MAKING THE GRADE

The ABCs Of Self-Storage Property Class

By Tammy LeRoy

The class A, class B, and class C grading of assets in self-storage real estate has long been a way of distinguishing between property types; but how, exactly, are those classes defined? Is age, size, amenities, or location of the property the biggest factor in determining property class? And, more importantly, are members of the industry on the same page when evaluating these assets?

Chris Sonne, managing director of Cushman & Wakefield's Self Storage Industry Group, says people speak of first- and second-generation facilities or class type without really providing a definition. Sonne prefers to think of product in terms of market conditions, and under-supplied local trade areas are best.

All Things Considered

Aaron A. Swerdlin, Senior Managing Director for Houston, Texas-based Storage Investment Advisors, LLP agrees that firm definitions of these classifications are difficult to nail down. "That's the million dollar question, and the basis of many arguments," he says. He also believes it is a common misconception that a beautifully built project with all the bells and whistles is a class A facility. "I couldn't disagree more," he says. "I start with the real estate and work from there. It's usually fairly easy to rehab a facility and bring the physical plan up a notch or two (from a C to a B or a B to an A). What is nearly impossible, however, is to take a bad location and make it a good one."

Swerdlin goes on to say that the facilities where the underlying real estate is high quality have experienced little value erosion, while facilities in secondary locations or secondary markets have seen 10 to 15 percent value erosion. Nonetheless, real estate isn't the only factor that differentiates facilities; the age, amenities, and condition of the property factor in as well.

Charles Ray Wilson, president of Pasadena, Calif.-based Self Storage Data Services, Inc. (SSDS), says that the final designation of property class is always relative to the market being analyzed. Variables also include age, architecture, parking, ancillary uses, and construction materials.

Swerdlin perceives different degrees of importance for these variables. "If someone forced me to identify the differences, I would rate the grades in the following manner," he says. "Twenty percent of the grade would go to the bricks and sticks; 10 percent would go to the age of the facility; 10 percent would go to deferred maintenance; 40 percent would go to the market in which the property was located; and 40 percent of the grade would go to the quality of the location. I can't imagine a way that would better mirror how the capital markets view the grading of self-storage facilities."

Class A Properties

Investors are most interested in class A facilities. In addition to physical features of a facility, visibility and location are important requirements for A facilities. Greg Kreizenbeck, CEO of Pacific Land & Investment, LLC, offers other qualifiers as well. "An A class facility offers the newest features, benefits, and amenities that the more demanding customer expects, and rental rates that are commensurate," he says. In addition, he says this property grade generally has an excellent lease-up history and is maintained to the highest standards.

"I think of class A as having an urban setting, being a relatively new facility with state-of-the-art fire, life, safety, and security amenities, and one that is aesthetically appealing," says Sonne. Another element of class A distinction is size. "Some say facilities under 50,000 square feet cannot be class A product," he

While there are pluses and minuses to standardizing self-storage property classifications, the bottom line is that investors will go where the cash flow is.

says. "This makes sense because there are management efficiencies in a larger facility: it costs less to run per square foot, so there is more cash flow."

In addition to location, and superior construction and management, Wilson adds to his own description that a class A property should have access to attract tenants who are willing to pay rents in the upper percentile of the marketplace, adding that you can't take a class C location and create a class A facility at that site.

Kreizenbeck says his company's StorSecure Self-Storage @ Hawaii Kai, located on the island of Oahu, is a prime example of a class A self-storage project. Why? "Outstanding location within a major metropolitan community, excellent visibility, and heavy drive-by exposure with convenient ingress and egress," he says, adding that it is also architecturally congruent with the surrounding environment.

Class B Properties

"Class B assets may be urban or suburban and are older (even up to 25 years), but in good condition," says Sonne. Many investors consider well-cared-for class B properties that need a few cosmetic changes good opportunities in the right markets.

Wilson notes that class B facilities, which he characterizes as having "average" locations, access, and visibility, compete at the low end of class A facilities. Security and construction, he says, ranges from average to good.

"To me, a B property may not be located in a major metropolitan community," says Kreizenbeck. "Visibility may be modest, typically a limited frontage site. The features, benefits, and amenities are limited. The design may be less attractive and dated." He adds that these may be quality properties but older, with rental rates lower than those of an A facility.

Class C Properties

Of all property classifications, class C probably evokes the most common stereotyped image. Nevertheless, some developers and investors are beginning to see the potential for rehabilitating these older facilities and bringing them up to class B status if the demographics are right.

"Class C assets are frequently older properties in need of repair or updating, often first-generation, single-level sites that may be unfenced, and they typically lack in the security features commonly found in newer assets," says Sonne. "Other considerations are unit mix and orientation (outside, inside, upper levels, and climate control)."

Wilson describes a class C property as having poor access and limited visibility, typically with growing functional and/or economic obsolescence. Often, there is deferred maintenance. A significant aspect of C properties is that rental rates are less than those of A or B properties. Some customers prefer the lowest-cost alternative, and with their lower upkeep costs, class C facilities adequately managed and in better than average condition can sometimes fill that niche.

Is Classification Necessary?

For Wilson, property classification is all about investor risk. In September 2006, he put a call out to the industry for the need to clarify these property classifications, which he believes is long overdue. On the SSDS Web site, Wilson published a brief summary of qualities that differentiate these classes, referring to definition guidelines used in other real estate associations. He invited others in the industry to reply, either agreeing with these guidelines or making suggestions for revision.

The response to Wilson's call from owner/operators, however, was minimal. Why? Wilson declines to speculate, but perhaps it is because many operators see a standardized classification a threat to the valuation of properties for sellers and for buyers seeking financing. What they deem as a class A property would hold less value if it became a B property under a uniform rating system.

"Appraisers are more interested in classification than anyone else at this point," Wilson says, noting, however, that older real estate sectors have used classification systems for decades. "The benefit is from an analytical standpoint," he says, "and eventually, it will come. In order for this industry to move forward and keep maturing, there has to be more transparency in it so that people can understand the nuances of the business."

Kreizenbeck illustrates how property type can affect a transaction even if the ROI on two properties is the same. "The characteristics of a class C property typically do not demand the same low cap rate as a class A property," he says, "therefore, the NOI capped by a lower rate demands a higher dollar value than the same NOI capped by a higher rate." For example, a buyer may be willing to invest in a class A property at a 6 cap, while a class C property might demand an 8 cap.

For example, if the NOI is the same for two properties at $1 million, a class A property capped at 6 leaves a corresponding property value of $16,666,667, and a class C property capped at 8 leaves a value of $12,500,000. "The bottom line is, the class A property demands a value of $4,166,667 more than the class C," says Kreizenbeck. Thus, 'classification' is important.

What really matters to self-storage investors in the end is buying a facility that promises to be profitable. "For example, a newer urban facility that is primarily interior upper units with climate control in an over-supplied market may not do as well as an older, suburban product that is single-level, outside access with no climate control in an under-supplied market." Sonne says. "It reminds me of the story of the famous bank robber. When asked why he robbed banks, he replied, 'because that is where the money is!' Self-storage is a cash flow business and smart investors go where the cash flow is, regardless of an arbitrary rating system."

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