The Art of Passive Income Podcast
With Mark Podolsky, AKA The Land Geek

Today's Guest: Scott Krone

Transcript

Mark: Hey, it's Mark Podolsky the Land Geek with your favorite nichey real estate website www.TheLandGeek.com and today's guest is really going to be interesting for most listeners because we don't really talk about this asset class very often and I'm really excited about it. My cohost, Scott Todd, is not available today so we are just going to get into. Today's guest is Scott Krone, from Coda Management. So, if you don't know Scott, he is the founder of Coda Management group and Coda Management Group teams up with investors to purchase strategically located, undervalued warehouse space and convert it into climate controlled self-storage facilities and they are a top three operator. So this is really, really an interesting asset class. I can't wait to get into it and get into the weeds with Scott Krone. Scott Krone, how are you?

Scott Krone: I'm doing well. Thanks for having me, Mark, I appreciate it.

Mark: Yeah. So you've been doing this a while, haven't you?

Scott Krone: I started Coda 20 years ago, but I've been involved with real estate investing for about 25 years now.

Mark: So Scott, you wake up one day and you're like, okay let's do this. Like how does that even come to be?

Scott Krone: On real estate and self-storage?

Mark: Well, taking an undervalued warehouse space and converting it into climate controlled self-storage.

Scott Krone: Got you. You're right, it's not like one day you wake up and you're like, I just want to build lockers, right. It's not the most sexy real estate investment out there in terms of appearance but it's a gradual progression. I began my career doing multifamily, working for a top 20 developer in the country and got to really see the ins and outs of larger real estate deals up to a $100 million. So, as I started Coda obviously I didn't have that bandwidth but we began doing multifamily and smaller mostly single-family and smaller multifamily projects and mixed use. And then the crash came in '08 - '09 and we began buying into the commercial realm and that's when we began seeing that there we some real inefficiencies within the self-storage arena in terms of new products coming online, and there were some market discrepancies that we could take advantage of. So, to me it's apartments without toilet's, it's a more simplified version of it, so our cost basis is about 10th of what it would take to do apartments or multifamily. So, there's a lot less risk and so we can analyze the market in a lot more specific, tangible results. So, that way we can make sure that our products are going into healthy markets.

Mark: Yeah really, really interesting. Self-storage is one of this interesting asset classes that we all see it on the inside of the road, I mean, everyone is kind of familiar with Shurgard and some of these bigger players. I think what most investors don’t realize is that, it is the safest asset class in real estate. It has the lowest default rate of all asset classes and interestingly enough second is mobile home parks. Did you know that Scott?

Scott Krone: We did. This is one of the reasons why we started and looked into it. It is because of the fact that we're not confined by a lot of the tenant regulations and laws in terms of evictions and those sorts of things. So, it's we can base the price pretty fluidly you know, what is going on in the market place. So, it's a lot easier to get leased up, it's a lot easier to manage on a daily basis because there’s just not as much headache to deal with. So, our cost basis on multifamily might be 45-55% of your economics or like a 35 to 40%. So we inherently have a cost basis differential right there.

Mark: I love it. Is it fair to say that in the way that you acquire the warehouse space and then do the conversion that the value is really in that piece as opposed to let’s say, I'm going to go create a syndication for multifamily and really if I'm going to buy C Class apartment building and upgrade it to B and do a value add, that way the money is kind of... You know, finding the deal is one aspect but really money is going to drive that. So, I'm the investor it's like well, the money is really driving this deal. I think you could make the argument that in your asset class management really drives that deal. Is that fair to say?

Scott Krone: I believe so, because of the fact that when we are taking the building and repurposing it, we'll buying it well below replacement cost. So, if I'm comparing our building to a brand-new building one where it's 65% cost valuation. So, we can enter into a market knowing that we can effectively undercut the pricing to get people in there because of the fact that we have a margin of 35% in there because of our cost basis. So, for us that's a huge competitive advantage if we're comparing our product to new self-storage we're coming in significantly below replacement costs. I mean the last building we bought, we bought it for $11 a square foot and it's a five-storey building. I just can build a building for $11 per square foot.

Mark: That's insane, that's insane. So, given your expertise what's some of the biggest mistakes you see people making in self-storage?

Scott Krone: Well, you know I can't speak to everybody, the thing that drives self-storage is really not if it's a growing economy or recession economy. You know, self-storage will thrive on either one. In fact some will argue that it even does better in recession market. We've seen greater CAP compression on the purchase of self-storage facilities in recession rather than in a growth period. So, the biggest factor is saturation. When I see people going into a market that already has a tremendous amount of self-storage products and very saturated market that is going to delay your lease up period, it's going to hurt your pricing, you're going to get less revenues. So, those are the things that are going to put pressure on it. I was just at a conference and one existing operator was looking at buying another facility and the current operator was selling it because there's new product coming online and he was trying to evaluate how much this is going to negatively impact his facility. Was it going to be a Class A facility versus his being in Class B? You know its Class B meaning, partially environmentally controlled versus a hundred percent environmentally controlled. My response to him was well, this is your stress test, this is going to be the valuation of how much can your product absorb with this new product coming online. So, you should be looking at this as a stress test scenario in terms of what your evaluations should be when you buy the property. If you overpay for it then you're going to be in a competitive disadvantage, if your pricing is above the stress test level. You've got to be below the cost of that new product that's coming online and that's how you know you can enter the market in a safe position.

Mark: Very interesting. So, in self-storage is it all about location, location, location?

Scott Krone: A hundred percent. It's down to a 3 mile to 5 mile radius. Every time we enter into a market we're doing feasibility studies, not just on the city but specifically on that location. We looked at one location in Milwaukee, that I immediately knew that the demographics did not support it. There's tremendous amount of single family homes, whereas I looked around I could see five or six other self-storage facilities. So, I just had the immediate premonition that there's going to be way too much product already online for that demographic and we went to another location and there wasn't any. So, the first one was way over saturated, it was above the saturation model and the second one was tremendously below it and so, that's why we ended up buying the facility that's tremendously below the saturation level and these are both within the Milwaukee city limits.

Mark: Yeah very, very interesting. One of my Jeff Dettmer, is in self-storage and sold a self-storage facility, he's looking to buy another one and he's kind of like, we'll talk about it casually. It's like, it's really hard now to find a good deal and so, why is it so hard to find real value add self-storage facility? I mean, what's your solution to that?

Scott Krone: The reason why it's hard to find an added value is that you know, the easiest way to do that is through expansion. So, if a facility let's call it a traditional class C or class B. When I'm saying Class C that's not a bad neighborhood that means that's 3rd generation. So, you typical drive-up facility which the site may or may not be paved but you have your basic large lockers on in rows, they're not conditioned. Class B, would be that same sort of product but having conditions facilities and Class A, would be fully conditioned drive-in, more urban type setting.

So, let's take a Class B or C, the only way to do value add is either through improved management or expansion. So, a lot of times expansion is not possible so if you're looking at improved management you may be looking to raise your rental rates, cut your costs a little bit but there's going to be a small amount of gap within that, that you can really improve upon. Now, if you're a single operator that could be some serious significant dollar offering, but if you're working with investors, there is just not enough margins there to make it worthwhile for them. With what we are doing we are taking buildings that are not even self-storage, so that's how we're doing the value adds. We are actually creating a product as opposed to expanding the product and that's the main differentiation of what we're doing compared to what others do.

When we were at this conference, I would say 90% of them were non-developers. They were looking to buy an existing facility and to add value to it. We were the only ones that were buying non-facilities and adding value to them to make them into facilities. There's one other developer there - we were the only two developers out of a group of probably 50 people.

Mark: So what's the biggest risk then? Because when I think of developer I think well, you know, with the stats 85% of developers go under, now the 15% that survive go really, really well, but often they end up running out of capital in the development phase. So, how do you sort of mitigate that risk?

Scott Krone: Well, my background is I got my Masters in Architecture from Illinois Institute of Technology, and my first job was working for a developer where we did design and build. So we were the developer, we were the architect and we were the contractor. So, that's the background where I learned. I learned how to build within, and how to put together the financial performance and the design and all of those things. So, that is how we mitigate it because we're controlling the build ourselves, we're not just looking to hire someone to do it for us. You know, we've developed over the past 25 to 20 years within our company of developing the systems to making sure we build it properly and well. So, that is how we mitigate the risk.

Mark: Very interesting. So, how do you create massive value by changing a properties use?

Scott Krone: Well, in commercial properties it's all done by your inner ROI, your net operating income. So, if you can take a facility which might be, I'm just taking round numbers, making $200,000 off of it and you can increase it to $1 million of revenue off of it and granted let’s say your costs are increasing as well. So, if you’re inner ROI goes from $100,000 to $600,000 you're increasing the value fivefold. So, that's the biggest distinction of what we try to do within commercial properties is to just increase cashflow because that will drive he ROI and then that will drive the CAP rate.

Mark: Very interesting. How long is your hold typically?

Scott Krone: It's a three to five year hold. We like to describe it as, it's not a microwave investment it's crock pot. You know you've got to let it develop and come to full cooking if you will and the longer we hold it then the better the investment is. My philosophy on real estate is the perfect time to sell is when you don’t have to sell. So, if you can hold it until you don't need it, then you'll get the best valuation for it.

Mark: I love that, the perfect time to sell is when you don't have to sell. That’s fantastic. So, for somebody that was really interested in learning more about the ins and outs of self-storage, self-storage investing what would be a good way to learn more? Because there is not a whole lot out there, is there?

Scott Krone: It is a little bit of an untapped resources in terms of education. People say well where did you read about it in the book and I didn't. I learned about it by doing it and I was doing it for another client and then we saw how to do it and that's how we began doing it. We have created a lot of blog posts about it to educate people on it. One of the resources that we used to help our investors is when we do attain these visibility reports we do give them to our investors and they are about 200 pages in length and a lot of it, let's just say 10 pages is what we need to identify whether the project site is good or not. The other 190 pages deals with explaining the market and so, we'll forward that on to people just so they can get a third party understanding of what the industry is about and how to evaluate it, how to access it and what's happening across the country. So, the other things that we do are, we get annual reports from different brokers across the country and then we also post those out for investors. That was they can see what's happening on our larger scale across the country in terms of the self-storage market.

Mark: Very interesting. Are there certain markets that you like more than others?

Scott Krone: Absolutely. I mean, right now if you look at the country with East Coast being on the right and the West Coast being on the left and if you drew a circle from New York, half circle all the way around to Seattle and down through the south those areas are tremendously oversaturated in my mind. So, those are areas that we’re not necessarily avoiding but we're not running into. So, what we're doing is we're looking at the Midwest and underserved areas. So, non-major cities so you know not Chicago where we're no longer buying in the Chicago end market but we're looking outside of that. So right now, we have investments in Wisconsin, Illinois and Ohio.

Mark: Very interesting. So, will you talk to brokers then and say, hey look, we're looking for undervalued warehouse space? Is that sort of the deal flow strategy or is it a little bit more complex?

Scott Krone: It's just not warehousing. I mean it could be office, it could be commercial. It's any space where we're looking for an 80,000 to 100,000 square feet. We do look at the demographics that's the first and foremost what we do when we look at the entitlements. Some of the other things we consider is whether or not we can obtain pace financing, as well as it's an opportunity zone. So, we have utilized sales towers to install tax cuts, pace financing to opportunity zones all ways in which to enhance our investors rate of returns. So, we don't just look at the investment but we look at other ways in which we can add value to the investment to make the returns more attractive.

Mark: Okay, just for the listeners that may not understand some of the things that you're saying. So, let's sort of unpack entitlements and pace financing.

Scott Krone: Entitlements are what the zoning allows you to do, what you are entitled to do with the property. So, a lot of times with commercial properties it might be permitted or allowable and then the distinction between permitted is you can go in and do it as a right, allowable means you still have to get their approval to do it. If it's allowable you have to go through the process of getting the cities permission to do what you want to do.

So, we have rezoned properties. One of the first ones we did was zoned originally commercial which would have allowed self-storage, but then right before the great recession it was rezoned to apartments and then they couldn't build the apartments in town homes. So, the property was sitting, unused for three years. So, we had to rezone it back to commercial in order to get the self-storage allowed. We've written zoning codes because we've gone into committee and they said well, we don't know how to do this but if you do it we'll approve it and so we've done that and we've bought other properties. Last year that we bought they were zoned as all right, so we knew that it was less risky for us to go and having to get the zoning. The other one that you asked about was pace financing.

Mark: Pace financing, yes.

Scott Krone: So, that's through the department of energy. As the property access clean energy act and what it does is if you go and show that you are making economic conferment's to the building to cut the costs for utilities and improving the green value of the building you can actually get that money applied to real estate taxes as opposed to debt. So, the banks viewed it as equity even though it's a payment that you make through your property taxes. So they'll freeze your real estate taxes, they'll increase your tax assessment to cover the cost of those improvements and they will amortize it over the length of the improvements. If you have had like a new furnace, the furnace will last for 20 years, they'll amortize the cost of the furnace over 20 years and then that way it gets paid through your property taxes and you pay twice a year.

Mark: Very interesting and then, as far as opportunity zones I know a lot of people know what the opportunity zones are, but it is a little bit complex. Can you describe opportunity zones and why you're maybe looking at those areas?

Scott Krone: Well, everyone refers to as opportunity zones but the really key component is the opportunity fund. So, the zones just describe where the government wanted to encourage economic development and growth. So, each was allowed to come up with their own zones and they were approved by the federal government. So, there's a map throughout the entire country which has these zones in it. The zone in itself is not the investment criteria, it's through the opportunity fund. So, if your property is in the zone then you can have an opportunity fund to qualify for the money invested in that property which is tax deferred, as well as the gains inside of it are tax free. So, there are a lot of advantages for that for capital gains and it expands the capital gains definition. So, instead of just having to do a 1031, you can invest in an opportunity fund and have a lot more flexibility in terms of with that investment. If you have capital gains from your stock or any other means of gain on your tax returns, you can shelter it and defer the tax gain through the opportunities fund and investment. So, the way that it works is if you invest in the opportunity fund then the opportunity fund can then invest in the property, that's in the opportunity zone. So, both our Toledo and Dayton properties are located in the zones and therefore our investors have looked to that as a way in which to shelter their capital gains. So, we've been helpful to our investors by creating this other vehicle which only magnifies the rate of return because of the fact that they are deferred in their capital gains.

Mark: Wow, fantastic. Can you talk about what sort of the investors' ROI would look like if they invested with you?

Scott Krone: Well, we view development as speculative; I mean make no mistake about it. So, we recognize that we have to offer greater rate of return than if it was in an existing facility. So, an existing facility what we're seeing in the market place is that, people might get a 12-15% rate of return on their investment. With the development, we see we've got to be north of 20%. So, we model all of our investments over 20% and our objective is to increase it beyond the 20%. So, that's each project is different but that is the minimum requirement that we won't go into unless we can yield that for our investors. So, when we look at the opportunity zones or the historic tax credits or the sale on the sale towers or the use of the pace financing, those are always in which we are increasing that rate of return but we don't project those into our modeling because we feel that those are bonus or gray situations.

Mark: All right, fantastic. Is there anything I should have asked that I didn't ask you?

Scott Krone: That's a big broad question, but I think the biggest thing that we try to do is we're always analyzing risk, we're looking at stress test, we're looking at how to minimize that risk in the marketplace and the way we're doing that is really, down the front end and that's the reason why we've really chosen this vehicle because of the fact that we can assess that risk going into it. When I was with multifamily or special single family, it was more like fulfill the dreams envisioned, you know build it and they will come. But we're taking a much more scientific approach to how we're doing this, because of the fact that we can study the marketplace.

Mark: Excellent. Well, we're at that point now Scott, where we're going to ask you for your tip of the week: a website, a resource, a book something actionable for the Art of Passive Income listeners to go improve their businesses, improve their lives. We've learnt a lot about self-storage and it’s such an interesting niche, the way that you’re doing it but now we're going to ask for one more tip.

Scott Krone: Well, when people ask me business questions you know about real estate, I tend to answer it more specifically about businesses as a whole or life as a whole because I feel that if you can apply those concepts to your business you'll be much better off rather than just studying one business concept. The one that has helped us the most in the past few years is a book called *The Road Back To You* it's by Ian Morgan Cron and no relation, different spelling. So, I'm not getting any residual income off of recommending his book but the concept is that we all have different personality types. There are nine different personality types and these four century monks came up with this idea and they were absolute geniuses. I don't know how they came up with it but they break everybody down into this nine personality types and the idea of it is, the more healthy you are the less these personality types get highlighted and the less healthy you are they become very magnified and angry in essence. So, we each have them but if we can understand more importantly ourselves we can better understand how to respond in different situations, but we can also then begin seeing what other people’s personality types are and begin having conversations being reflective of how they receive it. So, if we understand someone then we can begin taking their language or understanding where they are coming from, we can better communicate with them. So, we ended finding that we have increased our level of communication not only within our office but also with your clients by understanding the different personality types.

Mark: Okay. So, what's the name of the book again, find Your...?

Scott Krone: *The Road Back To You*.

Mark: Oh, *The Road Back To You*. Okay, *The Road Back to You,* all right. I'm going to get it right now and I'll have a link to it as well. So, *The Road Back To You* is... I'm trying to find it on. It's in *Enneagram Journey to Self-Discovery*, Ian Morgan.

Scott Krone: Ian Cron Morgan, it's called the Enneagram E-N-N-E-A-G-R-A-M and that’s the concept that these fourth century monks came up with.

Mark: Very interesting, all right, awesome. Well, sometimes our calendars get mixed up and Scott Todd just jumped on. What's up, Scott?

Scott Todd: What’s going on? I feel like I missed a great podcast but I figured I just swoop in for like the tip of the week. I don't know.

Mark: You can give your tip of the week if you like.

Scott Todd: Okay well, I'm going to build off of the tip that we've got and I'm going to tell everybody, just go Google *The 12 Steps To Intimacy*. Go Google that and basically around 1970 there was I think it's a zoologist, who went out and he studied basically the steps to intimacy, he published this in a book. Basically there are 12 steps to intimacy. It goes from like eye contact all the way to intimate relationships and what he basically says in this book and you can Google it and kind of get the same concept, is that essentially you know if you're going to build a solid relationship, an intimate relationship with somebody you need to go through all 12 of these steps. If you think about it, like if you were to jump any of these steps and you missed out on them well, essentially, it doesn’t necessarily build the strongest relationship.

So for example, if you went from like eye contact to a very intimate situation like almost immediately well then you're missing all of the other steps and so eventually like, you can say like, that is going to be a short-term relationship right, it’s a very short-term thing because you missed all of these steps. So you can say, well, what does this have to do with business? Well, if you think about this through the same concept as going through and building a relationship with your customer you can apply the same 12 steps to marketing and to your customer too. It goes with eye contact. What's eye contact? That's your marketing that you getting their attention and then you go through the process of holding hands or skin to skin contact. Well essentially that component you know, it could be shaking their hand in person or beyond that it could be you know some other component. Maybe it's hearing your voice through the telephone or some other component.

So, if you stop and you think about that there are 12 steps to building that intimate relationship with your customer, because when you build it all the way out essentially you're going to have a rock solid customer foundation. But if you skip from like eye contact to hey, buy this right now well you're probably not going to have a very solid relationship with your customer so think about it, Google it. Think about it, figure out how you can put it into practice in your own business and it really just goes along with the last tip because it's really about taking things that are outside of not necessarily business and relating it back to business.

Mark: All right, fantastic. Well, my tip of the week is learn more about Scott Crone and his company at CodaMG.com. Is that correct, Scott?

Scott Krone: That is. So, it's Coda M- as in Management, G as in Group dot com and that's where we have a lot of the blog posts and the other information that people want to find out about self-storage. We have examples on there for people.

Mark: All right, fantastic. Well, I want to thank all the listeners and just remind that the only way, the only way we're going to get the quality guests like a Scott Crone, is if you do us three little favors. You've got to subscribe, you've got to rate and you've got to review the podcast. Send us a screenshot of that review to support@TheLandGeek.com we're going to send you for free the $97 Passive Income Launch Kit.

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Scott Krone: We are. Thank you very much for hosting us. We really appreciate the opportunity.

Mark: Scott Todd, thanks for jumping on man, better late than never, right?

Scott Todd: Exactly. Done beats perfect, right?

Mark: Done beats perfect. Again, I want to thank all the listeners and let...

Scott Todd: ... freedom...

Mark: ... ring. Thanks everybody.

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