Self-Storage: From D to A Over 30 Years

A review of how a once-ridiculed asset class has evolved into a core piece of every portfolio manager's commercial real estate allocation

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THE SELF-STORAGE INDUSTRY

In a word, self-storage has become a necessity for many Americans.

The Numbers Don't Lie: The Base Case for Self-Storage as an Asset Class

The self-storage industry had a humble beginning in the 1960s in Texas, where real estate developers built rows of prefab sheds with garage doors on the outskirts of town and rented them for 50 cents per square foot per month. The developers saw a behavioral pattern that did not match the living patterns of families in the United States – we accumulate a lot of "stuff" yet never have enough space in our houses or apartments to store all we accumulate.

On the demand side, not much has changed over the past 50 years. Americans continue accumulating furniture, keepsakes, financial records and other "stuff" while living in dwellings with woefully too little space to store all they are accumulating. Our population is much more mobile and is also aging, leading to life events that create a need for a place to store our things. In a word, self-storage has become a necessity for many Americans.

To counter the long drive times to remote, sometimes unsafe locations, the self-storage industry has brought storage to the people in their own neighborhoods. The rows of garage doors on the outskirts of town have been replaced by very attractive multi-story Class A buildings at "Main and Main" in the nation's largest cities. The institutionalization of this property type has increased awareness and usage of the self-storage product over the years. The result – the 50 cents per foot monthly rent has grown exponentially, and self-storage rents in major metropolitan areas are now highly correlated to Class A apartment rents.

17.25%

Average Annual Total Return, 225 Basis Points Higher than the Next Highest Returning Sector

The evolution of this property type has produced the highest shareholder returns in the commercial real estate sector. According to information published by the National Association of Real Estate Investment Trusts, the industry association for United States REITs, over the past 29 years self-storage REITs have led all REITs in total shareholder return, with an average annual total return of approximately 17.25%, nearly 225 basis points higher than the next-highest returning sector.[1]

1 "Complete History of Annual Returns by Investment Sector and Property Sector – Annual Returns by Property Sector and Sub-sector: 1994 - 2022," REIT.Com, National Association of Real Estate Investment Trusts, Inc., February 2023

A Brief History of the Self-Storage Industry in the United States

Self-storage industry historians attribute the first self-storage facilities in the United States to Martin and John Bekins and The Moving and Storage Company, founded in 1891 in Iowa, which quickly moved west to facilitate the migration of the US population near the turn of the 19th century.[2] The primary driver of demand in those days was the mobility of US workers seeking opportunity in the American west.

The modern self-storage era began in Odessa, Texas in 1964 when Russ Williams and Bob Munn opened A1 U-Store-It U-Lock-It U-Carry-the-Key, a building made of cinder blocks and corrugated steel with wooden overhead doors that local oil companies used to store supplies.[3] This was the prototype for the first-generation storage facility – typically a row of single-story prefab buildings made of corrugated steel with roll-up doors in industrial areas on the outskirts of cities and suburbs. The first-generation facilities had no climate-controlled units, and the facilities may or may not have had a security fence. The owners of these facilities tended to be mom-and-pop owners.

1960s

1970s

1980s

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During the 1970s and 1980s, larger real estate companies formed to develop, own, and operate self-storage facilities. These players improved the prototypical self-storage facility by paving parking lots and driveways, adding security fences, and introducing property managers and management offices. These second-generation facilities continued to be located mainly in industrial areas or the outskirts of cities or suburbs.

2 "The History of Self Storage: From China to Omaha," Neighbor Blog, Neighbor Storage, Inc., January 31, 2019, The History of Self Storage: From China to Omaha | Neighbor Blog
3 Jon Fesmire, "The Surprisingly Interesting History of Self Storage," Storagefront Blog, Storagefront, November 6, 2014, The Surprisingly Interesting History of Self Storage | Storagefront

In the mid-1990s, the first public self-storage REITs, Storage USA, Shurguard, Public Storage, and Sovran Self-Storage, had successful initial public offerings and listed on the New York Stock Exchange. With the advent of the publicly-traded REITs came a third generation of self-storage product, one not so different than the second generation in terms of building design but marked by locations that were significantly more customer-focused, often in the heart of the city. The third-generation facilities had some climate-controlled units, sold retail products like moving/storage boxes and locks, rented moving trucks, and sold tenants insurance for their stored items. These facilities typically had the latest security technology, such as automated gates and security cameras, and could command a significantly higher rent due to the convenient locations.

The public REITs accessed large amounts of institutional capital for much of the balance of the 1990s and grew largely through the development of new facilities in primary markets. Facility design continued to evolve, with the proliferation of some climate control features in drive-up units and two-story climate-controlled buildings that could accommodate more storage units on

1990s

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2000s

The early 2000s were marked by self-storage industry consolidation and survival in the face of existential threats, demonstrating the resiliency of self-storage and its ability to perform well in all economies.

2010s

The self-storage sector has developed a new generation of self-storage facility. The new prototype is designated Generation V, or “GenV.”

a smaller parcel of land. This fourth-generation facility was a cross between the third-generation purpose-built drive-up facility that characterized the product introduced by the REITs in the mid-1990s and the multi-story facility that is prevalent today. The institutional investor interest in self-storage allowed for the formation and growth of several large owner-operators in addition to the public REITs. These owner-operators included StorageMart, The William Warren Group (operating under the StorQuest brand), Safeguard Self-Storage. In addition, U-Haul diversified its truck rental business to become a leading U.S. self-storage owner-operator.

The first decade of the 21st century was marked by self-storage industry consolidation and survival in the face of existential threats, demonstrating the resiliency of self-storage and its ability to perform well in all economies. After the attack on the World Trade Centers and Pentagon on September 11, 2001, much of the U.S. economy suffered a dramatic downturn that lasted several months and prompted government stimulus, yet the self-storage industry experienced a much shorter period of occupancy decline followed very quickly by sustained growth. Two large M&A transactions (Storage USA acquired by G.E. Capital and Shurgard acquired by Public Storage) and two new self-storage REIT IPOs (Extra Space and CubeSmart) produced four public companies with strong balance sheets and the ability to thrive going forward. They were quickly put to the test, as 2008 and 2009 produced the Great Financial Crisis and the Great Recession, which lasted into late 2009. While the self-storage industry lost customers like everyone else during this period, with occupancies dropping to the 80% range from the mid-80s prior to the events[4], the sector was the only REIT sector to post positive total shareholder returns during both 2008 and 2009, and the combined return for both years led all REIT sectors.[5]

The period from 2010 until the present has seen historical outperformance by self-storage companies, marked by five individual years with total shareholder returns for the public self-storage REITs in excess of 25% (the highest being 79.4% in 2021) and an average annual total shareholder return for the sector of 18.76% from 2010 through 2022.[6] Again, this leads all NAREIT property sectors as well as the S&P 500.[7]

2 BILLION

Net Rentable Square Feet of Self-Storage Contained in Approximately 51,000 Facilities in the United States

Moreover, the self-storage sector has developed a new generation of self-storage facility. The new prototype, designated Generation V, or GenV (with the "V" signifying the word "vertical"), is characterized by vertical construction utilizing state-of-the-art building design and materials, a dense, urban core location, controlled facility access and other safety measures utilizing the latest technology, multiple elevators, facility-wide WiFi, and 100% climate-controlled units. These facilities are part of the fabric of dense neighborhoods in large cities throughout the United States, command premium rental rates, and their proliferation has raised the bar on self-storage rents across the U.S., positioning the sector for sustained long-term growth.

Presently, there are approximately 2.0 billion net rentable square feet of self-storage contained in 51,000 facilities located across the United States. The amount of square footage per person in the United States is estimated at 6.1 square feet.[8] The estimated percentage of U.S. households that rent self-storage is 11.1%, up almost 20% over the past five years. Approximately 59% of the self-storage square footage in the U.S. is owned by the top 100 operators (with 32.3% owned by six public companies, reflecting the increased institutional interest in the sector).[9] Occupancy rates are at all-time highs, with the five reporting public REITs reporting average occupancy for the fourth quarter of 2022 of approximately 93.0%.[10] The public equity market capitalization for the five self-storage REITs is approximately $103.9 billion.[11]

4 R. Christian Sonne, MAI, "Self Storage Economics," The Appraisal Journal, Appraisal Institute, Summer 2013
5 "Complete History of Annual Returns by Investment Sector and Property Sector – Annual Returns by Property Sector and Sub-sector: 1994 - 2022," REIT.Com, National Association of Real Estate Investment Trusts, Inc., February 2023
6 Id
7 "Index Dashboard: S&P 500 Factor Indices," S&P Dow Jones Indices LLC, January 2023
8 Alexander Harris, "U.S. Self-Storage Industry Statistics," SpareFoot Storage Beat, SpareFoot, January 27, 2023, citing 2023 9 Self-Storage Almanac (31st Edition), MiniCo Publishing, 2023
9 Id
10 Company Earnings Releases for CubeSmart, Extra Space Storage, Life Storage, National Storage Affiliates and Public Storage, February 2023
11 Company Analysis – Key Metrics: Self-Storage, Green Street Advisors, February 28, 2023

Self-Storage Fundamentals

Self-storage is rented in small units (generally 25 to 300 square feet) primarily to individuals who lease single units on a month-to-month basis. The typical GenV facility contains between 70,000 and 80,000 rentable square feet divided into 700 to 1,000 individual self-storage units. Month-to-month leasing allows self-storage operators to adjust rents to individual tenants more rapidly than most other property types. This ability to rapidly change rents serves self-storage well in an inflationary environment.

Self-storage is more attractive to investors than other property types for other reasons. These reasons include:

01 HIGH PROFIT MARGINS

Operating expense ratios for typical GenV facilities are only 30-35% of revenue.

02 EASE OF OPERATION

The typical GenV facility needs only one or two employees (and this number is declining with technological advances like controlled access, online rentals, and kiosks), lessening operating costs and the time and effort required to manage human resources.

03 LIMITED RECURRING CAPITAL EXPENDITURES AND MAINTENANCE

The vast majority of square footage in the typical GenV facility consists of concrete floors, steel walls and doors, and LED lights, none of which require constant maintenance or replacement. The primary maintenance items are elevators, roofs, and parking lots, which must be repaired/replaced very infrequently. Moreover, the design and mix of sizes of self-storage units has not changed materially in 50 years, making self-storage a low risk for obsolescence.

04 SMALL MONTHLY RENT AMOUNT

The typical self-storage unit rents for less than $200 per month, and typically, rent is automatically charged to a credit card that the tenant keeps on file. This dynamic provides efficiency in cash management, a low level of bad debt. and the ability to pass through rent increases without dramatically affecting the customer's budget.

05 PERSISTENT "NEED" FOR SELF-STORAGE

Americans continue to accumulate possessions that they do not intend to discard and live in dwellings that are too small to house all their "stuff." For this reason, self-storage has become a necessity for many families. As the U.S. population continues to grow, people continue to age and move around. While land becomes more scarce (resulting in even smaller dwelling units), demand for self-storage should remain high and customer length of stay should continue to increase.

06 PURCHASING HABITS OF SELF-STORAGE CUSTOMERS

With the advent of the smartphone and other computing technology, purchasing decisions are increasingly made after online research, and self-storage significantly benefits from this phenomenon. Consequently, according to the last self-storage demand study conducted by the Self-Storage Association (the industry association for the self-storage industry), most prospective self-storage customers do not evaluate more than one facility. This consumer behavior allows well-managed and well-marketed facilities to gain greater shares of prospective customers. Once customers rent space in a facility, they typically do not move to other facilities due to price or dissatisfaction; the next move is home. Therefore, customers tend to stay longer than they intend, allowing for continuous use of existing customer rate increase ("ECRI") programs.

07 ACCESS TO BEST-OF-CLASS FACILITY MANAGEMENT

Four of the five public self-storage REITs (Extra Space, CubeSmart, Public Storage and Life Storage, excluding National Storage Affiliates) and several private operators provide third-party property management services to facility owners. The REITs provide branded properties, access to their marketing and revenue management programs, professional on-site managers and regular educational programs for owners utilizing these services. REITs manage third-party properties in the same manner they manage their own portfolio properties, providing smaller owners utilizing their services with many of the advantages of scale that they possess.

50%+

More Than 50% of Self-Storage Customers Rent Storage for More Than 1 Year

Self-storage demand is driven in large part by life events. Many in the industry refer to the five Ds of self-storage – death, divorce, dislocation, downsizing, and disaster, while the Covid pandemic introduced another D – decluttering. Customers come from all generations, with the vast majority of renters being from the Millennial (34%), Gen X (34%) and Baby Boomer (27%), and Greatest & Silent (3%) generations.[12] More than 50% of self-storage customers rent storage for more than one year.[13] The average length of stay of a self-storage customer in a self-storage facility is now more than 14 months. Increased customer stickiness allows for self-storage managers to effectively use ECRI programs, with the typical customer receiving a rent increase after as little as four months following the initial rental of the unit, with additional increases every 9 to 12 months thereafter. The constant presence of the five Ds has required the self-storage industry to gravitate from what could have been considered "D" quality real estate in 1994 to the Class A facilities of today.

The self-storage industry experienced a robust development cycle from 2013 through 2019, with several thousand GenV facilities being delivered in the top 40 U.S. markets. From that experience, the industry

12 U.S. Self-Storage Outlook, *Green Street Advisors*, January 31, 2023
13 Id

has established a new normal for the time required to stabilize a newly delivered self-storage facility. Self-storage is not conducive to pre-leasing, due to its monthly, need-oriented leasing structure. Consequently, on the day a new self-storage facility opens, it has no tenants. Depending on facility size, between 3 and 4 years is required to reach a "stabilized" occupancy rate (generally 85%) for a new facility and 4 to 5 years to reach economic stabilization (i.e., the stabilized occupancy rate at stabilized rental rates with normal concessions and discounts). During lease-up years, new self-storage facilities will experience higher than normal occupancy, revenue and net operating income growth rates.

Following economic stabilization, self-storage can be expected to deliver annual rent growth that exceeds the rate of inflation. From the period 1994 through the third quarter of 2022, the cumulative annual growth rate for self-storage rents was approximately 4.3%, compared to an inflation rate of approximately 2.5%. During the same period, the net operating income growth rates for the self-storage REITs has averaged over 5%, leading all other REIT sectors over that period.[14] The combination of strong rent growth and real estate industry leading net operating income growth has driven top-tier risk-adjusted returns for investors for more than two decades.

As with any other commercial real estate type, risks to self-storage investors exist. The primary risks to the strong fundamentals cited above include:

01 CHANGES IN ACCUMULATION HABITS

Current or future generations of Americans could change their propensity to accumulate physical possessions, which would reduce self-storage demand.

02 NEW DEVELOPMENT SATURATING CERTAIN MARKETS

During the period between 2013 and 2019, the self-storage industry experienced an unprecedented amount of new supply, which resulted in a significant slowing of rent and net operating income growth. New demand drivers resulting from the pandemic as well as muted new supply due to higher costs and higher interest rates have boosted fundamentals substantially above historical levels. An easing of inflation and interest rates is likely to stimulate new self-storage development as developers are likely to chase the returns produced by continued strong fundamentals in the sector.

03 DISAPPEARANCE OF CERTAIN DEMAND DRIVERS

Covid brought accelerated the "work from home" phenomenon, causing millions of Americans to clear space in their homes to establish home offices. Any broad-scale reversal of work-from-home would slow storage demand. Likewise, declines in home sales, new job creation, and worker mobility could cause temporary declines in self-storage demand.

04 INCREASED GOVERNMENT REGULATION

Some jurisdictions have imposed rent control and other laws on owners of self-storage facilities, resulting in slower revenue growth, increased bad debts, and lower profitability in those markets. To the extent increased regulation of self-storage becomes a trend, as it has in other sectors like multifamily and single-family rental housing, the historical overperformance of self-storage could end.

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12 U.S. Self-Storage Outlook, *Green Street Advisors*, January 31, 2023

The Future of Self-Storage in the United States

The future for self-storage in the United States is bright – in fact, it seems brighter than at any time in the industry's history.

Self-storage facilities are newer, located in better areas closer to self-storage users, largely climate-controlled, equipped with modern security equipment, and offer a vast array of unit sizes to suit almost any need. The property type is now considered a "main food group" for institutional investors. Institutional capital is flowing into the sector at a greater rate than ever before. Fundamentals have again proven to be resilient in bad economies – the sector's best 18 months in its history occurred during a global pandemic. Self-storage has raised its grade over thirty years from a D to an A, and so long as the five Ds that drive the big D (demand) remain, self-storage should keep its A grade for years to come.

14 U.S. Self-Storage Outlook, *Green Street Advisors*, January 31, 2023

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The risk of investing in the self-storage market. The success of self-storage depends, in part, on conditions in the self-storage market. The rental of self-storage space is highly competitive. Self-storage properties could be adversely affected by competitive properties in the real estate market, which could affect the operations and ultimate value. Self-storage operators must retain current tenants at favorable rates, attract quality tenants, and provide an attractive and convenient environment. There is significant competition among self-storage owners and operators and other self-storage alternatives which could have an effect on occupancy levels, rental rates, and other operating expenses.

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