Chilton
Capital
Management

1177 West Loop South, Suite 1310
Houston, Texas 77027

TELEPHONE: 713 650 1995
FACSIMILE: 713 650 1739
TOLL FREE: 800 919 1995

info@chiltoncapital.com
www.chiltoncapital.com

For further information,
direct inquiries to Christopher L. Knapp,
Chief Executive Officer
800 919 1995 or by email:
info@chiltoncapital.com

What's Behind the Self Storage Door? Cash Flow! | June 2013

In May, US equity REITs reported strong earnings as most companies beat or raised guidance. However, comments from the Fed about tapering quantitative easing sooner than the market expected pushed up interest rates, bringing the 10 year US Treasury note yield to 2.16% as of May 31, 2013, up from 1.63% on May 2. REITs took a hit soon after Mr. Bernanke's speech, with the MSCI US REIT Index (RMS) finishing the month down 5.9% despite being up 3.9% month to date as of May 21. Year to date, the RMS is up 8.5%, while the S&P is up 15.4% after posting a +2.3% return in May.

All Properties are Not Created Equal: Self Storage Focus

The self storage industry has long been America's 'dirty little secret'-ly awesome investment that has rarely received the credit it deserves from the public markets. Certainly not the 'sexiest' property sector, the most interesting thing that has ever happened to self storage has been the popular TV reality series 'Storage Wars'. However, in its simplicity lies under-appreciated cash flow. Needing little more than a broom and an onsite employee or two after being built, the self storage sector enjoys some of the highest operating margins (typically over 65%) found in commercial real estate upon stabilization. The profitability is even more impressive considering that the turnover rates are extremely high for storage operators. It is normal for only 50-60% of customers to remain for over one year. Another enticing attribute of the business is the growth in ancillary income — principally, property insurance sold to customers that generated over $150 million in operating income in 2012 for the publicly traded self storage REITs.

Chilton Overweight to Self Storage

We are overweight the self storage property sector due to many compelling benefits ranging from solid growth in net operating income, low capital expenditure requirements, and enormous economies of scale. The internet has been a game changer for this property type in recent years as advertising via "The Yellow Pages" has essentially been replaced with the power of computers. In the process, it has given the public companies enormous advantages over private entities that lack the resources to compete with the internet presence that exists with all of the public storage REITs. For example, the largest single owner, Public Storage (NYSE: PSA), spent over $15 million with Google in 2012. This is just one small facet of the new face of lead generation/customer focus that includes sophisticated call centers, internet search engine optimization, social media (such as Facebook and Twitter), call tracking technology, and revenue management systems. As we illustrate in Figure 1, the storage REITs have produced superior total returns for shareholders relative to the MSCI US REIT Index using one year and five year comparisons.

Self Storage Industry Overview

Storage units come in a variety of sizes, but the average unit is essentially a 10' x 10' box with annual rent of about $100 per month and up, depending upon location. Concessions on rent or a free moving truck are used to entice the potential tenant into getting into the unit. Once there, the average renter *plans* to stay for 3-6 months, but *actually* stays 9-12 months. Rent increases occur every 9-12 months. About half of the tenants are on auto-pay, so tenants are left with a decision to either spend a day moving items from one unit to another (or back home), or accept the $5 or $10 extra per month. For any of our readers out there that may be experiencing the above situation, just know you are not alone.

According to the Self-Storage Almanac, there were 50,859 storage facilities in the US in 2012. The average size for most facilities is 600 units that encompass about 70,000 sqft. Self storage facility ownership remains highly fragmented. The top ten self storage companies owned about 11.4% of total US self storage properties. The top 50 own only 15.1%. There are

FIGURE 1: SELF STORAGE REIT OVERVIEW

Company Name	Ticker	Price	Facilities	Real Estate at Cost ($billions)	Market Cap ($billions)	Median 3-Mile Population	Median 3-Mile Household Income	Total Return 2012	Total Return Last 5 Years***
Public Storage	PSA	$166.93	2,267	$11.1	$28.8	96,000	56,000	11.3%	18.4%
ExtraSpace	EXR	$44.42	861	$3.4	$5.0	94,000	57,000	54.4%	25.9%
CubeSmart	CUBE	$17.22	514	$2.4	$2.3	79,000	55,000	41.8%	13.3%
Sovran Self Storage*	SSS	$70.80	461	$1.8	$2.2	184,000	62,000	50.8%	15.3%
Average**						**89,667**	**56,000**	**39.6%**	**18.2%**
MSCI US REIT Index								**17.8%**	**5.6%**

*SSS provides only 5-mile median population and household income

** Median 3-mile population and houshold income averages exclude SSS

***Annualized as of 12/31/2012

SOURCE: GREEN STREET ADVISORS, COMPANY REPORTS AS OF 12/31/2012 AND 3/31/2013. PRICES AS OF 5/20/2013

four public equity REITs that specialize in the space and collectively own or manage 4,103 properties or 8% of the total. The small ownership share by the REITs bodes well for further consolidation of this industry. Last year, the four REITs acquired $1.6 billion of existing facilities. Given the REITs' access to low cost capital and the economies of scale, acquisitions should remain the principal growth driver for years to come.

New Supply at Historical Lows

In contrast, development of new properties is at historic lows, especially in the better submarkets where the REITs are active. The average annual supply growth (as measured by the number of facilities) between 1994 and 2008 was 6%. Since then, it has dropped to 2%. Convenience and price are high on the list of consumers in selecting a storage unit. Barriers to new supply are numerous including higher land prices, rising construction costs, and the 2-3 years it takes for a new property to become cash flow positive. For the private developer, construction financing can be difficult to obtain and expensive. Accordingly, most of the REITs (who have easy access to capital) are consistently upgrading existing locations by adding climate control, enhancing security, expanding the number of units, and augmenting space for ancillary services such as truck rental and merchandise sales. Returns from redevelopment and ancillary operations typically equal at least 10% and represent one of the best uses of capital.

Above Average Demand Growth

Population density is the key driver for success of a storage facility. Demand, which has been consistent in a strong economy, has also been resilient when conditions have weakened. Public Storage notes in its 2012 Annual Report that the key reasons people use self storage has remained the same for the past 40 years— the four D's: downsizing, divorce, death, and dislocation (job transfer, layoff or natural disaster). Its large portfolio is a good proxy for industry statistics. Since 1995, the average occupancy has been 90.4% with the lowest number of about 85% in 2003. Even during the 2008-09 recessions, occupancy was above 88%. All of the public self storage REITs had occupancy rates above 86% for the quarter ended March 31, 2013, which was exceptionally high compared to historical first quarter numbers.

The combination of limited new supply and high occupancy rates coupled with slow improvement in the economy suggests rental growth should be better in 2013 and 2014 than the 3% average change over the past 20 years. Accordingly, estimates for earnings growth or AFFO (adjusted funds from operations) should be above REIT industry averages and equate to about 9% annually over the next two years. Leverage ratios for the storage group are significantly below industry averages due principally to PSA which sports a leverage ratio under 20%. The excellent track record and good fundamental outlook has not been lost on investors which have bid stock prices to levels above estimated net asset values (NAVs) by about 50%. We believe the cap rate of 6.6% used by many analysts to produce NAVs is too high given current interest rate levels and the quality of the assets held in REIT portfolios. At 5%, stock prices would be in line with net asset values per share.

The Self Storage REITs

The publicly traded self storage REITs are Public Storage, Sovran Self Storage (NYSE: SSS), ExtraSpace (NYSE: EXR), and

FIGURE 2: SELF STORAGE REIT VALUATION AND BALANCE SHEET METRICS

Valuation Ratios as of 5/20/2013 Company Name	Ticker	Dividend Yield	Dividend / 2013 FFO Payout Ratio	Implied Cap Rate	Price/2014 FFO	Price/2014 AFFO	NAV Premium	Debt+ Preferred/ Gross Asset Value	Net Debt+ Preferred/2013 EBITDA
Public Storage	PSA	3.0%	71.1%	4.7%	21.8	23.4	50%	15%	2.4
ExtraSpace	EXR	3.6%*	83.4%*	4.9%	20.3	22.0	53%	34%	7.1
CubeSmart	CUBE	2.9%	52.0%	5.5%	19.3	22.3	36%	42%	7.0
Sovran Self Storage	SSS	2.7%	54.9%	5.6%	19.8	22.3	42%	29%	5.9
Average		**3.1%**	**65.4%**	**5.2%**	**20.3**	**22.5**	**45%**	**30%**	**5.6**
Bloomberg REIT Index		**3.2%**	**61.0%**	**5.5%**	**17.4**	**21.0**	**28%**	**39%**	**7.0**

*Based on annualized dividend to be declared on 6/12/2013

source: Green Street Advisors, Chilton Capital Management research & analysis, company reports as of 12/31/2012 and 3/31/2013

note: Bloomberg REIT index statistics are market cap weighted according to Chilton Capital Management except NAV premium which is from Green Street Advisors. SSS valuation metrics are according to Chilton Capital Management, while PSA, EXR, and CUBE are from Green Street Advisors.

CubeSmart (NYSE: CUBE). Given that the 'look and feel' of a storage facility is not very important (if at all) to a tenant, there are subtle differences between the companies that have had outsized influence on same store growth and total returns historically.

Public Storage

Public Storage owns more storage units than the other three storage REITs combined. In fact, its brand identification is enormous with the public at large—a rare attribute for a real estate company. PSA has a market capitalization of $28.8 billion and is the second largest REIT in the MSCI US REIT Index. PSA is a member of the S&P 500 index and is one of the largest landlords in the world with over 1 million tenants. Remarkably, PSA has virtually no debt at the property or entity level; the company funds itself (almost) completely with perpetual preferred stock and excess cash flow. Since 2000, PSA has raised a mere $250 million in common equity, therefore minimizing dilution of shareholders. In contrast, PSA has been the leader among equity REITs in preferred equity by raising $8.9 billion over the same period, of which $3.6 billion was outstanding as of March 31, 2013.

As shown in Figure 2, PSA is the most expensive of the four self storage REITs. However, PSA boasts the highest median 3-mile population average at close to 96,000. From 1994 to 2012, PSA has averaged same store net operating income (SS NOI) growth of 4.1%, which compares to the REIT average of only 2.4%. Green Street Advisors projects SS NOI growth to average 4.6% annually from 2013 to 2017, versus only 3% for the average REIT. Importantly, PSA retains a significant portion of that growth as it averages only 5.4% of NOI spent on maintenance capital expenditures versus 12.0% for the average REIT. The PSA management team is easily one of the most well-respected management teams in all of REIT-land. This may help to explain why PSA trades at a 50% premium to NAV as of May 20, 2013.

ExtraSpace Storage

With 642,000 units under its umbrella (including management properties), EXR is the country's second largest self storage company after Public Storage. Not to be outdone, the EXR management team has put together a track record of value creation from June 2006 to June 2012 that is second to none, according to Green Street Advisors. MVA, or Management Value Added, is the difference between the change in Net Asset Value (NAV) and the price appreciation (or depreciation) at the property level, including leverage. During that 6 year period, EXR management capital allocation decisions added 28%, the most of all REITs included in the study. In second place was PSA with 19% MVA.

By most metrics, EXR is the second most expensive self storage REIT. However, EXR maintains the second highest median 3-mile population density at 94,000, and the highest median 3-mile household income at $57,000 (versus PSA at $56,000). EXR has a market capitalization of $5.0 billion and is included in the S&P 400. EXR's high quality balance sheet and management team help to explain the 53% premium to NAV that the public has ascribed to the stock. In May, EXR announced a 60% increase in their dividend, which equates to a yield of 3.6% using the stock price on May 20. This took EXR from the lowest yielding storage REIT to the highest yield. We expect similar increases in dividend payouts from the other storage REITs.

Sovran Self Storage

Sovran, operating under the name Uncle Bob's Self-Storage, owns or manages approximately 270,000 self storage units. Although SSS was not a part of the MVA exercise by Green Street, SSS management does maintain a solid reputation in the REIT sphere, trading at a 42% premium to NAV as of May 20. According to the pricing metrics in Figure 2, SSS is fairly cheap relative to EXR and PSA. However, same store rents per occupied sqft for the first quarter 2013 averaged $13.80 for EXR and PSA, compared to $10.61 for SSS. Geographic dispersion helps explain the lower number for SSS inasmuch as 40% of its portfolio is located in two states: Texas and Florida. Furthermore, California is a top market for the other three storage REITs while it nonexistent in Sovran's portfolio.

Sovran believes the 5-mile median statistics are more representative for the trade areas of their properties than the 3-mile numbers. As such, their numbers are not comparable to the other REITs. However, we can glean that Sovran's portfolio is located in fairly dense areas with above average median income. SSS and EXR were two of the top performing REITs in the MSCI REIT Index in 2012 as they closed the gap in valuation ratios with PSA.

Cube Smart

Founded in 1996, CubeSmart made its initial public offering at $16.00 in 2004 under the name U-Store-It and ticker 'YSI'. CUBE changed its name to CubeSmart from U-Store-It in 2011 in an effort to differentiate it from other mom-and-pop owned facilities with similar names. CEO Dean Jernigan has been at the helm since 2006, and has been responsible for some controversial decisions. In particular, a large, expensive acquisition of a storage portfolio in New York City, concurrent with a dilutive equity raise has cast a shadow over the company for now. As a result, CUBE trades at the lowest NAV premium in the group.

However, it still does trade at a premium due to the positive growth trend industry-wide and in particular for the public REITs. CUBE's 3-mile metrics have been significantly boosted due to the NYC exposure, and the equity raise substantially helped the balance sheet to be more inline with the index. Going forward, we expect earnings growth to be close to the average for the sector, and the below-average payout ratio could be indicative of a dividend raise.

A Good Store of Value

In a space where a tenant does not discriminate on appearance, the operations management and capital allocation decisions are extremely important. Unlike an office or a shopping center REIT, a new façade or a spruced up lobby is not going to affect a tenant's decision. Unlike the apartment sector, a tenant is on a month-to-month lease and can leave at any time. Smart marketing via the internet, signage, and call center effectiveness can sway a tenant one way or the other. Keeping cost of capital low and balance sheet flexibility high can alter the outcome of an acquisition pursuit. The dispersion in returns between the storage REITs indicate that these small nuances can make a big difference in dollars for shareholders. Though we believe the self storage sector will continue to grow rents at an above average rate, we strive to find the management teams that can gain a small advantage that could result in higher earnings growth and better balance sheets *before* it shows up in their earnings reports.

Matthew R. Werner, CFA
mwerner@chiltoncapital.com
(713) 243-3234

Bruce G. Garrison, CFA
bgarrison@chiltoncapital.com
(713) 243-3233

RMS: 1389 (5.31.2013) vs. 1280 (12.31.2012) vs. 1087 (12.31.2011) vs. 1000 (12.31.2010) vs. 792 (12.29.2009) vs. 933 (9.30.2008) and 1330 (2.7.2007)

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

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

C