

# Not-So-extreme MAKEOVERS

## Smart Investors Look At Class C Properties For Growth

By David Lucas

**D**espite a declining housing market that prompted a pause in the self-storage market in 2007, self-storage real estate remains an attractive investment for investors large and small. The industry's robust years brought more institutional investors into the field, and that trend continues as we enter 2008. With deep pockets, these investors have their sights set on Class A properties, which are typically newer, state-of-the-art facilities set in prime locations.

With the run-up in Class A prices in recent years, many operators and smaller investors have been priced out of the Class A category. Many

of these investors are left to pursue Class B and even Class C facilities that generally are older, first- and second-generation properties. These investors are analyzing these real estate types to determine the best turnaround candidates for upgrade. With a fresh coat of paint, some re-paving, and sometimes, a complete tear-down and renovation, even some of the unloved Class C properties are getting makeovers and commanding rents that can approach those of Class A facilities.

"The larger institutional players are more interested in buying Class A or Class B properties in markets where they need additional facilities, and they're shying away from 'C' properties

that are first-generation and early second-generation product because they take too much time and energy to bring them up to their standards," says Chico LeClaire, vice president/investments and senior director of the National Self Storage Group of Marcus & Millichap in Denver, Colo.

"You're finding entrepreneurs, local and regional players, and sometimes players who are crossing state or regional lines to buy these properties they think are well located," LeClaire says. "They improve them to the point where they can be competitive with some of newer products and still be able to offer units at discounted rates."

### Land Banking

Class C facilities are products of a time long, long ago when developers would survey an odd parcel of land, shrug their shoulders and say, "I guess we may as well throw up some self-storage on this acre until something better comes along."

This practice of "land banking" was prevalent in the early days of self-storage about 30 years ago, according to Steve Mellon, senior partner with Houston, Texas-based Storage Investment Advisors. "Typically, a Class C facility was created to generate minimal income until the piece of property was worth more and could be redeveloped," he says. "The Class C product does not have the retail feel of a newer facility. A lot of self-storage facilities were created with that feel 30 years ago, basically developed on a piece of land almost as an afterthought, and not intended to be the highest and best use from day one."

Turning this type of real estate into anything resembling a Class A facility is difficult, and the circumstances have to

be right to attract investors. Sometimes, the facility is near a major artery but its entrance is out of the way and easily overlooked. With the housing boom in recent years, the demographics of an area may change as more affluent home buyers enter a neighborhood. Sometimes these properties are just tired and need a fresh coat of paint and some bright lights to become attractive. Then again, some are just ugly ducklings.

Like other real estate, self-storage is all about location. "You can't change the location," says Maurice Pogoda, president of Farmington Hills, Mich.-based Pogoda Companies. "Most properties that were grade 'C' locations years ago haven't necessarily gotten better; the demographics haven't traveled to them."

Mellon adds, "You still have to have the demographics in place to account for redeveloping a facility. If the demographics have been the same for 30 years and not changing, there's probably a reason why no one has built a newer facility in

that area. You can construct a nice facility but if the demand isn't there, you're going to be suffering."

However, with the right location and market conditions, older Class B and Class C properties can attract investors. "One major contributing factor is a market area that is undergoing a transition," Mellon notes. "If a property was built 30 years ago in some industrial part of the city and over the years, you're seeing buildings being torn down and turned into condos, apartments, and housing developments, then you'll see an investor servicing the new demographics coming into the neighborhood."

Pogoda Companies actively seeks candidates for makeovers, but generally above the Class C category. "We're looking for the right location because ultimately that's the real key," Pogoda says. "Even a property in poor condition in the right location will probably still do well. We're trying to find diamonds in the rough or a worn property where the

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owner has gotten tired and let the property get tired.”

Pogoda has a general profile of a good upgrade candidate. “We’re looking for good, solid, retail-type locations with major road frontage, high traffic counts, high density, and hopefully, the best location in that marketplace even though the property may be old and tired,” he says. “We’d rather search for those than buy older properties in ‘C’ locations because some of that is sheer obsolescence.”

### Penciling Out

When a makeover candidate is discovered, the developer must weigh the costs of acquisition and upgrades against the higher rates that can be charged in that market to determine if the project will ultimately make economic sense.

“If the property needs paving, a new gate system, new fencing, new doors, paint, and roofs, when all is said and done, you’ve got to say, ‘What are you buying here?’” Pogoda says. “Do the numbers make it so that when you add all those improvements, you’ll still get a rate of return that is acceptable? That means buying properties right rather than overpaying for them.”

Pogoda is in the market for value properties that complement his company’s current portfolio, regardless of how the real estate may appreciate in the short term. “We don’t necessarily look for it to pencil out,” he says. “We’re looking for it to be a long-term hold. As long as when we make our improvements, we still get a rate of return that we are seeking. It might not necessarily be worth doing to the average person, but for us to keep within our corporate and quality image we’re looking for, we’ll be willing to make those improvements to have the type of product we want in our portfolio.”

Pogoda was involved in 10 acquisitions in 2007—an unusually high number—but economic conditions and the right opportunities existed. “Right now, in Michigan, we have economic issues that have lasted for a long time,” he explains. “People started to wonder how much longer they want to stay in this kind of economy. Since we are in it for the long haul, we’re willing to buy at depressed

prices and hold onto them. We’ve got the financial wherewithal to do that.”

The company holds 40 properties with three million square feet and Pogoda is still searching for other candidates for makeovers. “We’re looking to expand elsewhere; we’re just looking for the right opportunities,” he says.

Store House Co. President Don Tolva is another developer who has found a niche in upgrading self-storage facilities. Tolva began buying self-storage properties in 1988 to complement his apartment, condominium, and strip center developments. For the past few years, he has dedicated his energies exclusively to self-storage. He currently owns two self-storage properties, but he has bought and sold over a dozen.

“Frankly, it’s hard to find properties that meet my criteria,” Tolva says. “I want them where I can either have vacant land to expand on or I want to be able to go in and tear down buildings and build multi-story or exterior access climate control.”

Before making a large financial investment, the facility must show a promise to generate higher rents. Tolva is looking to take an \$8 rent and turn it into a \$12 rental, for example. “If you get all the right factors, they pencil out extremely well—as well as a new development,” he says.

Tolva also looks at other factors such as a location on a busy street in a metro area outside the heart of a city. Competition is another important component in the equation.

“Is the competition asleep at the wheel or are they very aggressive?” Tolva says. “I want them to be aggressive; I don’t want them asleep at the wheel. If it’s mom and pop asleep at the wheel, maybe I can’t raise rents quite as well. I want the big REITs next to me because I know I can beat them because I’m small.”

One important factor investors should consider before taking on self-storage redevelopment is the distance from their base of operation, because this kind of project requires considerable hands-on



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attention. "I would want to be within driving distance, because the biggest issue with Class C property is maintenance," Mellon says. "An investor is going to have to roll up their sleeves and do more work on those properties and that's hard to do unless you can get to them easily."

Headquartered in Oak Brook, Ill., the Store House develops properties primarily in Georgia and Indiana. A convenient,

inexpensive way to travel to the property is paramount for Tolva. "We do a lot of things out of state so [I look for] a reasonable airline that gets me there fairly easily," he says.

### Cosmetics Versus Renovation

Putting a new face on an old self-storage facility can run the gamut of simple cosmetic changes or minor renovation all the

way to tearing down existing buildings and putting up new structures. "Sometimes it's as simple as painting," Pogoda says. "Sometimes it's more expensive, where we're going in and repaving, we're replacing doors, and we're reconfiguring to add climate control. We're looking at the construction quality in an older property, whether it will lend itself to easily being refurbished or whether it's tearing down and starting again. Then, of course, it's a question of whether you are getting it at the right price to be able to afford to tear it down."

Experienced entrepreneurs who bottom-feed on Class C properties can make a nice living finding lowly Cinderella candidates and turning them into the belles of the ball. "The investors that are experienced purchase a Class C product and incorporate enough changes to where it's almost a B property," Mellon confirms. "A typical example is tearing down the front building, putting up a nice, climate-controlled building, and totally redeveloping the front office. When you drive by the site, it looks like a Class B facility even though 75 percent of the buildings are original."

Pogoda Companies has taken this approach with some of its redevelopments. "With a lot of older properties, what we'll do is go in and tear down a number of buildings and build a multistory building in front," Pogoda says. "That will upgrade the entire property and just put a coat of paint on the rest of it."

Tolva may purchase an 80,000-square-foot facility and add another 20,000 square feet of climate-controlled space to it. On one property the Store House built 108 10-by-10 climate-controlled units to go along with other renovations. "Those new climate-control are doing extremely well, and we'll probably add some more," he says.

### New Kid On The Block

While adding one or two new buildings readily identifies an older facility as a new kid on the block, sometimes a few cosmetic changes will turn a wallflower into a beauty holding a full dance card. Just a different color may be all that is required. "I'll pick a slightly brighter white just so it looks different," Tolva confirms. "That



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kind of stuff is cosmetic, but we also do other things. In an existing property, we used a slightly different color so people think of it as a different facility. We came in and insulated the ceilings, came in with HVAC units, and put up garage doors. Everything else was cosmetic.”

When he replaced traditional roll-up doors at one facility with garage-style doors and automatic openers, they became popular with tenants. Store House managers rent many of these units simply by demonstrating the automatic garage doors.

Another feature that attracts attention to his redeveloped properties is the marketing window, which is a floor-to-ceiling retail window that lets passersby see into the self-storage facility and view specialty items for sale.

“We’ll think of a way to put in marketing windows because people like to see our lights,” Tolva says. “We leave the lights on at night and it’s like a beacon. We’ve got to bring people in with the razzle-dazzle of a different color, different

signs, and lights. Once they’re in, we can get that \$12 rent.”

Marketing windows give the Store House a form of advertising with the added benefit of bypassing local sign ordinances.

### Learning Experience

For investors who have real estate experience and want to enter the self-storage business, a Class C facility may be a good starting point. “It’s a good way for the first-time investor to get into a self-storage facility and learn the business and make decent cash flow,” Mellon says. “Class C property is a good stepping-stone for an investor to learn and understand the storage business with lower risk compared to jumping into a \$6 million, Class B property.”

Newcomers typically will buy a self-storage property for \$1 million to \$2 million to enter the business, whereas a middle-of-the-road Class B facility might require \$4 million.

“Why not get into a smaller facility, learn the business, while earning money?” Mellon asks. “As the investor gains a better understanding of the business, earns a track record, and learns the financing angles, they will be more efficient on the next few storage deals they purchase.”

In most cases, investors must be ready to ride out the facility for the long haul because “flipping” the property and selling it within one or two years is usually not feasible.

“Do not expect to purchase the facility for \$1 million and sell it for \$3 million five years from now,” Mellon says. “Are they going to hit a home run? Probably not. They’ll make eight percent, nine percent, 10 percent return a year, but they’ll get a great education.”



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