepancy between their strategies and a less experienced owner can be quite significant.



Chapter 4 - Why Self-Storage?

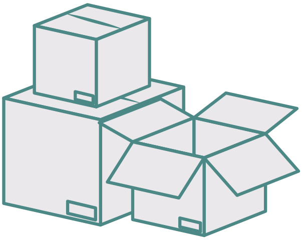
Any top-tier operator will have a pre-existing template in place for:

- Optimizing online marketing/sales:
  - Website management
    - SEO
- Pay-per-click
- Cultivation of relationships with related businesses:
  - Truck rental companies
  - Universities
  - Military bases
- Implementation of extensive management protocols that have been optimized over decades and through hundreds of properties
- Branded merchandise sales
- Use of secret shoppers to validate market supply/demand for the product



Because of the misconceptions surrounding this asset class, there are a significant number of mismanaged properties whose owners fail to optimize these efficiencies, especially ancillary income.

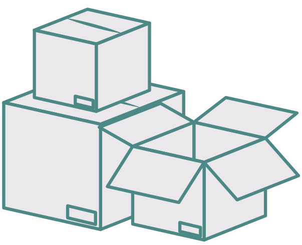
Independent owners control 77% of the self-storage properties in the U.S. Many of these “mom-and-pop” owners do not maximize their property’s income potential via the systems outlined above. All of these components can create a tremendous value-add opportunity, with very little capital expenditure. Further details will be provided on this topic in the “Due Diligence” section of this eBook.



Chapter 4 - Why Self-Storage?

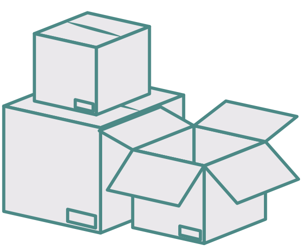
Because of the prevalence of inexperienced owners who do not have an accurate understanding of how to analyze rental rates, there are many facilities in the U.S. that are charging under-market rent but have a solid 90%+ occupancy.

When you combine this with the fact that self-storage facilities utilize monthly lease renewals that allow for faster rental increases, as well as the economic disincentive regarding high moving costs, it becomes clear why having a captive tenant base can be so lucrative.



Another benefit of monthly lease renewals is the ability to remove problem tenants without lengthy eviction or litigation processes.

Unlike the laws governing residential houses or multi-family apartments, the laws that govern self-storage operators are much more advantageous for the owner, as opposed to the tenant. In most states, it is well within a manager/owner's legal grounds to lock, remove, and sell a tenant's possessions within 30-60 days. Furthermore, due to the favorable laws governing self-storage, an attorney is usually not required to complete an eviction. Not only does this motivate tenants to pay on time, it also allows managers to quickly remove problem-causing tenants who are slow to make their monthly payments.



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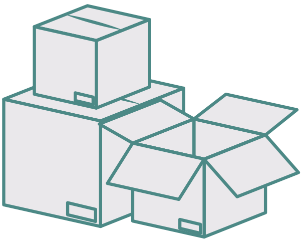
Chapter 4 - Why Self-Storage?

It is standard industry knowledge that the vast majority of issues that take place in a typical investment in self-storage are caused by tenants who do not pay on time. Because of this, if a sponsor purchases a dilapidated property and quickly removes those who are unwilling to adhere to the “no pay, no stay” policy, the previously undesirable property can turn into a safe, clean, and profitable facility very quickly.



Cash Flow vs. Cap Rate Compression

When considering any type of investment, it is very important to analyze the projected returns on a ***risk-adjusted basis***. When investing in leveraged commercial real estate opportunities, the returns generally hover around the 13-20% range. However, because no two investment opportunities are the same, comparing one property with a 13% return-on-investment (ROI)* to another property with an 18% ROI, without factoring in the perceived risks of the investments, will not give the investor an accurate picture.

*(Total Net Gain / Total Investment Amount) / Years Invested =
Return-on-Investment (ROI)
EXAMPLE: ($180,000 / $200,000) / 10 Years = 9% ROI

Chapter 5 - Value Added Returns with Minimal Capital Expenditure

Cash Flow vs. Cap Rate Compression

Think of the cap rate as the unleveraged return a buyer is willing to accept when purchasing a property. The higher the cap rate, the higher the return needed to meet the requirement, and therefore, the ***lower*** the purchase price. Similarly, the lower the cap rate, the lower the return the investor is willing to receive and, therefore, the ***more*** he or she is willing to pay for the property.

FOR EXAMPLE: if the NOI remains $1,000,000, but the market cap rate compresses from 10% to 8%, the value of the property increases from $1,000,000 to $1,250,000, because investors are willing to pay ***more*** for the same property at the later date.

Chapter 5 - Value Added Returns with Minimal Capital Expenditure

Cash Flow vs. Cap Rate Compression

While NOI is relatively predictable, cap rates are more subject to the whims of the market. This is similar to the way that dividends from stocks are relatively reliable but the P/E ratios can fluctuate significantly.

One of the benefits of self-storage is that there are several ways to increase the NOI, which allows investors to receive substantial returns without relying on cap rate compression.

Chapter 5 - Value Added Returns with Minimal Capital Expenditure

Value-Add Investments

Generally speaking, value-add real estate investments are investment opportunities where the subject property is producing cash flow from rental income, but there is potential to add value to the facility by making improvements to the asset, rehabbing the property, or significantly increasing operational efficiencies.
Usually, these value-add strategies are considered riskier than stabilized investments because of the uncertainties as well as hard costs, associated with repositioning a large commercial property. However, in exchange for these incurred risks, higher returns can be captured later down the road when the property is sold.

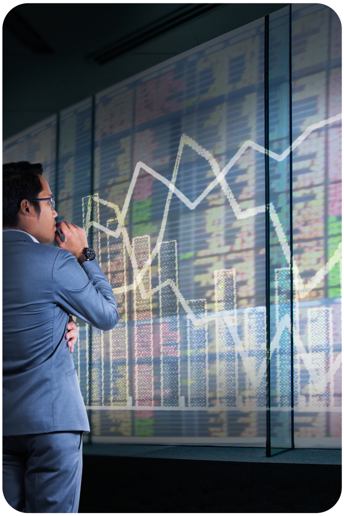
Chapter 5 - Value Added Returns with Minimal Capital Expenditure

Value-Add Investments

FOR EXAMPLE: if there is a $15,000,000 Class B multi-family apartment that needs $2,500,000 in capital expenditure to be repositioned as a Class A apartment, the sponsor is most likely planning on updating the appliances, redoing the flooring, repainting the interior and exterior, significantly rehabbing the amenities, and potentially building new units. Once the repositioning is complete, the manager can increase rents as they begin to cater to the new, higher-quality tenant.

Chapter 5 - Value Added Returns with Minimal Capital Expenditure

While this can be a very lucrative way to invest, the risks associated with all of those processes, particularly any building of additional units, which may require city permits and approvals, can create a significant amount of unpredictability during the lifecycle of the investment.



When looking at investments on a risk-adjusted basis, self-storage again presents itself with great potential because of several strategies that allow operators to increase to the NOI without tremendous capital expenditure. In fact, several of these strategies require little or no money out of pocket whatsoever.

U-Haul

The most lucrative example of these low-risk value-add components is achieved by purchasing facilities that are not currently offering U-Haul rentals and implementing this piece upon attaining ownership.

As mentioned earlier, the times during which people are most likely to use self-storage involve some kind of life change, many of which require a moving truck. Top-tier operators have a pre-existing relationship with U-Haul, which can be very beneficial to all parties involved. Essentially, on a typical 50,000-100,000 square-foot facility, there is room for at least 10-15 U-Haul trucks which can be parked on the property at essentially no cost to the owner. Once the trucks are parked there, the property manager can rent the trucks out to tenants and receive a commission from U-Haul for facilitating the transaction.

U-Haul

In order to effectively market this U-Haul component, property managers must be educated on how to sell this product to tenants, which does not require more than a few hours of training. However, if the strategy is implemented effectively, a typical medium-large facility can bring in an additional $2,500-$3,500+ per month directly to the bottom line at no capital expenditure to the investors.

$3,500 x 12 = $42,000 (Increase in NOI) / 7.5% Cap Rate = $560,000 added to the property's value.

Again, this requires zero capital expenditure and is simply a matter of the sponsor leveraging a pre-existing relationship with U-Haul.

U-Haul

Adding the U-Haul component can increase the value of properties in other ways as well. Experienced sponsors have found that the implementation of U-Haul alone should increase physical occupancy by 6% on average due to the increased traffic to the facility solely for those seeking to rent U-Haul trucks.

Something else to consider is that when tenants are renting trucks onsite, they are more likely to purchase moving merchandise such as tape, scissors, boxes, dolly rentals, etc. This eBook will cover more details of merchandise sales later in this chapter.

Mandatory Tenant Insurance

Another similar strategy is to purchase properties based on in-place income that are not mandating their tenants' purchase insurance and to implement this requirement immediately upon taking ownership of the property.

Tenant insurance, essentially the same as insurance for a rented home or apartment, insures the items stored in the facility against losses due to flood, fire, theft, vandalism, etc. Again, most top-tier operators have relationships with self-storage-focused insurance companies who offer self-storage-specific insurance policies.

Mandatory Tenant Insurance

Similar to the U-Haul strategy, the property manager must be knowledgeable about the product in order to make this strategy effective. They must also follow formal guidelines and must be licensed in the state in which the facility is located. However, once the property manager is able to explain it confidently and the licensing has been finalized, it is easy to implement a lucrative mandatory tenant insurance policy.

On a typical facility, this strategy can bring $1,500+ per month directly to the bottom line. $1,500 x 12 = $18,000 (Increase in NOI) / 7.5% Cap Rate = $240,000 added to the property's value.

Mandatory Tenant Insurance

This strategy can be especially lucrative if the operator has several facilities covered by the same insurance company. Due to the economies of scale, the commissions the insurer will pay can be substantially larger than if they were being paid to a typical independent owner, another benefit of investing via an industry-leading sponsor.

Not only will this help the bottom line, in the event that a tenant’s possessions are damaged, but this also guarantees they will be compensated by the insurance company quickly, causing much less of a headache for the property manager.

Discrepancy Between Physical and Economic Occupancy

As mentioned earlier, there is a “stickiness” unique to the tenant base because it is more expensive to move self-storage facilities than it is to accept a modest annual increase in rental rates. This mathematical reality can produce lucrative returns for investors by identifying facilities that have a significant discrepancy between physical occupancy and economic occupancy.

Physical Occupancy – The percentage of units that are rented. For example: if there is a facility that has 500 units, and 400 occupied, the facility's physical occupancy is 80%.

Discrepancy Between Physical and Economic Occupancy

Economic Occupancy – The economic efficiency at which the facility is operating. For example: if the facility has 500 units that, if fully occupied and optimally performing, should produce $400,000 in annual NOI, but is only producing $250,000, the facility is 63% economically occupied.

Chapter 5 - Value Added Returns with Minimal Capital Expenditure

The discrepancy between the physical and economic occupancy is an excellent determinant of the potential profitability of an investment in a self-storage facility due to the tenant base being receptive to rental increases.

There are several reasons for this discrepancy to be unnecessarily high:

- Rental rates are below market rents
- Employee/Management Fraud
- Tenant theft
- Delinquent customers
- Concessions that are too high
- Prepaid rent discounts
- Employees expensing personal expenses through the facility's balance sheet • Late fees that are too low

Chapter 5 - Value Added Returns with Minimal Capital Expenditure

Another of the many benefits of investing through a top-tier self-storage operator is that they will be able to accurately identify this discrepancy while conducting due diligence, while the seller of the property may be completely unaware of the inefficiencies, despite having owned the property for years.

Over the timeline of an investment in a self-storage facility, the goal will be to optimize the efficiencies of the property, which will cause the economic occupancy to meet the physical occupancy.

Keep in mind that attaining 100% physical occupancy is not the ultimate goal. A facility's physical occupancy should hover around 90% because the property manager needs availability for new potential tenants, and anything above 90% occupancy shows that the manager should be implementing more aggressive rental increases.

Chapter 5 - Value Added Returns with Minimal Capital Expenditure

Climate-Controlled Expansions/Retrofits

The popularity and development of climate-controlled units in self-storage facilities first became common in the late 90s during the sudden increase in attention to this asset class. Climate-controlled units are designed to protect tenants' sensitive belongings such as artwork, wine, and family heirlooms from increases or decreases in temperature and humidity.

There are two ways to take advantage of this value-add strategy as an investor. One way is to invest in properties with too few climate-controlled units for the market and then retrofit standard units into climate-controlled units, and the other is to expand the facility with exclusively climate-controlled units.

Climate-Controlled Expansions/Retrofits

Most experienced operators suggest that 20%-60% of a facility’s units be climate-controlled. If the percentage of climate-controlled units is significantly lower than this or if the facility does not offer the product whatsoever, purchasing the property with this value-add strategy in mind can be very effective. Of course, the demand for these units will be greater in areas with high humidity, but they are desirable throughout most of the U.S. because even normal seasonal changes in temperature can damage furniture and art. In fact, it is quite common to find facilities all over the US in which the climate-controlled units are over 90% occupied while there is a significant vacancy in standard units.

Chapter 5 - Value Added Returns with Minimal Capital Expenditure

Climate-Controlled Expansions/Retrofits

Although these units are slightly more expensive to build than standard units, they usually rent for a 15-30% premium, more than making up for the upfront costs.

Keep in mind that due to the capital expenditure, the potential for permit requirements, uncertainty during development, and the complexity of the plan, this strategy involves more risk than the others mentioned, but this eBook would be incomplete without outlining the unique opportunity that lies in this strategy.

Merchandise Sales

Another mistake mom-and-pop operators make is failing to fully maximize their ability to sell merchandise to tenants. For example, it is not uncommon to find a facility where the manager simply loans out a pair of scissors for free instead of selling them to a tenant. Not only are these managers missing out on the opportunity to make a profit from helping their tenants, but the merchandise could also be branded which will increase brand awareness in the market and therefore foot traffic to the facility.

Here are some of the examples of items that must be provided to maximize a facility's merchandise sales:

- Locks
- Boxes
- Box-Cutters
- Bubble wrap
- Tape
- Cold beverages/Snacks

Merchandise Sales

All of these items carry a significant profit margin because the tenants almost always need them immediately.

It is common that an experienced operator may purchase a facility that is underperforming on merchandise sales and, within a twelve-month term, easily increase the bottom line by $500 per month.

$500 x 12 = $6,000 (Increase in NOI) / 7.5% Cap Rate = $80,000 added to the property’s value.

It is worth reiterating that this exemplifies the beauty of this asset class: a small change such as more effectively offering and displaying items such as scissors, or locks, can increase a property’s value by up to $80,000.

Admin/Late Fees

One of the major transitions from a less-experienced management company to an industry-leading operator is the implementation of administrative and late fees.
An **Admin Fee** is typically a $12.50-$25.00 upfront fee that tenants pay when they move in. Admin fees will usually amount to 1-5% of net rental revenue, depending on tenant turnover.

Late Fees are fees that are implemented when tenants pay somewhere between 1-30 days late. There are many state-specific laws that outline the way in which self-storage late fees must be implemented. As a rule of thumb, managers should implement a $20 or 20% of monthly rent late fee in order to keep the late fee structure simple and easy to explain to new tenants.

Admin/Late Fees

In a typical market, late fees should amount to about 1.5% of net rental revenue if the property manager is charging the tenants effectively.

When a property is significantly underperforming on these two line items, late fees could add another $500/month and administrative fees at least another $300/month.

$800 x 12 / 7.5% Cap Rate = $128,000 added to the property's value.

Chapter 6 - Due Diligence Questions Every Investor Needs to Ask

Who is the Sponsor You are Relying On?

Pay close attention to this section because, when it comes to passive investments in commercial real estate, particularly out-of-state properties, the most critical piece of the investment is the sponsor/operator. They are likely providing the opportunity, creating the underwriting assumptions, and managing the day-to-day operations of the facility, which we now know requires specialized knowledge and experience. Over the long run, the quality of the sponsor is going to be more important than the potential profitability of the asset, the age of the building, the market demographics, or any other typical due diligence metric.

While there are many ways to identify if the sponsor is the type of person (or company) you should rely on to generate lucrative returns with your investment capital, it is important to take a holistic look at the full picture in order to make a knowledgeable assessment of the people with whom you are potentially doing business.

Chapter 6 - Due Diligence Questions Every Investor Needs to Ask

What is their Track Record in the Industry?

If someone is overseeing a $10,000,000+ investment opportunity, it is critical that they have extensive experience in the industry. Each investor's rule of thumb is different, but looking for 10+ years of experience with 10+ properties, or 1,000,000 square feet under management are some solid benchmarks.

Does the Sponsor Have a Clean Background?

As a passive investor who is making a bet on a person, or group of people, background check services can be extremely beneficial. Always run a background check on the sponsor's managing principals in order to ensure that none of them have a suspicious history, most importantly fraud. Background checks are the most overlooked part of due diligence amongst investors, but the cost/benefit is unparalleled. Most attorneys can provide this service upon request.

Chapter 6 - Due Diligence Questions Every Investor Needs to Ask

Are They Putting Themselves in a Position to Deliver?

One of the major ways to vet potential managers is to consider if they are putting themselves in a position to under-promise and over-deliver or over-promise and under-deliver. Underpromising and over-delivering is great news for an investor, while the reverse is completely unacceptable. Unfortunately, many operators attempt to inflate an opportunity's returns in order to get a property funded, but this will be terrible for the relationship over the long term. This eBook will discuss some of the ways in which operators will attempt to inflate the returns of an opportunity in the "Underwriting" section below.

Chapter 6 - Due Diligence Questions Every Investor Needs to Ask

What do the Underwriting Assumptions Suggest about the Sponsor?

When it comes to commercial real estate projections, the details of the underwriting assumptions can vastly alter the projected profitability of the opportunity. Many times, these assumptions can be buried in sophisticated spreadsheet models which overwhelm investors and lead them to simply assume the underwriting model is credible.

One of the major ways operators can inflate the returns is to assume a significant cap rate compression during the hold of the opportunity.

Because the cap rate dictates the value of the property based on a multiple of income, cap rate compression can make a significant difference in the investor's projected ROI.

What do the Underwriting Assumptions Suggest about the Sponsor?

For example, if the operator is purchasing a property at a 7.5% cap rate and planning on selling it at a 6% cap, the total return is going to be extremely dependent on the projected cap rate compression. Conversely, conservative sponsors generally underwrite a slight (.25-.5%) cap Rate expansion, in order to put themselves in a position to over-deliver.

Remember, if there is a value-add proposition, such as a significant discrepancy between physical and economic occupancy, there should be a cap rate expansion assumed in the projected returns because once that discrepancy is eliminated (as the facility becomes optimized), there is less “meat on the bone” for the end buyer.

What do the Underwriting Assumptions Suggest about the Sponsor?

Another example of overly aggressive underwriting assumptions is unsubstantiated rental increases, especially once the property has achieved market rates.

Most operators know that purchasing properties that are undercharging rents is a lucrative strategy because you can theoretically aggressively raise rents upon purchase. The challenge comes when the sponsors do not alter their rental increase assumptions once the property has been increased to market levels.

What do the Underwriting Assumptions Suggest about the Sponsor?

For example, if a property is 12% under market rents on average, the property manager may increase rents by 6% immediately upon purchase, and 6% again in 6-12 months, so as to phase in the 12% increase without motivating too many renters to vacate. However, it is important to look at the underwriting model and ensure that the operator is ***not*** assuming they will be able to maintain that 6% rental increase for the remaining years of the property's anticipated hold timeline. Due to the sticky nature of self-storage tenants, the facility may very well be able to continue to increase rents at the 6% rate, but in order to remain conservative, the operator should decrease the assumptions to match up with typical price inflation in order to set himself up to under-promise and over-deliver.

Similar to the above, another aggressive assumption some operators will utilize is a significant divergence between rental increases and expense price inflation.

For example, once the property has reached market rates, if the operator is assuming expense prices will increase by 3% per year, the rental increases should also be very close to 3%. Similarly, if the expense price increases are assumed to be 3% and the rental rates are assumed to increase at least 6%, the divergence between these two line items will make a considerable difference in the projected performance of the property.

Over the long run, this can make an extremely significant difference in the projected cash flow and overall returns because these rates are compounding annually. It is especially important to make note of these assumptions when attempting to predict the property’s value 7-10 years from purchase.

Chapter 6 - Due Diligence Questions Every Investor Needs to Ask

What is the Surrounding Population and the Daily Traffic Count?

More than 85% of self-storage tenants choose their facility by driving past it. In fact, almost 100% of self-storage tenants live within a 5-mile radius of the facility where they rent a unit. Selecting a populated market (approximately 50,000 residents within a 5-mile radius) with consistent traffic is critical from an investor’s perspective. Though it is not a set-in-stone rule, most experts suggest 20,000-25,000+ traffic counts per day.

It is important to remember that in order for the traffic to effectively convert to rented units, the facility must be highly visible to those 20,000+ drivers. Visibility is the single most important determining factor for renting vacant units. If the facility is hidden behind an office, trees, or some similar obstruction, the drivers are far less likely to visit the property.

What is the Nearby Median Household Income?

The reality is that people use self-storage when they need it. However, in order to “need” self-storage, the tenants much have items to store and money to pay for the service. If a facility’s tenant base lacks either of these components, the property will not produce favorable results. In order to ensure this is not the case, investors should ideally focus on facilities that have a $50,000 median household income within a 3-mile radius. Though this rule is reasonably flexible, it is critical that the median household income in the immediate area is above the $30,000 per year mark.

Chapter 6 - Due Diligence Questions Every Investor Needs to Ask

Is the Facility Large Enough?

When investing in any type of commercial real estate, it is important to consider not only the quality of the tenants but the quantity as well. One of the rules of thumb for self-storage facilities is 50,000 net rentable square feet or above, which usually works out to 400+ units. Because there are several major fixed costs of operating self-storage, most notably the onsite property manager, large facilities will help mitigate these costs and provide a lucrative return for investors via economies of scale.

Also, if a facility meets the 400+ unit requirement, it will provide sufficient tenant diversification, which will increase the dependability of the distributable cash flow.

Is the Property in a Market That is Undersupplied?

Another metric to be aware of is the property's square footage demand equilibrium within a 1, 3, and 5-mile radius. In the U.S., the national average rentable square footage of self-storage per person is 7.8 square feet per person. To be conservative, when considering investing in a property, multiply the population of a specific radius by 7 to estimate the market's square-footage demand equilibrium.

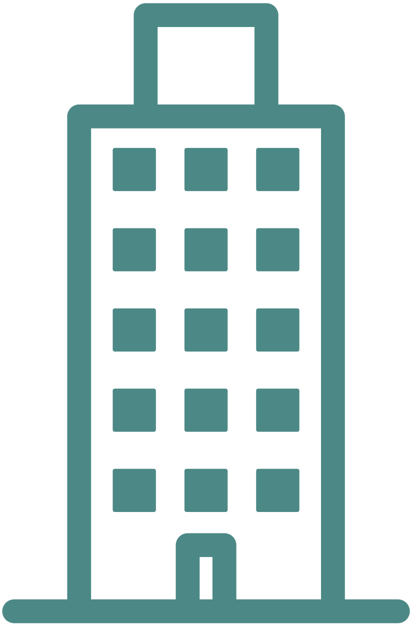
For example, let's say there are 50,000 people living within a 5-mile radius of the property. 50,000 * 7 square feet = 350,000 square feet market equilibrium

Once this number is determined, research and calculate the total square feet of self-storage within the 5-mile radius of the property to establish how under or oversupplied the market is.

For example, if there are 275,000 square feet of self-storage within a 5-mile radius: 350,000 (demand) – 275,000 (supply) = 75,000 square feet undersupplied.

Chapter 6 - Due Diligence Questions Every Investor Needs to Ask

This would be a solid indicator that the facility in question could turn out to be a lucrative investment opportunity. One thing to take note of is that the average medium-large self-storage facility is 50,000 square feet. In a market that is 75,000 square feet undersupplied, a fairly large facility could be developed within the 5-mile radius of the subject property without inverting the supply/demand ratio.



However, if the market is only undersupplied by 15,000 square feet, the development of one medium-large sized property could cause the market to be oversupplied, in which case, a significant increase in population must occur in order for property managers to effectively raise rents and increase occupancy.

Chapter 6 - Due Diligence Questions Every Investor Needs to Ask

A Passive Investor's Guide to Self-storage

Kahseim Tucker

That being said, it is important to remember that each market can vary in terms of demand for the product.

Some markets will average significantly less square footage per person and more affluent areas may average more. Furthermore, popular vacation destinations, particularly markets near bodies of water, could have low permanent populations but self-storage could be in high demand due to the storage requirements of water-related sports.

Keep in mind that markets that are driven by demand from water sports equipment storage may be highly seasonal, which could cause significant volatility in quarterly cash flow distributions.)

Are the Loan Terms too Aggressive?

Out of all the possible problems that can take place during a real estate investment of any kind, incurring overly aggressive leverage has the potential to be by far the most devastating.

It is commonly known that real estate has created more millionaires than any other asset class. What is much less discussed is that it has caused more bankruptcies than any other investment as well. The vast majority of the major problems in real estate are caused by investors and operators who utilize overly aggressive loans and fail to refinance before the balloon payment is due. In the next section, we take an in-depth look at the difference between conservative loans and those that are too risky to pursue.

Chapter 7 - Let's Talk About Loans

An Introduction to Loan Terms

As mentioned earlier in the eBook, the single best predictor of the performance of your investment is not the location, the desirability of the asset, the amenities offered, or even the underwriting assumption, but the performance of the person on whom you make your bet. Due to the wide range of available financing options out there, keep this in mind when in the process of analyzing the specifics of the loan because there is a lot to be learned from the (aggressive vs. conservative) choices the operator has made when selecting financing options.

There are a few metrics to keep an eye on to ensure that the sponsor is not incurring too much risk through aggressive leverage.

1. Loan-to-Value
2. Time Horizon Term of Balloon Payment
3. Interest-Only Portion
4. Debt Service Coverage Ratio

Chapter 7 -
Let's Talk About Loans

1. Loan-to-Value (LTV)

The loan-to-value ratio is simply the ratio of the total loan amount to the value of the property, which is established by an appraisal.

Loan Amount / Property Value = Loan-to-Value (LTV)
$7,000,000 (Loan Amount) / $10,000,000 (Property Value) = 70% LTV

Generally speaking, the higher the LTV, the more aggressive the loan is. Typically banks require that the Loan-to-Value of the property be close to 70%.

Chapter 7 - Let's Talk About Loans

Sometimes banks will be willing to lend considerably more than 70% of the value of the property if the manager is going to implement some sort of capital expenditure (example: climate-controlled unit expansion) that will substantially increase the value of the property.

Be careful when considering these more aggressive leverage ratios because if the market corrects, or if the value-add strategy is not implemented effectively, you could have a problem refinancing or selling the property for more than is owed on the loan.

2. Time Horizon of the Balloon Payment

Almost all of the horror stories of investing in real estate typically are the result of a balloon payment coming due (the principal balance being owed) before the property can be refinanced or sold.

Typically, short-term or one to three-year balloon payments entail less expensive fees and rates. However, the allure of these loans is far outweighed by the potentially negative outcomes that can take place if there is a significant change in market conditions or the availability of liquidity when the balloon comes due.

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Chapter 7 - Let's Talk About Loans

A Passive Investor's Guide to Self-storage

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Despite the growing popularity of self-storage as an investment vehicle over the last few decades, the availability of capital provided by lending institutions during an economic correction can change significantly. Typically, when there is a downturn, banks decrease their risks and therefore reduce the LTVs on which they are willing to lend.

For example, if there is a property with an NOI of $500,000, a bank may be willing to lend $4,600,000 for the purchase of the property (about a 70% LTV). However, if the bank were to create a loan for this same property during a recession, it may be only able to lend $3,300,000 (50% LTV) because of the change in liquidity.

When a balloon payment comes due, the sponsor typically replaces the maturing loan with a new loan. The problem is, that they may be $1,300,000 short unless the NOI significantly increases during the time of the hold.

This is why the value-add strategies mentioned in the eBook earlier are so critical. There are low-risk ways to immediately increase the NOI, which will significantly increase the value of the property so that in the event of a liquidity crisis, it will be more likely that banks will be willing to grant the sponsor enough debt to keep investor capital protected. Perhaps more importantly, the longer the term of the balloon payment, the longer the property manager has to implement and optimize these strategies, which will create further protection.

3. Interest-Only Portion

One line item to check during due diligence is the length of the interest-only portion of the loan. This is the amount of time in which the payments only include the interest, without any principal repayment. Conversely, on a traditional loan, once the property is purchased, the loan immediately starts amortizing as it decreases the loan balance, further increasing the investors' equity position in the property. At the end of the loan term, the property will be owned free and clear, and, at that point, the LTV would have decreased to 0%.

One tactic certain aggressive operators will use is to implement lengthy interest-only portions in order to reduce the payment size of the debt, which will give the appearance that the opportunity is more lucrative than it is. Due to the fact that these payments do not include principal paydown, they are significantly smaller, and therefore, the cash flow during these years can appear to be much stronger than it would be without the extended interest-only component.

Generally, a one-year interest-only is appropriate, with two years being acceptable. However, anything greater than two years is considered aggressive and an opportunity with four-years+ of interest only should usually be disregarded immediately.

Keep in mind, when analyzing an opportunity that is underwritten with several years' interest only, the cash flow will be deceivingly high when compared to another opportunity without an interest-only portion of the loan. Depending on the amount of leverage the operator is utilizing, an extended interest-only period can boost the cash-on-cash returns by 1-5% (annually) for the years where the interest-only portion is taking place. This could mean the difference in a specific year's cash flow is 15% rather than 10%. If investors are not cautious to take note of whether or not the difference is due entirely to the term of the interest-only portion of the loan, they could make an investment decision based on incomplete information.

4. Debt Service Coverage Ratio (DSCR)

Another metric to take note of when conducting due diligence is the Debt Service Coverage Ratio (DSCR). This is the ratio of cash flow available for debt service.

Net Operating Income / Annual Debt Services = **Debt-Service-Coverage-Ratio (DSCR)**

EXAMPLE: $700,000 (NOI) / $458,318 (Annual Debt Service) = 1.5 DSCR

In the example above, the property is scheduled to produce 50% more cash flow than is necessary to pay off the in-place loan. This would be a ***conservative*** DSCR. Most banks require a DSCR ratio of 1.2 to ensure cash flow is sufficient to cover loan payments on a continuous basis.

It is important to remember that real estate never produces the originally projected results. The actual returns will always be higher or lower. In order to compensate for this, investors should conduct a sensitivity analysis with the DSCR, so that they can anticipate how the DSCR responds to changes in the performance of the property.

FOR EXAMPLE:

- What happens to the DSCR if the property's physical occupancy drops by 10%?
- What happens to DSCR if the average price/square foot decreases by 10%?

When you conduct this sensitivity analysis, if you are utilizing a conservative DSCR, the property's income will still have enough padding to pay the debt service and provide cash flow to investors. However, if the sponsor is utilizing an overly aggressive leverage point, these changes in the property's performance could eliminate the cash flow and potentially put the DSCR below the 1.0 mark. This would mean the property would be cash flow ***negative*** and would require additional external capital in order to keep the debt payment in good standing and avoid foreclosure.

Remember, the ***higher*** the DSCR, the more ***conservative*** the leverage point. One of the reasons value-add self-storage is a solid investment is that when the manager implements strategies such as raising rents, increasing efficiencies, and adding ancillary income, the property's NOI increases, and therefore, so does the asset's protection from problems related to its ability to repay the monthly mortgage.

Chapter 8 - Conclusion

As you can see from this eBook, the self-storage business requires considerable industry knowledge to be operated effectively. However, due to increased access to passive investment in high-quality commercial real estate via the crowdfunding structure, more and more investors are able to leverage top-tier operators' expertise with their investment capital. This is especially beneficial in an asset class like self-storage where the execution of the strategies laid out in this eBook is absolutely critical to investment success.

Chapter 8 - Conclusion

There is no need to be intimidated by the complexities of the self-storage business. With the knowledge you have learned here, not only have you become familiar with one of the most under-represented asset classes in the crowdfunding space, but you are also well on your way to effectively conducting due diligence on a real estate sponsor, making an educated assessment of whether they are conservative or aggressive by analyzing their assumptions. With this knowledge in hand, you may soon be enjoying the many benefits of investing passively in self-storage, receiving cash flow directly to your bank account.

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Chapter 8 - Conclusion

Keep in mind, that because the market, legislation, and supply/demand for businesses are in constant flux, educating yourself on alternative investments will be never "complete." Even the titans in the self-storage industry only remain experts as long as they continue their dedication to learning and adapting to new information and changing market conditions

One of the best ways to remain ahead of market trends, get advice from industry leaders, and learn about different asset classes is to subscribe to the **MAJESTIC VISION LLC – Real Estate Podcast** on **iTunes, SoundCloud**, or **Stitcher**. These podcasts cover virtually every type of real estate transaction that exists and include discussions with some of the leading sponsors, managers, and investors in the office, retail, multi-family, self-storage, and mobile home park business.

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Chapter 8 - Conclusion

Another way to further your education is to ensure that you are signed up as an investor with **MAJESTIC VISION LLC**. If you have not yet done so, make sure to create an account and verify your status as an accredited investor (if applicable), in order to receive our educational newsletter.

Our team is dedicated to educating our investors. If you have any questions about investing in self-storage, or otherwise, don’t hesitate to contact us at (904) 906-4973 or **kahseim@themvproperties.com**

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Chapter 9 - About the Author

KAHSEIM TUCKER

Kahseim Tucker is a full-time real estate investor and founder of Majestic Vision LLC. Being from the sunshine state of Miami Florida and an experienced professional real estate investor, Kasheim Tucker recognizes and values the trust his clients instill in him to meet their expectations far and beyond their standards. Kasheim Tucker and his team understand what that means every day.

Prior to entering the real estate space, he served his country in the United States Navy for 7 ½ years with several deployments and exited with an Honorable discharge. Afterward,
he spent over 20 years as a licensed locomotive engineer on a Class 1 railroad and owned his own business.
Owning his own business gives him the pleasure and joy of serving clients during difficult times of their lives which provides leadership and guidance. These experiences instilled in him give him the discipline to build the most professional real estate business in Florida. His team and himself, strive for excellence and know how to meet their client's expectations consistently.

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Chapter 9 - About the Author

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