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Crow Holdings Capital

Self-storage — a resilient, needs-based investment

Contributor

Ben Doherty

Head of Self-Storage and Industrial Investments

Crow Holdings Capital

Jonathan A. Schein, senior vice president and managing director of global business development for Institutional Real Estate, Inc., recently spoke with **Ben Doherty,** head of self-storage and industrial investments for Crow Holdings Capital. Following is an excerpt of that conversation.

Tell me about Crow Holdings' history in the self-storage sector. How long have you been at this?

We have invested approximately $237 million of equity across 54 investments since 2015. Our transactions in the storage sector have included both value-add acquisitions and ground-up development, as well as converting existing buildings — such as warehouse, office buildings or retail stores — into self-storage.

Why do you like the self-storage sector?

Our conviction in self-storage is supported by a variety of reasons, but the key driver is that storage is a necessity-based product, which we believe makes it more resistant to economic swings. Self-storage assets also generally require little capital reinvestment compared with other traditional real estate assets. Additionally, the rent rolls provide significant credit diversity. For these reasons, the sector's stabilized cash flows tend to be more predictable.

With concerns about how late we are getting in the cycle, what does it mean to be resilient to economic swings?

Predicting economic cycles is like predicting interest rate movement, but we believe key demand drivers for storage, such as demographic trends and life events, including relocations, household downsizing, divorce and death, among others, reduce the sector's correlation to economic swings. Additionally, the acceptance and use of self-storage continues to trend higher each year, creating new demand for the space. Most of the concern today is focused on new supply and its operational impact on the performance of existing inventory, which is why understanding your competitive trade area is paramount.

Millennials have a different relationship to "stuff" than prior generations. What is their participation in storage like?

There was a lot of speculation about whether millennials would be users of storage. However, a recent study by The Self-Storage Association notes that, as a percentage of households, millennials have the highest usage of U.S. self-storage, as compared to Gen X and baby boomers. Younger generations are taking longer to form permanent households, exhibiting an increased proclivity to rent. This is partially driven by delayed life events, such as marriage and having children, increased student debt levels, escalating home prices and a reduction in single-family home completions — especially for smaller "starter homes" — since the GFC. They are also more mobile, resulting in increased relocations that can trigger storage needs. Even as millennials begin to buy houses, self-storage trends to date indicate they are not so different from prior generations when it comes to requiring storage for their excess stuff.

What is the biggest challenge in self-storage today?

The main headwinds for storage today are new supply and increased operating costs. New supply has affected the fundamentals in many markets, which we believe underscores the importance of infill, larger and more densely populated target markets. Our investment strategy typically focuses on the top 30 MSAs. These are the markets we believe will experience the broadest demographic growth due to a more diversified economy, greater population and job growth. Additionally, we believe the overhang of new supply to be more short-term in nature, as certain markets with early-cycle deliveries have already begun to recover from population growth and slowing new supply.

With recent concerns of oversupply and the resulting pressure on rents, how has your investment strategy in self-storage changed?

Excess supply has been the national headline news; however, many major market owners today generally feel the delivery of excess supply has peaked and that fundamentals have flattened or have started gaining upward momentum. Additionally, certain markets with high barriers to entry continue to outperform. As supply has been outpacing demand on a national level for a few years now, rents in high-barrier markets from second quarter 2017 through first quarter 2019 averaged 2.6 percent rent growth, while other markets averaged 2.0 percent rent growth, per CoStar. We continue to emphasize pursuing a major market strategy in those trade areas we believe are underserved and provide deep population density.

Could you talk about your strategy for acquisitions and development?

We look for value-add investments in supply-constrained trade areas where we believe there is an opportunity to acquire the asset at a favorable basis and reposition the asset or develop new product at a basis below comparable trades in underserved markets. We look to create operational improvements and enhance terminal value by bringing an institutional approach to asset management, while creating scale and optionality in our portfolio.

What do you think is driving up transaction volume and the institutionalization of the sector?

Self-storage is still a highly fractured sector and has historically been managed by local, individual operators and generally funded by high-net-worth investors. Public REITs represent about the 25 percent of the U.S. market share, and while institutional ownership in self-storage has increased by approximately 15 percent in the last decade, we estimate that about 65 percent of the ownership base remains non-institutional. However, during the last several years, we have seen a significant inflow of institutional capital into the space that has primarily been focused on stabilized assets and larger trades, as well as development opportunities.

We really believe in the space and love the fact that it is a needs-based product, driven by life transitions. It is relatable and necessary, and we believe secular demographic trends will continue to drive demand for the space.

What other effects do you see from institutionalization?

It is absolutely providing greater valuations and liquidity to the capital market side of the business. From 2010 to mid-2018, self-storage property values have appreciated more than 120 percent, the highest of all REIT sectors. Storage has historically been a local business. Today, more diversified sources of capital are pursuing both stabilized and development opportunities and, as a result, we have seen cap-rate compression of approximately 400 basis points in the last decade. The institutionalization of the space has also resulted in the improved appearance of self-storage buildings, many of which have transformed from metal sheds into attractive multi-story buildings with climate control. The introduction of technology into the space has also streamlined operations substantially.

How have changes in technology impacted the self-storage market?

Long ago, this used to be a Yellow Pages business. Today, our customers can access their storage via the internet. We spend about $30,000 per store on marketing, which includes buying Google ads and other marketing pieces to attract customers who are accessing space via the internet. Most are reserving and paying for their storage online. It is a quick move-in process and that is why operators will have an internet rate and a walk-in rate, the latter being more expensive.

What opportunities do you see in the self-storage sector in the future?

We will continue to develop class-A product where we believe barriers exists for new supply and demand is outpacing supply. We will also acquire existing facilities at a basis below replacement cost and where we see value-add opportunity, such as expansion, replacing the operator and repositioning the asset.

When we entered the space, we bought several value-add acquisitions from local operators where the next generation was not interested in storage or capable of managing, so they chose to exit the business. Those legacy assets are much harder to identify today because many of those trades have already occurred.

Looking forward, we expect fundamentals to hold steady although at slower growth rates more in line with historic norms. Despite headline news of new supply, we believe it will be short term in nature and the self-storage sector remains well positioned to continue to outperform the broader REIT market in operating metrics. We expect cap rates to remain stable as capital that is more diverse in nature continues to be deployed into the sector.

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About Crow Holdings Capital

Crow Holdings Capital (CHC) is the real estate investment management company of Crow Holdings. Led by a highly experienced team, Crow Holdings Capital manages more than $9 billion of real estate assets through its series of eight flagship value-add funds invested across property types in the United States, as well as its specialized fund strategies for retail, self-storage and multifamily. Crow Holdings is a privately owned real estate investment and development firm with a 70-year history and a proven track record of performance, partnership and innovation.

Contact Information

www.CrowHoldingsCapital-RE.com

3819 Maple Ave | Dallas, TX | 75219

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