BEYOND THE GLOBAL HEALTH CRISIS

Marcus & Millichap

SPECIAL REPORT SELF-STORAGE

SUMMER 2020

Self-Storage Displays Resilience During Pandemic-Driven Economic Downturn Although Potential Challenges Lie on the Horizon

Health crisis disrupts self-storage sector, creating avenues for new demand. The rapid and unexpected spread of the new coronavirus has upended many aspects of daily life and clouded the outlook for commercial real estate, including self-storage. The storage sector differentiates itself, however, with short-term demand drivers. As college campuses closed and people sequestered in their homes, storage needs increased. Greater storage use may also come from businesses as they reopen and adjust to social distancing protocols, which may require them to store furniture and other items off-site. Current renters are holding onto their units as well until the future becomes more clear. All of these factors bolster the sector during a time of extreme uncertainty, although how self-storage properties perform in the longer term will depend on when the pandemic is contained.

Coronavirus alters the future of self-storage use. The health crisis emphasizes the need for storage operators to increase the adoption of automated features if they have not already done so. Digital advertising, online rental systems, and electronic security access all reduce health risks to new customers and employees, a cost-saving measure that is also advantageous to executing new leases in the current climate. Disruptions caused by COVID-19 are also altering self-storage fundamentals. Many construction projects face delays of some kind, further reducing the current pipeline from its 2018 record, a measure that may benefit the sector in the long run. Less competition from new supply should help offset downward pressure from asking rents that may manifest as more consumers and businesses reconcile with reduced incomes or revenue.

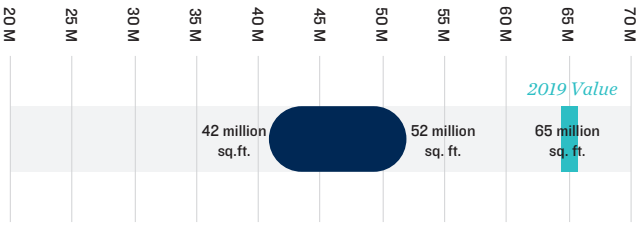
Investment and capital markets remain open for self-storage. Both investors and lenders have been encouraged by self-storage's resilience compared with some other property types. Self-storage properties are a preferred asset class for underwriting loans that will go into new securitizations, while investors of other commercial buildings are looking to the sector as a way to manage risk and diversify holdings. In the event of a more substantial economic downturn, storage properties benefit from certain countercyclical demand drivers that help mitigate overall losses to rental revenue. There is still some caution in the marketplace, however. Buyers are focusing on populated markets with diversified economies while financiers are favoring borrowers already known to them.

Highlights

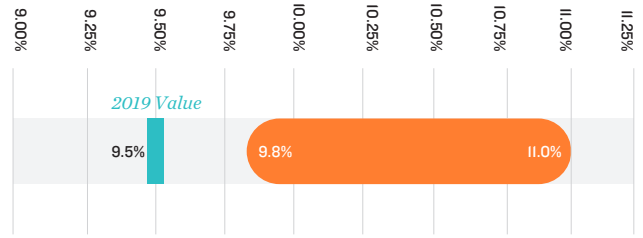
- Projected performance under multiple scenarios.
- Analysis of self-storage's health crisis response.
- Details on how the sector may change moving forward.
- Repercussions of COVID-19 on construction.
- Impact on investment sales and capital lending activity.

Self-Storage Performance Outlook: Projected 2020 Benchmarks

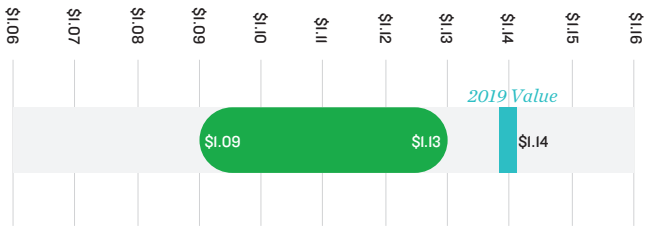
2020 Construction Forecast Range



2020 Vacancy Forecast Range



2020 Average Asking Rent Forecast Range



Sources: Marcus & Millichap Research Services; Union Realtime; Yardi Matrix

2020 Outlook: Self-Storage Sector Stable For Now; Risk Exposure Rises as the Economic Downturn Persists

Shorter — **Economic Downturn** — *Longer*

Stronger — **Economic Recovery** — *Weaker*

Short Downturn/Strong Recovery

- V-shaped economic recovery
- Stay-at-home orders bolster demand in short term
- Minimal interruption to construction pipeline
- Outside buyers enter market to diversify
- Capital remains available as lenders prefer self-storage assets

Extended Downturn/Strong Recovery

- Extended U-shaped economic recovery
- Fast recovery stabilizes demand after shutdown weighs on leading
- Construction pipeline for next 12-24 months reduced
- Less new supply pressure may induce more investment demand
- Limited bridge financing impacts properties still in lease-up

Short Downturn/Weak Recovery

- ✓-shaped economic recovery
- Less income weighs on demand after sequestering ends
- Projects in planning stages are reevaluated
- Diversification drives investment, greater focus on major markets
- Capital available, underwriting standards moderately tighten

Extended Downturn/Weak Recovery

- L-shaped economic recovery
- Despite some countercyclical demand, net usage declines
- Active and planned projects face delays, aid stabilized assets
- Buyers focus on long-term value acquisition
- Liquidity limited, lenders favor stabilized assets in core locations

Short Downturn/Strong Recovery

Rapid recovery paves way for regular operations by year end. Were the economic downturn to be resolved by late summer, short-term storage needs stemming from sequestering would give way to stabilized demand drivers in the second half of the year. A minimal disruption to self-storage performance would help keep proposed construction projects on track, while the interruption to properties underway would be brief. Developments located in less populated areas may be entirely unaffected by health concerns. While some conservative investors may temporarily exit the market, sales activity would be bolstered by out-of-sector buyers looking to reduce their risk exposure and reposition portfolios.

Short Downturn/Weak Recovery

Longer recovery timeline would modestly temper outlook. In the eventuality where the economy is slow to recover from a brief but severe health crisis, self-storage use would face downward pressure. Short-term needs arising from home-based work and schooling would give out to less demand due to lost income and revenues. Construction projects already underway would continue after a brief interruption, but property proposals may be reevaluated given the new demand climate. Investment into self-storage would continue as other property types would likely face greater challenges, with buyers focusing more on stabilized assets in core neighborhoods of markets with diversified economies.

Extended Downturn/Strong Recovery

Costs of extended downturn would outweigh immediate gains. If the pandemic continues past the summer, the short-term benefits to the storage sector from people working from home and other factors would be outweighed by other costs. The extended closure of several businesses along with the associated higher unemployment would limit who could afford to rent a storage unit. At the same time, longer moratoriums on construction would delay many projects. Less new supply pressure for a sector that has been undergoing heavy development recently may actually entice new investment into stabilized assets. Properties built within the last couple of years still looking for lessors would be particularly challenged, however, and less likely to obtain bridge financing.

Extended Downturn/Weak Recovery

A deep and prolonged downturn would impair sector growth. An economic downturn that extends for multiple quarters or years would negatively impact self-storage along with most types of commercial real estate. Some countercyclical demand drivers, such as household consolidation, would temper losses, but the net result would still be fewer self-storage renters. Construction projects underway would be delayed while proposals would be reconsidered. The reduced development pipeline may aid the sector in its eventual recovery, encouraging investors with a long-term outlook. Limited liquidity may constrain sales activity in the near term, though.

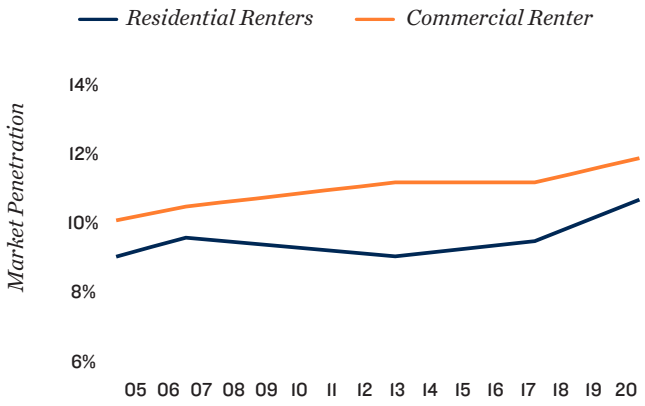
New Health Guidelines and Restrictions Emphasize Short-Term Need for Storage

Homes doubling as schools and offices create demand for self-storage. The disruption to normal life caused by COVID-19 has changed people's needs, including storage. More demand has come from the many college students who had to pack up their dorms early and return home, in addition to greater space needs from office workers who have gone remote. In order to make space for these changes, more people may need to move personal belongings into a separate storage unit. Widespread sequestering has also temporarily brought family and friends who do not normally live together into the same household. All of these factors have put space at a premium, bolstering the self-storage sector amid a broader health crisis and economic downturn. How long this situation persists is still unknown. The California State University system has already suspended in-person classes for the fall, and if other colleges and businesses follow suit then more people may need to hold on to storage units for longer.

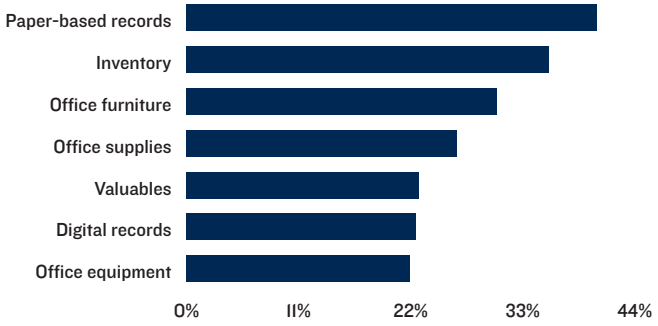
Social distancing increases businesses' storage needs. The effects of the health crisis on self-storage demand are not confined to residential customers. Businesses are also having to adapt to today's circumstances in ways that emphasize storage use. As the country begins the incremental process of reopening, many commercial operations are having to adapt their space to meet new health guidelines. Restaurants, offices, hotels and other businesses, in order to accommodate social distancing, will need to remove some furniture. For companies that have on-site storerooms, the current economic slowdown may prompt them to reduce expenses by consolidating their footprints. Instead of leasing more office or retail space, a business could rent a storage unit at a comparatively lower per square foot cost. These dynamics will help offset lost revenue from commercial renters who are no longer in operation or able to pay for storage space.

Current demand trends to impact investor decisions. The coronavirus' influence on self-storage use may also affect investor sentiment. Property owners' risk exposure has changed, though not to the same degree as other asset classes. New demand drivers for both residential and commercial self-storage use will help maintain operations across various metros and between both urban and suburban zones. The current climate may in fact draw new buyers from other property types. While self-storage is not immune to the economic costs caused by this pandemic, other product types are facing greater challenges at the moment. Investors looking to rebalance their portfolios are likely to apply additional focus to self-storage assets in light of stronger near-term fundamentals.

Self-Storage Use Becoming More Common

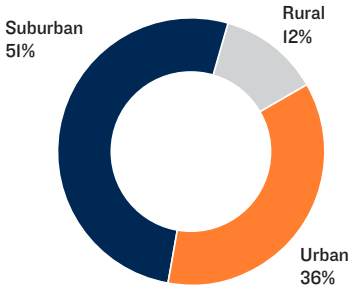


Most Commonly Stored Items By Commercial Tenants



Share of Commercial Renters Who Store These Items

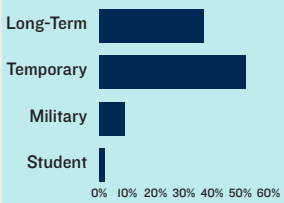
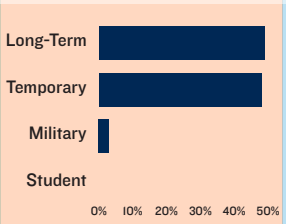
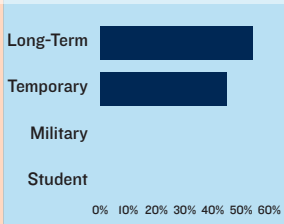
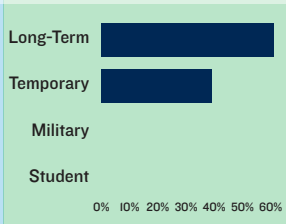
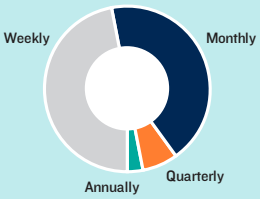
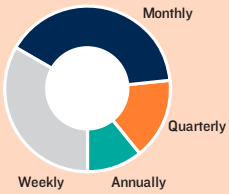
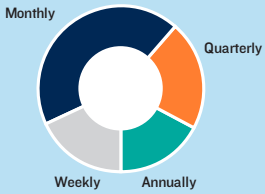
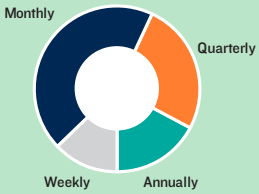
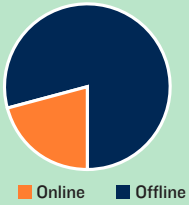
Majority of Residential Renters Still Located in the Suburbs*



** Values may not add to 100 due to rounding.*

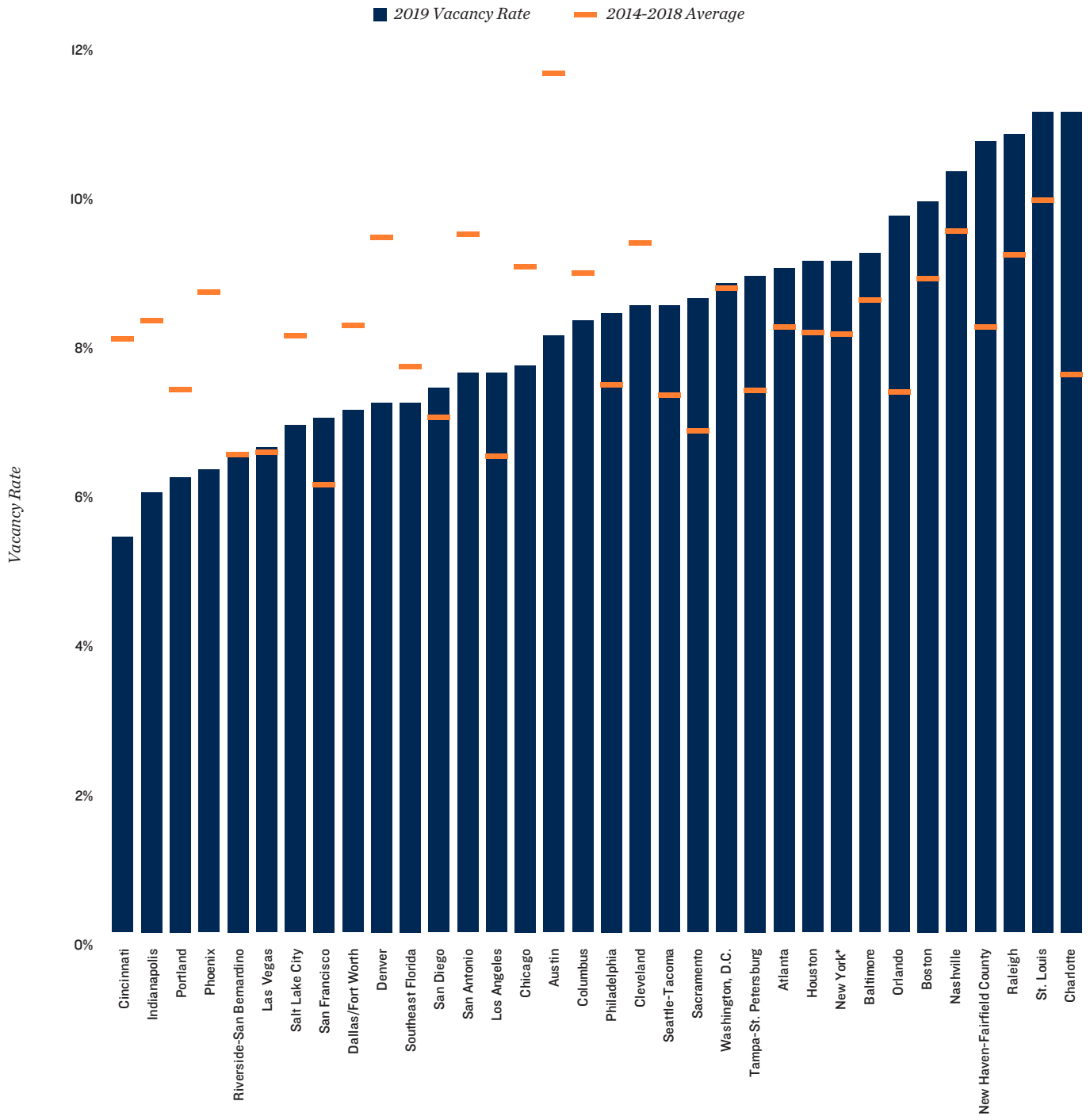
Sources: Marcus & Millichap Research Services; Self Storage Association 2020 Demand Study

2020 SELF-STORAGE RENTER DEMAND PROFILE BY GENERATION

	Millennials	Generation X	Baby Boomers	Greatest Generation
Market Penetration	19%	10%	5%	5%
Breakdown of Renter Types				
Most Popular Unit Sizes	5 x 5; 10 x 10	5 x 10; 10 x 10	10 x 10	5 x 10
Visitation to Unit				
Most Valued Features	Electronic Gate Access; Pest Control; Air-Conditioned	Pest Control; Electronic Gates; Anytime Access	Electronic Gate Access; Drive-Up Access; Pest Control	Pest Control; Close to Residence; Drive-Up Access
Share of Renters Who Looked Online				

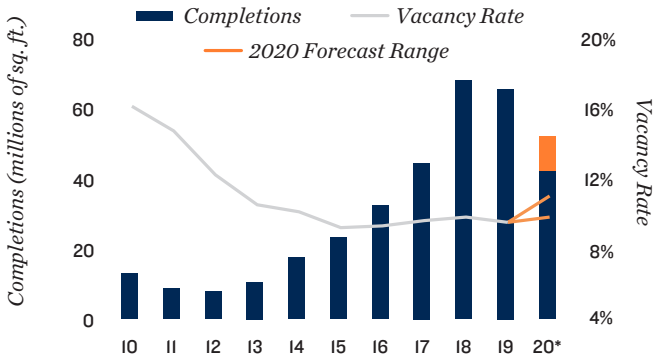
Sources: Marcus & Millichap Research Services; Self Storage Association 2020 Demand Study

INLAND METROS STAND OUT WITH BELOW-AVERAGE VACANCY LEVELS

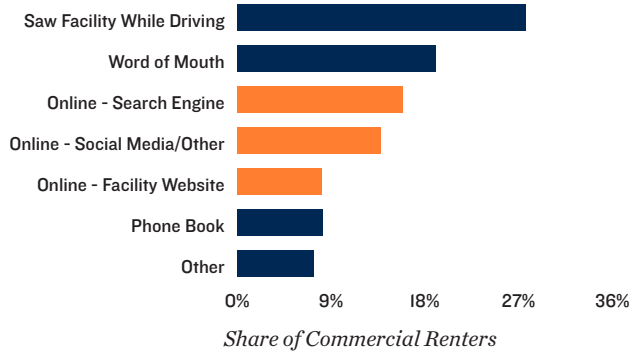


** New York vacancy rate encompasses parts of Newark and Jersey City*
Sources: Marcus & Millichap Research Services; Union Realtime

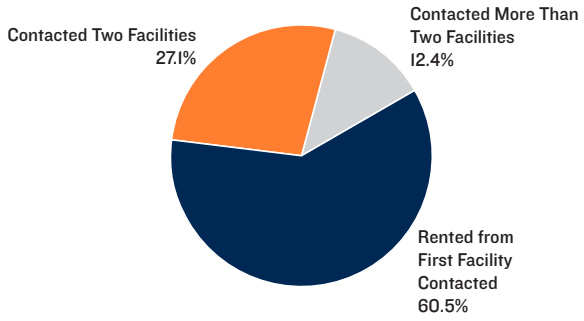
Demand Was Keeping Pace With Elevated Supply Going Into 2020



All Online Searches Now Eclipse Traditional Means of Finding a Facility



Prospective Tenants Largely Rent From First Facility They Contact



** Forecast*
Sources: Marcus & Millichap Research Services; Self Storage Association 2020 Demand Study; Union Realtime; Yardi Matrix

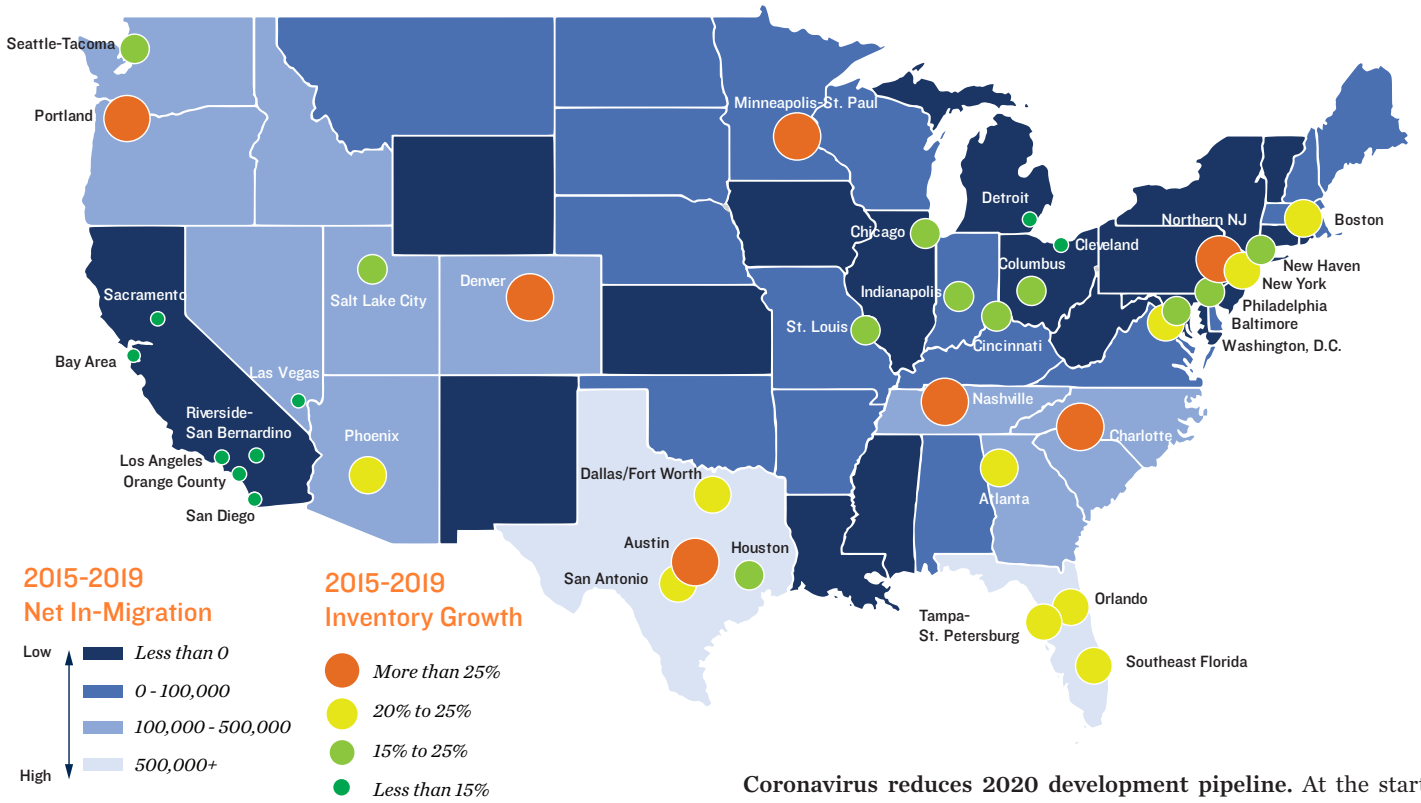
Operations Go Digital; Auctions Face Uncertain Legal Status in Some States

Health crisis adds new push for automation. The automation of self-storage properties was already a rising trend before the spread of the new coronavirus further emphasized this need. Multiple technology tools are now available to help self-storage businesses limit how many employees need to be on location at any one time. Electronic keypad door and gate locks allow renters to have 24-hour access to facilities, while networked unit locks allow both renters and owners to enable and track individual unit access. A robust website with online reservation and payment tools, self-service kiosks on location, and call-center services substantially reduce human capital needs. More large-scale self-storage providers are incorporating one or more of these technologies into their management service. Some organizations, such as the major self-storage REITs, offer these services to properties owned by other parties. Smaller or private operations may collaborate with these management providers to reduce staffed hours and control health risks.

Auction activity slows amid a myriad of state eviction orders. Stay-at-home orders and moratoriums on commercial evictions have interfered with another notable aspect of the self-storage business: the lien auction of items stored by a delinquent tenant. More than half of all states have adopted a moratorium on commercial evictions that either outright prohibits the eviction of self-storage renters or places such action in a legal uncertainty. In some cases evictions are not outright prohibited, but the suspension of court hearings makes execution unlikely. Often, lien auctions are still permitted but cannot take place in person due to restrictions on physical gatherings. Multiple online auction services are available and were in common use before the pandemic. However, in recent weeks the number of auctions have declined, suggesting that either by explicit order, general caution, or overall concern, self-storage operators have stepped back on taking such actions at this time.

Contagion emphasizes importance of digital presence. Sequestration and a reluctance toward close physical contact with strangers may push self-storage businesses to reconsider how they engage with customers. Only 38 percent of residential self-storage renters searched for a unit online in 2020, but that is up 7 percent from three years ago. The trend will only become more prevalent in the future as the population ages and more tenants come from generations accustomed to interacting digitally. Owners are recognizing this pattern, with online advertising representing a growing expense. A website capable of executing new unit rentals and monthly payment collections is a natural extension of this process. For small private owners looking to improve automation and digital outreach, working with a service to build a website is likely the fastest and most immediately beneficial strategy.

Development Wave Largely Aligns With Population Movement As Coronavirus Constricts 2020 Construction



Years of historically elevated development weigh on certain markets, with outlooks further complicated by health crisis. Since 2014, the total amount of self-storage space in the U.S. has grown by nearly 17 percent, more than half of which was added in just the past two years. While much of the recent construction surge was to make up for subdued development following the 2008-2009 financial crisis, the accelerated pace has strained self-storage operations in several markets. Inventories in Denver, Charlotte and Austin all grew by more than 30 percent over the past five years, with Nashville not far behind. Other metros with heavy development include Northern New Jersey, Dallas/Fort Worth and Minneapolis-St. Paul. High levels of net in-migration partially offset ample supply additions in many instances, but pockets of oversupply still arose. Properties delivered within a several mile radius of other new completions or existing assets are most exposed. Another year of active development was anticipated for 2020 before the onset of COVID-19, which has further complicated the outlook for new deliveries as well as self-storage developers and owners more broadly.

Coronavirus reduces 2020 development pipeline. At the start of 2020, an estimated 55 million square feet of storage space was scheduled to open. While that is 10 million fewer square feet than arrived the year before, the original 2020 pipeline would still have represented a 3.4 percent year-over-year increase to supply. Disruptions caused by the new coronavirus, including interruptions to supply chains and moratoriums on construction, have changed that timeline. Total deliveries for 2020 now range between 42 million and 52 million square feet, depending on how and when the current health crisis is fully resolved. While many parts of the country have started to partially reopen, the process is incremental and could be reversed if infection rates spike. A more prolonged shelter-in-place period would delay projects currently under construction, shifting some deadlines into 2021. If the economic costs of the shutdown also impairs consumers' ability to spend on storage more than expected, then properties under proposal could also be reevaluated. While the reduced development pipeline would reduce competition for assets still in lease-up, the broader effects of the pandemic may harm them. Many people are still sequestered, delaying major decision-making that could affect their storage needs. While this hesitation may benefit facilities with high occupancy, it complicates the process of finding tenants for new openings.

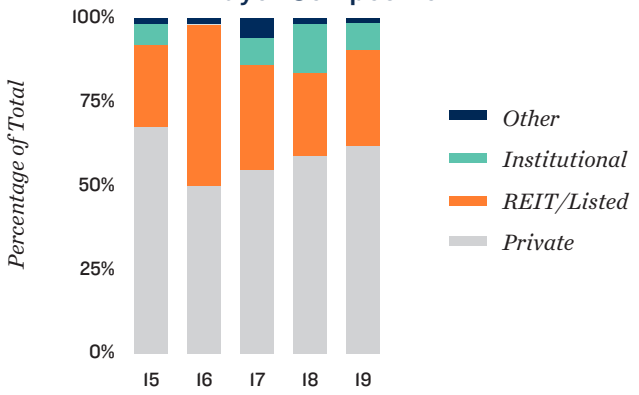
Sources: Marcus & Millichap Research Services; U.S. Census Bureau; Yardi Matrix

Self-Storage Broadens Investment Appeal In Difficult Time; Capital Largely Available

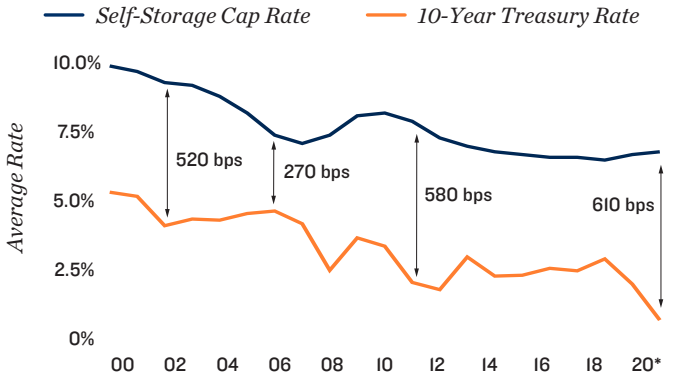
Private investors remain active as new buyers enter sector. The resilience displayed by the self-storage sector during the ongoing pandemic has bolstered the transaction market in an uncertain time. While several large institutions have suspended acquisitions, smaller groups and private buyers with available capital are still active. The net result for the first quarter of 2020 was a 5 percent decline in sales velocity compared with a year ago. Decreases of this magnitude are not uncommon in the seasonal self-storage industry and were well below the larger reductions in sales activity recorded by other asset classes. Self-storage's comparative stability is also drawing new buyers to the sector who are looking to diversify their portfolios. Both new and established self-storage investors are, because of broader economic uncertainty, focusing more on core areas in primary and secondary markets. This will likely lead to fewer assets in smaller cities with less-diverse economies changing hands in the coming months.

Many financiers continue to engage with self-storage assets. Capital liquidity remains readily available even as certain lenders temporarily remove themselves from the marketplace. Some life insurance companies have paused self-storage loan origination while both national and local banks continue to provide financing to familiar borrowers. The largely dormant CMBS market is also starting to become more active, with self-storage a preferred asset class for securitization. Recent loan-to-value ratios of 60 percent to 65 percent show a willingness on behalf of financiers to take on slightly more leverage than with some other property types. Several months of principle and interest reserves are usually required, however. Borrowers are also generally not able to take full advantage of historically low Treasury rates as many lenders have widened their margins. Bridge financing has also become much more constrained. This could prove a dilemma for non-stabilized properties with existing loans coming due that are unable to meet leasing expectations because of widespread stay-at-home orders.

Private Investors Continue to Dominate Buyer Composition ❖



Cap Rate Spread Over 10-Year Treasury At Widest Point in Over Two Decades



* As of March 31, 2020
❖ Sales valued at $2.5 million and greater
Sources: Marcus & Millichap Research Services; CoStar Group; Real Capital Analytics

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Price: $1,500

Sources: Marcus & Millichap Research Services; CoStar Group, Inc; Federal Reserve Bank of St. Louis; Self Storage Association 2020 Demand Study; Real Capital Analytics; U.S. Census Bureau; Union Realtime; Yardi Matrix