

## Self-Storage Investments: An Alternative High-Yield Asset Class

The stock market has been volatile of late and tends to make even the most ardent supporters nervous. It is this volatility that pushes investors to look at alternative asset classes that are not correlated with the stock market and smooth out the overall performance of their portfolio.

The asset class of real estate has a relatively low correlation with the stock market and offers diversification in your portfolio while throwing off cash returns along the way. This has been why I have been a part of many commercial multifamily investments as they offer diversification into a tangible asset that is not directly correlated with the market and produces reliable cash flow.



**I believe self-storage is another asset class that offers excellent returns and diversification with some appealing downside protection.** Refer to my first article below on my growing interest in self-storage to get additional education on this niche. This research propelled me into developing relationships with some top self-storage

operators and in June, 2016, we offered investors our first self-storage fund investment opportunity. We are ramping up for more opportunities in 2018.

<https://www.thompsoninvesting.com/single-post/2017/02/17/Self-Storage---Growing-Interest-as-an-Investment-Niche>

In this article, I will take a more macro view of the industry looking at trends and drivers propelling the industry and then provide 5 reasons I believe self-storage may make sense as part of a well-diversified real estate portfolio.

### Background

Self-storage is a unique asset class. It has a reputation of providing high yields and has shown to be relatively resistant to recessions due to its lower declines and default ratios versus other asset classes. While still a relatively new industry that really got its start in the 1960's, self-storage is already sizable. Here are some statistics on the scale of the self-storage industry in the U.S.:

- According to IBIS world, annual self-storage revenue is projected to rise to \$37.5 billion in 2017.
- Number of self-storage facilities in the U.S: 44,061

- Amount of self-storage space per capita in the U.S.: 5.4 square feet per capita
- Percentage of U.S. households that rent a self-storage unit: 9.5%

In its early years, the industry was largely dominated by mom-and-pop operators and, even today, is still highly fragmented. As self-storage gained traction, large branded chains such as Public Storage and CubeSmart entered the market and elevated business practices, quality of real estate and operating efficiency.

Today self-storage is less of the well-kept secret it once was due to growing institutional ownership. Publicly traded self-storage REITs (Real Estate Investment Trusts) have been one of the top performing sectors in recent years with a good track record of delivering dividends and stock appreciation.

### Asset Class Overview - Trends and Drivers

Climate-controlled: Facilities that offer climate controlled and humidity-controlled space in all or part of properties have become increasingly popular over the past decade. People don't want to store items of importance in musty and moldy environments and they are willing to pay a premium to protect their belongings.

Additional Revenue Streams: Storage-facilities may boost income by incorporating a variety of other complementary businesses at the same property, such as truck-rentals, pack-and-ship franchise and retail are adding other revenue drivers.

### Demand Drivers

Population growth: Since population growth is a logical driver of storage demand, self-storage developers are looking at real estate more strategically and locating closer to their customers. Storage does well in densely

populated areas, as well as markets that are experiencing population and job growth.

The American Consumer: People buy a lot of stuff and have a natural reluctance to throw anything out. Suburban garages fill up quickly with a variety of household items that folks want to store to make room in the garage for their car.

### Changes in Use

The self-storage industry has seen substantial change both in terms of how locations are developed and used as well as how they are operated. The following are few of the highlights:

Location: Over the past decade, self-storage properties have moved into urban centers to be closer to their customers. That shift has been propelled by the new trend of urbanization as demographics such as Millennials and Empty Nesters are moving to cities with smaller dwelling offering little space for storage.

Technology: Operators are embracing technology in all aspects of their business. There is growing competitive pressure to offer facilities that are clean, safe and secure. In response to market demands, facilities are incorporating technology into surveillance and security ranging from CCTV monitoring to key card access. Operators also are utilizing technology to improve efficiencies, such as using software to track renter history and issue alerts to late payers or send automatic notifications for rent increases.

### Five Reasons to Invest in Self Storage:

#### 1) Asset Class Returns:

According to the National Association of REIT **the self-storage sector produced an**

**average annual return of 17.43% from 1994 to 2017.** For comparison here are the returns from some other REIT sectors during that same time:

Office: 13.26%  
 Retail: 12.75%  
 Industrial 13.36%  
 Residential: 13.42%  
 Apartments: 13.32%  
 Manufactured Homes: 13.27%  
 Mortgage: 11.18%  
 S&P 500: 7.54%  
 (<https://dqydj.com/sp-500-return-calculator/>)

I would encourage you to look at the data from NAREIT, there is a lot of interesting data here.

<https://www.reit.com/data-research/reit-indexes/annual-index-values-returns>

Let's assume you had \$200,000 to invest in 1994 and put your money equally into two investments. One investment for \$100,000 in a self-storage REIT and reinvested all earnings while you put another \$100,000 into the S&P 500 and reinvested all dividends. By 2017, the self-storage REIT would have grown to \$4,026,413 while your S&P 500 stock fund would have grown to \$532,243. Self-storage outperformed the large capitalization stocks index by a whopping \$3,494,170. Now, astute investors recognize that past performance is not necessarily indicative of future performance, but this is clearly eye-opening and worth further study.

## 2. Recession Resistance:

According to the NAREIT the self-storage asset class also outperformed other sectors in the most recent recession. From 2007-2009 the self-storage sector produced an average of -3.80%. For comparison here are the returns

from some other REIT sectors over that same time:

Office: -8.16%  
 Retail: -12.32%  
 Industrial: -18.31%  
 Residential -6.43%  
 Apartments -6.72%  
 Manufactured Homes .47%%  
 Healthcare: 4.92%  
 Mortgage: -19.54%  
 S&P 500: -22.03%  
 (<https://dqydj.com/sp-500-return-calculator/>)

Why was self-storage able to outperform almost every REIT sector during the most recent recession? When the economy is good and disposable income is on the rise then people buy more "stuff" and need a place to store it, which makes sense.

Amid the recession homeowners were losing their homes to foreclosure or downsizing to apartments, they turned to self storage units to be a logical choice, kind of a temporary staging area



awaiting better times. At the heart of this issue is the fact that Americans have a culture of buying too many things and we can't seem to get rid of most of it. The demand curve for self-storage seems to be inelastic which helps pull the sector through any major downturns. Estimates are that one-third of storage space is filled with items that have been there for over three years.

## 3) Rent Growth and Positive NOI:

In-place self-storage tenants are generally not price sensitive, as the self-storage rental fee is

normally a small portion of a tenant's monthly disposable income. This allows operators to raise rents as the market demand grows without an impact on occupancy. For example, if you are paying \$100 a month for your 10x10 storage unit and the rent goes up 6 % to \$106 a month most tenants are not price sensitive enough to rent a moving truck and spend a Saturday moving to another storage facility.

In addition, there is minimal communication between different tenants at a given facility, which allows for the operator to selectively adjust rental rates for individual tenants. This is one of the main reasons large self-storage operators can, in general, increase rental rates 5 - 8%. What does this rent growth allow for? An increase in net operating income drives increased value of the property which drives returns for investors.

#### 4) Cash Flow and Tax Benefits:

One of the many benefits of real estate investing in self-storage is cash flow. This cash flow is sought after by many investors who look to live off passive income. Cash flow in the 8 – 10 % annual range is typical. This income is offset by common deductions that many real estate properties take advantage of such as property taxes, debt interest, and accelerated depreciation. As a result, this asset can be very tax efficient when held in a taxable portfolio. We invest primarily through syndication structures with limited partners (our investors) that take advantage of these pass-through deductions which allows them to keep more money in their pockets.

#### 5) Fragmented Market:

Nearly 80% of self-storage properties remain in the hands of small, independent investors. The sector's solid past performance has caught the attention of large institutional investors. Larger

properties are increasingly the subject of interest from institutional buyers, including the larger self-storage companies that run themselves as REITs. The top 6 public companies control approximately 18% of all the facilities with the remaining approximately 82% of the facilities controlled by independent owners. This fragmentation should provide for the opportunity for well capitalized and sophisticated players to selectively target individual assets and portfolios at attractive cap rates thereby enabling these players to gain scale. Once stabilized these portfolios become attractive assets for a REIT to purchase and create an exit for us as investors.

In sum, the investment community has taken notice of self-storage as a viable commercial real estate asset class, and the underlying dynamics continue to fuel the sector's success. **With solid recent past performance and upward trending occupancies and rental rates, self-storage represents a tremendous opportunity** if purchased at the right price and with the right operator. When you put it all together, an asset class that is known to be recession resistant yet offers stable cash flow, in a growing yet consolidating market, poses a relatively compelling argument for inclusion in a diversified commercial real estate portfolio.

