

# A Core Sector

## Capital Seeks Safety And Returns Through Self-Storage Investors Survey 3Q 2020

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Self-storage continues to out-perform other core commercial real estate (CRE) through the pandemic and resulting recession. On the public side, self-storage REITs in total are up +4.12 percent year to date (YTD) as of Sept. 12, 2020, in a range from +2.26 percent (LSI) to +6.17 percent (EXR). On the private side, cap rates have actually declined slightly from our 3Q 2019 Investor Survey, reflecting record low Treasuries (and interest rates) and continued investor growth in storing capital in the self-storage sector.



Cap rates have compressed 10 basis points from a year ago, and discount rates have also compressed 10 basis points. Terminal cap rates, however, have remained the same, suggesting some caution regarding the future. For the first time, investors indicate a sub-five percent cap rate for Class-A product. One active market participant states, "For core (gateway markets), I think cap rates are mid-4s and IRRs are low 6s". Key indicators by Investment Quality are summarized in the Segmentation table below right.

The self-storage team at Newmark Knight Frank surveyed market participants about a wide variety of data points, including the usual cap rate, yield rate, and growth rates. Additional information includes trade area size, absorption time, marketing time, profit on costs, optimism index, and other metrics. Over 50 market participants were interviewed, bolstered by anecdotal insights gained from a record number of calls with key market participants hosted by Aaron Swerdlin, vice chairman at Newmark Knight Frank. The calls were based on discussions with key market leaders with up to 250 participants on the calls held weekly. According to Swerdlin, a record amount of capital is seeking safety and returns in self-storage due to the long-run performance history in bull and bear markets.

Survey participants include buyers, brokers, owners (small and large

operators including REITs, national, and regional owners), investors, lenders, and REIT analysts. Most interviews were conducted by telephone or electronic conferencing. Survey research interviews referenced in this report occurred primarily in the 3Q 2020, but they reflect sentiment throughout the pandemic. The results of the data this quarter are also compared to an 11-year time series for trend analysis, summarized in the table at the end of this report. Survey results are summarized in Key Performance Indicators (KPI) as follows:

- Last year we forecast further declines to cap and yield rates, due to spreads to Treasuries and swaps. Cap rates from this survey, based on a look forward, declined to the lowest indicators recorded to date.

- Self-storage cap rate spreads to apartment cap rates decreased to 28 bps, much lower than the eight-year average of 44 bps (apartment cap rates have increased 12 bps over the past year on average).
- Operations showed turbulence in March and April, but they have since been on a normal or "better than expected" course for 2020. Throughout the pandemic, move-outs have declined compared to past years. As delinquencies increased early in the pandemic, auctions were delayed by state regulation or compassionate operators. However, by July, business returned to normal; this suggests continued growth in collections (or effective gross income) through the fourth quarter.

### Segmentation by Investment Quality - 3Q 2020

	Class A	Class B	Class C
<b>Discount Rate (IRR)</b>			
Range:	6.50% - 8.50%	7.50% - 9.25%	9.25% - 11.00%
Average:	8.20%	8.70%	9.70%
<b>Capitalization Rate</b>			
Range:	4.50% - 5.50%	5.50% - 6.25%	6.25% - 8.50%
Average:	5.00%	5.75%	6.50%
<b>Terminal Capitalization Rate</b>			
Range:	4.75% - 5.75%	5.75% - 6.50%	6.50% - 8.75%
Average:	5.25%	5.75%	6.75%

Source: NKF Self Storage Investor Survey, 3Q 2020

- No-contact or “contactless” rentals are on the rise. The sophistication in the sector in social media and revenue management enabled seamless transition to contactless transactions. Customers reserve on the phone and show up at their unit to find a bag with executed documents, a lock, and other information.
- The spread between the 10-Year Treasury is currently 482 bps, compared to a 20-year average of 395bps for the self-storage asset class. The lowest spread of 254 bps was in 2006, the prior highest spreads were 487 bps in 2010 and 486 bps in 2012.
- Traditional financing with leveraged loans of 70 to 75 percent is available for strong sponsors in the four percent to 4.5 percent range, but lower leveraged loans can obtain sub-four percent interest rates. Facilities in lease-up are finding bridge financing at 60 percent to 75 percent loan to cost at rates generally under five percent.
- Market segmentation remains among Class-A, -B, and -C properties. In general, Class-A properties have an NOI per square foot (of rentable area) at \$10 per square foot or higher; Class-B properties are in a range of \$6

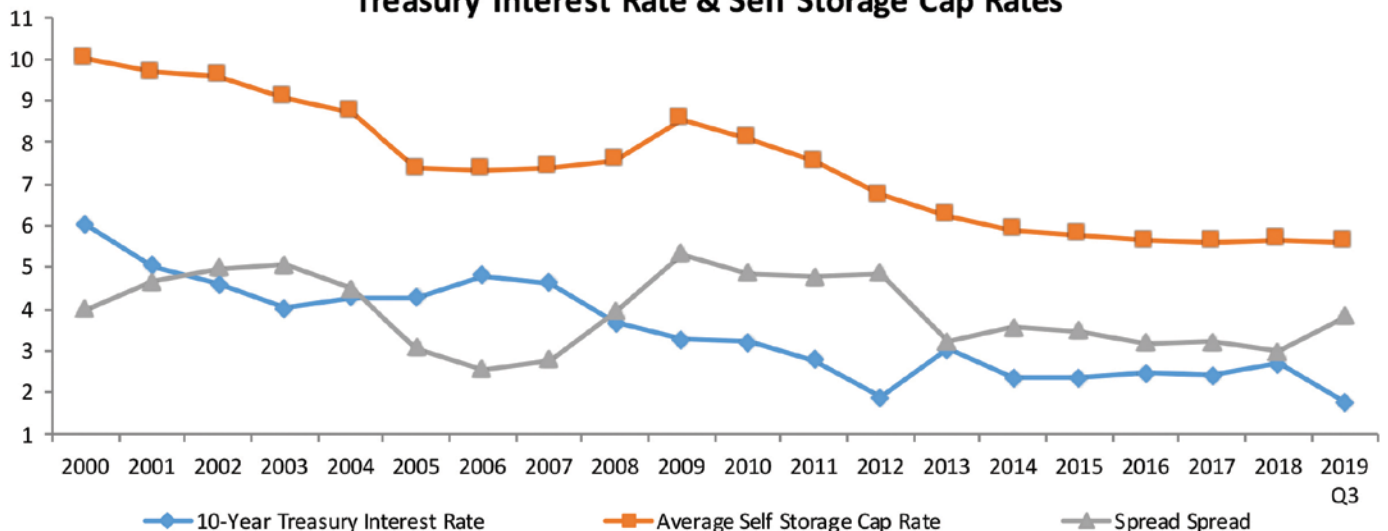
to \$10 per square foot; and Class-C facilities are generally less than \$6 per square foot. Our Investor Survey this quarter was based on respondents representing all three classes: Class-A (35 percent), Class-B (42 percent), and Class-C (23 percent).

- Discounted cash flow analysis is now used by 88 percent of market participants. Even in Class-C or secondary/tertiary markets, the DCF is considered the most reliable market metric. Participants continue to note that accounting for revenue enhancement and NOI growth over the holding period is driving the use of DCFs.
- Discount rates (non-levered IRR) continue to decline to an average of 8.45 percent. It is interesting to note this represents an average spread of 295 bps to the average cap rate. For years, we have seen an emphasis in selecting the IRR as a function of the spread between the cap rate and yield based on NOI growth. More recently, we have seen a small group of investors use lower IRRs or discount rates and higher terminal cap rates, ignoring the NOI growth rate. This modeling is typical to other core CRE, but it also suggests market expectations that NOI growth will vary from the rate of appreciation.

This modeling tends to result in similar net present value conclusions as typical modeling, but it may be further indication that self-storage is fairly considered a core sector.

- Average rental growth rates are 3.25 percent, a decline of 15 bps suggesting revenue enhancement models in the top 100 CBSAs is peaking. We received several enthusiastic reports that revenue enhancement works equally well in secondary and even tertiary markets. One owner of a Class-C portfolio noted double-digit returns to top line revenue due to “turning revenue management levers on full.” This suggests a continuing trend toward cash flow management over management to physical occupancy.
- Terminal cap rates results are flat, suggesting confidence in the self-storage asset class over the long run.
- Average trade area size remains relatively stable at a typical radius average of 3.25 miles, although drive times under 15 minutes are also a consideration (and many prefer 10-minute drive times). Demand for the sector is estimated by market participants to be 7.3 per square foot per capita, a slight decrease from one year ago.

**Treasury Interest Rate & Self Storage Cap Rates**



## Self Storage Time Series - Survey Research

	3Q 2020	3Q 2019	3Q 2018	3Q 2017	3Q 2016	2015	2014	2013	2012	2011	2010	2009
<b>Trade Area (Miles)</b>												
Range:	1.00 - 5.00	1.00 - 5.00	1.00 - 5.00	1.00 - 5.00	1.00 - 5.00	1.00 - 5.00	1.00 - 5.00	1.00 - 5.00	1.00 - 5.00	1.00 - 5.00	1.00 - 5.00	1.00 - 5.00
Average:	3.25	3.20	3.18	3.14	3.20	3.14	3.20	3.25	3.22	3.20	3.15	3.21
Change:	1.56%	0.63%	1.27%	-3.38%	1.56%	-3.03%	1.54%	0.93%	0.63%	1.59%	-1.87%	1.23%
<b>Demand (\$F per Person)</b>												
Range:	2 - 8.5	2 - 8.5	2 - 8	2 - 8	2 - 8	1 - 8	1 - 8	1 - 8	1 - 8	1 - 8	1 - 8	1 - 8
Average:	7.3	7.5	7.1	6.9	7	7.1	7.1	7.35	7.31	7.15	6.98	6.73
Change:	-2.67%	5.63%	2.90%	-1.43%	-1.41%	No Change	-3.40%	0.55%	2.24%	2.44%	3.71%	3.22%
<b>Capitalization Rate</b>												
Range:	4.50% - 8.50%	4.50% - 8.50%	4.50% - 8.50%	4.75% - 8.50%	4.90% - 8.00%	5.00% - 8.25%	5.25% - 8.50%	5.50% - 8.50%	6.25% - 8.50%	6.50% - 8.75%	7.00% - 9.50%	7.00% - 10.00%
Average:	5.50%	5.60%	5.68%	5.60%	5.64%	5.74%	5.90%	6.25%	6.75%	7.30%	7.75%	8.75%
Change:	-10	-8	8	-4	-10	-16	-35	-50	-55	-45	-100	75
<b>Absorption Time (Months)</b>												
Range:	18 - 36 Months	18 - 36 Months	18 - 36 Months	18 - 36 Months	18 - 36 Months	18 - 36 Months	18 - 36 Months	18 - 36 Months	20 - 40 Months	24 - 40 Months	24 - 48 Months	24 - 48 Months
Average:	36	32	30	29	27	28	28	30	33	36	35	34
Change:	4.0	2.0	1.0	2.0	-1.0	No Change	-2.0	-3.0	-3.0	1.0	1.0	1.0
<b>Marketing Time (Months)</b>												
Range:	2 - 6 Months	2 - 6 Months	2 - 6 Months	2 - 6 Months	2 - 6 Months	2 - 6 Months	2 - 6 Months	2 - 7 Months	3 - 6 Months	3 - 9 Months	3 - 9 Months	3 - 12 Months
Average:	6.0	4.4	4.2	3.7	4.0	3.5	3.0	3.0	3.0	4.0	5.0	11.0
Change:	1.6	0.2	0.5	-0.3	0.5	0.5	No Change	No Change	-1.0	-1.0	-6.0	4.5
<b>Profit (on Cost Only)</b>												
Range:	15% - 35%	15% - 50%	15% - 50%	15% - 50%	15% - 50%	10% - 25%	10% - 25%	10% - 25%	10% - 25%	10% - 20%	10% - 15%	10% - 20%
Average:	26.00%	25.00%	24.00%	23.00%	25.00%	21.00%	21.00%	20.00%	17.50%	15.00%	12.50%	14.96%
Change:	4.00%	4.17%	4.35%	-8.00%	19.05%	No Change	5.00%	14.29%	16.67%	20.00%	-16.44%	-5.67%
<b>Optimism Index (1-10)</b>												
Range:	5.00 - 9.00	5.00 - 9.00	5.00 - 9.00	5.00 - 9.00	5.00 - 9.00	3.00 - 9.00	3.00 - 9.00	3.00 - 9.00	3.00 - 10.00	3.00 - 9.00	5.00 - 9.00	5.00 - 9.00
Average:	7.7	7.5	7.1	6.9	8	8.1	8.1	7.5	7.25	7	6.15	5.5
Change:	2.67%	5.63%	2.90%	-13.75%	-1.23%	No Change	8.00%	3.45%	3.57%	13.82%	11.82%	-8.33%
<b>Market Conditions</b>												
Under-supplied:	25%	27%	28%	27%	39%	42%	42%	25%	20%	15%	10%	10%
Over-supplied:	31%	33%	32%	28%	21%	20%	20%	30%	40%	50%	60%	65%
Equilibrium:	44%	40%	40%	45%	40%	38%	38%	45%	40%	35%	30%	25%
<b>Strategy</b>												
Buy:	44%	41%	37%	36%	43%	55%	55%	52%	47%	42%	40%	20%
Sell:	40%	39%	42%	38%	24%	20%	20%	24%	35%	41%	45%	60%
Build:	16%	20%	21%	26%	33%	25%	25%	24%	18%	17%	15%	20%
<b>Discounted Cash Flow</b>												
Usage:	88%	86%	82%	81	75	70	70	61	52	41	33	36
Holding Period:	10 Years	10 Years	10 Years	10 Years	10 Years	10 Years	10 Years	10 Years	10 Years	10 Years	10 Years	10 Years
Cost of Sales:	2.0%	2.0%	2.0%	2.0%	1.8%	2.0%	2.0%	2.0%	2.8%	3.5%	4.0%	4.0%
<b>Discount Rate (IRR)</b>												
Range:	6.50% - 11.00%	7.50% - 11.00%	7.50% - 11.00%	7.75% - 10.75%	7.75% - 10.75%	8.00% - 10.75%	8.00% - 11.00%	8.25% - 11.00%	9.00% - 11.50%	9.50% - 11.50%	10.00% - 12.00%	10.00% - 12.00%
Average:	8.45%	8.55%	8.73%	8.75%	8.63%	8.75%	9.00%	9.25%	10.25%	10.50%	11.25%	11.50%
Change (Basis Points):	-10	-18	-2	12	-12	-25	-25	-100	-25	-75	-25	75
<b>Rental Growth Rate</b>												
Range:	3.00% - 6.00%	3.00% - 6.00%	3.00% - 6.00%	3.00% - 6.00%	3.00% - 6.00%	3.00% - 6.00%	3.00% - 6.00%	3.00% - 6.00%	3.00% - 6.00%	1.00% - 5.00%	1.00% - 5.00%	1.00% - 5.00%
Average:	3.25%	3.40%	3.50%	3.50%	3.55%	3.60%	3.50%	3.25%	3.50%	3.25%	3.50%	3.00%
Change (Basis Points):	-15	-10	No Change	-5	-5	10	25	-25	25	-25	50	50
<b>Expense Growth Rate</b>												
Range:	2.00% - 5.00%	2.00% - 5.00%	2.00% - 5.00%	2.00% - 5.00%	2.00% - 5.00%	2.00% - 5.00%	2.00% - 5.00%	2.00% - 5.00%	2.00% - 5.00%	2.00% - 5.00%	2.00% - 5.00%	2.00% - 5.00%
Average:	3.05%	3.10%	3.00%	3.02%	3.01%	2.94%	3.00%	3.00%	3.25%	3.00%	3.00%	3.00%
Change (Basis Points):	-5	10	-2	1	7	-6	No Change	-25	25	No Change	No Change	No Change
<b>Terminal Cap Rate</b>												
Range:	4.75% - 8.75%	4.75% - 8.75%	4.75% - 8.75%	5.00% - 8.30%	5.20% - 8.20%	5.25% - 8.25%	5.50% - 8.50%	6.00% - 8.50%	6.50% - 8.75%	7.00% - 9.00%	8.00% - 10.50%	8.00% - 10.50%
Average:	5.85%	5.85%	5.92%	5.86%	5.88%	6.01%	6.15%	6.50%	7.00%	7.50%	9.00%	9.00%
Change (Basis Points):	0	-7	6	-2	-13	-14	-35	-50	-50	-150	No Change	50
Spread to Cap Rate (Basis Points):	35	25	24	26	24	27	25	25	25	20	125	25



- The optimism index (1 lowest, 10 highest) indicates an average score of 7.7, the highest score since 2016. Optimism may be renewed due to strong performance during the pandemic, and reports that new construction is contracting significantly.

**Market participants report that after a pause due to the pandemic, transaction activity is steadily increasing. Class-C assets remain the most active (generally under \$3 million), but portfolio sale activity is increasing as well ...**

- Average marketing time (to sell a property) has increased to 6.0 months, respondents citing a longer transaction process due to the pandemic. Average absorption time continues to decline, as asking rates are cut dramatically to boost physical

occupancy during absorption of new facilities.

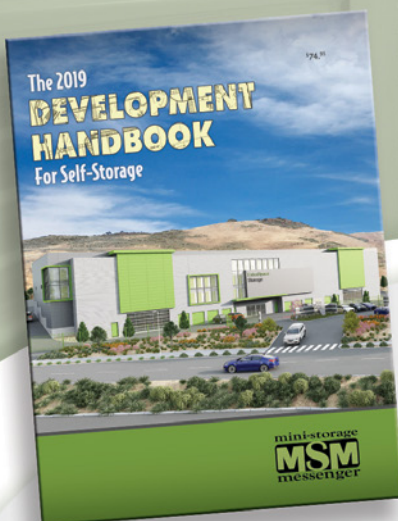
- In terms of market conditions, the survey indicates 44 percent equilibrium, 31 percent over-supply, and 25 percent under-supplied. Interestingly, in terms

of strategy, 44 percent estimate now is the time to buy, 40 percent indicate now is the time to sell, and only 16 percent indicate now is the time to build. Brokers consistently report more buyers than sellers in the market, and new investment sources are entering the sector.

Market participants report that after a pause due to the pandemic, transaction activity is steadily increasing. Class-C assets remain the most active (generally under \$3 million), but portfolio sale activity is increasing as well, including a \$44 million portfolio sale in Texas. Bloomberg reports that Brookfield is exploring the sale of 120 assets across 23 states seeking \$1.3 billion. Globe Street said that REIT Jernigan Capital announced a definite merger agreement with NexPoint Advisors L.P. to go private in a deal reportedly near \$900 million. Survey results this quarter, along with an 11-year time series, are detailed in the table on page 53. 

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