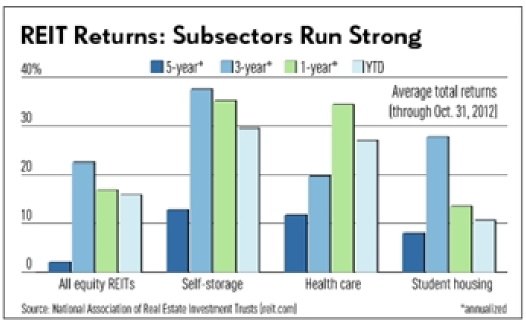
Self-Storage, Other Niches Draw Real Estate Investors

By JOE GOSE, FOR INVESTOR'S BUSINESS DAILY
Posted 12/27/2012 03:42 PM ET



View Enlarged Image

Hunting for stable and predictable income, institutional investors and real estate investment trusts have moved beyond mainstream commercial real estate sectors. They've been expanding their holdings of things like self-storage units, student housing communities and medical office buildings.

It used to be that these alternative niches mainly attracted small local and regional investors. But the market for them has grown tens of billions of dollars bigger than it was seven to 10 years ago, analysts note, although it's still fragmented. And today, they say, it has two to three times the number of professional investors as then.

Many such investors looked at how these assets muscled through the recession, and then jumped in.

REITs in the space have yielded substantially better returns than equity REITs overall in the last five years, industry data show. And demographics have driven alternative asset performance more than the economy has, says Christopher Merrill, CEO of Harrison Street Real Estate Capital, which specializes in niche properties.

"Many are attracted to our sectors as they offer steady performance in downturns and thus can provide diversification by offsetting the cyclicality that the market has seen in traditional real estate portfolios," said Merrill, whose Chicago firm has $4 billion in assets under management. "At the same time, these sectors produce yields that are 150 to 200 basis points higher than traditional property segments, so there is a very attractive risk-return proposition."

Money In The Markets

From 2004 to the end of this October, the market capitalization of health care REITS grew more than 300% to about $67 billion, according to data from the National Association of Real Estate Investment Trusts. Meanwhile the market cap of self-storage REITs has tripled to $30 billion. And while there were no publicly traded student housing REITs at the end of 2004, NAREIT data show now there are three with a total market cap of $5.8 billion.

IBD's Finance-Property REIT industry group ranks just No. 141 of 197 groups tracked. And all equity REITs generated an annualized average total return of just 2% over the five years ended Oct. 31, according to NAREIT. But its data show niches outperforming: Student housing REITs saw an average of 8%, as trusts in the health care and self-storage areas had average returns of 11.7% and 12.8%, respectively.

Why are yields higher? Merrill notes that some 70% of college students need off-campus housing and aging Baby Boomers need health care. Self-storage has benefited from the steady thrum of marriage, divorce and other life events — not to mention moves from houses into apartments after the housing bust.

Storage was one of the most resilient asset classes in the downturn, given its low cost and need-based nature, Merrill says. Demand "comes from downsizing" as the population ages, he adds, and areas with a "high percentage of renters."

But he notes that about 30% of demand comes from business users who find storage a low cost way to run their operations.

Growing competition, Merrill acknowledges, has driven down capitalization rates, a measure of a property's initial yield that falls as

Public Storage is the largest self-storage REIT in IBD's Finance-Property REIT industry group, while Extra Space Storage is the top-rated one. AP View Enlarged Image

prices rise. Generally top properties in the best locations across all three niches trade for a cap rate of roughly 5.5% to 6.5%, observers say, while lower-quality real estate and smaller-market assets have higher rates.

Sales of medical office buildings in 2012 exceeded $5.2 billion through mid-December, a year-over-year rise of 66%, according to research firm Real Capital Analytics. Additionally, some $3.3 billion of student housing properties have changed hands through mid-December, a year-over-year hike of 30%.

Real Capital doesn't track self-storage transactions, but officials at property brokerages **Jones Lang LaSalle** (JLL) and Marcus & Millichap report brisk activity. Over the last few weeks alone, an affiliate of New York-based **W.P. Carey** (WPC) paid $58 million for seven self-storage properties in Tampa, Fla., and west Texas, in two separate transactions.

Other REITs that specialize in the property type include **Extra Space Storage** (EXR), **CubeSmart** (CUBE) and **Public Storage** (PSA).

How investors execute their strategies varies according to the sector.

A lot of small suites and small tenants characterized medical offices in the past, for example. But industry consolidation driven by mergers between doctor groups and hospital acquisitions of doctor groups are creating bigger and more stable medical office tenants, says Mindy Berman, a managing director with Jones Lang.

Subsequently, medical office buyers have tended to emphasize finding modern buildings leased by quality providers across most markets, she says. Publicly traded **Ventas** (VTR) and **Duke Realty** (DRE) REITs, as well as nonlisted Griffin American Healthcare REIT II, have been the most active buyers of medical office properties over the last 24 months, according to Real Capital.

Institutional buyers of self-storage units, however, are generally targeting high quality properties in major metros. Those big owners control as much as 50% of the properties in the top 20 markets, estimates Charles "Chico" LeClaire, senior director of Marcus & Millichap's self-storage group.

Historically mom-and-pop or other small investors owned about 80% of the properties, and it's still that way in smaller markets, he adds, but likely not for long.

"Secondary markets are probably where the next big push of the institutions will be," LeClaire said. "They've pretty much gobbled up all the recently available product in primary markets."

Steve Mellon, a managing director with Jones Lang, also anticipates more activity in smaller cities, particularly by self-storage REITs that already have a presence in a market.

"They're under lots of pressure to grow, so they're not in the mood to sell off product," he said. "If they own a substantial amount of property in a city, then they will always try to add more in that city."

In some cases, institutional investors are teaming with local self-storage operators to find expansion opportunities. That's giving local operators a chance to branch out — after most were stuck at three to four properties 10 years ago, he adds.

School Rules

Active buyers of student housing in the past 24 months include **American Campus Communities** (ACC), **Education Realty Trust** (EDR) and the private equity arm of Kayne Anderson Capital Advisors, among others, according to Real Capital.

Student housing earned more confidence from professional investors as the properties kept high occupancies during the economic downturn, says James Tramuto, a managing director with Jones Lang. It indicated that while parents chose cheaper universities, they still housed their kids in high-end apartment communities that often have furnished bedrooms, pools, fitness areas and other amenities, he says.

"There was a big concern when we moved into recession that parents would have dialed back the amount of money they were willing to pay for nice fancy housing, and it didn't happen," he said. "We saw really nice properties do just fine."