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Self-Storage Industry Is Poised for More Growth

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Summary

The US self-storage sector is poised for continued strong growth this year, owing to solid tenant demand and rising rents. Limited new supply of facilities also is driving the industry's success, and the underlying dynamics likely will be strong for the next three to five years.

Several unique characteristics contribute to the industry's stability, such as short-term leases that give self-storage companies flexibility to respond to market changes and a diverse customer base that helps limit the risks of exposure to only a single tenant or handful of tenants. Self-storage REITs are in a stronger position than small, local operators, which increasingly are turning to REITs to handle their customer service and other functions in a third-party capacity. The larger REITs likely will continue to benefit from further consolidation. The sector's strength also is tied to its ability to weather a rough economy, as seen during its relatively quick recovery from the recession compared with other real-estate asset classes.

We rate two of the four publicly traded self-storage REITs, Public Storage ((P)A2/stable) and CubeSmart (Baa3/stable).

Distinctive Characteristics Help Maintain Sector Stability

A number of key characteristics contribute to the relative stability of self-storage, including the ability of companies to negotiate short-duration leases. Short-term leases allow owners to adjust rental rates at any time, giving them flexibility to react quickly to market changes and demands. The industry also has minimal capital expenditures because companies rarely need to spend heavily to refurbish units after tenants vacate. Additionally, the sector has a low break-even occupancy rate, of approximately 60% to 72%, which helps boost profitability.

Self-storage companies have a diverse customer base, which reduces the risks of exposure to only a single tenant or handful of tenants. The industry is resistant to economic shifts and can benefit even when customers face adverse life changes, such as foreclosure, divorce or a downsize in housing.

Additionally, commercial customers are growing, providing added occupancy stability and longer average rental terms. In 2012, commercial tenants' average length of stay was 27 months, while residential tenants stayed 18.1 months on average.[1] Self-storage operators are attracted to markets where businesses thrive, allowing them better access to coveted commercial clients. Commercial tenants run the gamut from large pharmaceutical companies to small business owners and entrepreneurs.

Two trends continue to support more demand for self-storage. Like the multifamily sector, self-storage benefits from the growing number of "echo boomers" - people ages 18-34 - who are renting apartments rather than buying homes. Also, home ownership is declining overall. The home ownership rate in the US fell to 65.3% in the fourth quarter of 2012, compared with an all-time high of 69% in the fourth quarter of 2005.[2]

Strengths of Self-Storage REITs Outweigh Challenges

Self-storage REITs are particularly well positioned, because they stand to benefit the most from solid industry fundamentals such as strong demand supported by limited supply and construction over the next two to three years. New supply across the industry continues to be constrained compared with the boom years in 2000-2005, when nearly 3,000 new self-storage facilities were being built every year. As Exhibit 1 shows, new construction starts totaled less than 950 from the third quarter of 2006 to the third quarter of 2012, which has permitted demand to outpace supply.

EXHIBIT 1

New Construction Remains Low

Source: Cushman & Wakefield, Inc., Self Storage Performance Quarterly. New starts tracked by F.W. Dodge.

With few projects delivered across the country, existing facilities, particularly those in strong markets, will benefit from higher occupancies and rental rates. Although development is expected to rise modestly over the next few years, the construction and entitlement process for new facilities can be cumbersome. The period for new properties to reach stabilization, the time it takes to reach reasonable occupancy levels, could take an additional two to three years.

REITs also benefit from strong management teams with solid operating acumen. REITs have developed sophisticated revenue management systems and in-house call centers, which allow them to capture more volume and rental inquiries than in the past. REITs frequently serve as third-party

1 Self-Storage Almanac 2013

2 US Census Bureau Housing Vacancy Survey

managers for local operators. By serving in this capacity, REITs can expand into new markets and extend their brand names without deploying additional capital.

The publicly traded REITs also have good access to all sources of public and private capital. Through their access to capital at rates that are substantially lower than private operators can obtain, REITs are in a strong position to acquire smaller competitors.

The challenges for companies in the sector include limited alternative use for facilities. Additionally, the industry is highly competitive and operating intensive, and industry fragmentation will continue to limit meaningful and scalable growth. Only about 10%-15% of self-storage properties are publicly owned, according to the Self-Storage Association. Public Storage is the industry leader, holding direct and indirect equity interests in more than 2,000 self-storage facilities in 38 US states. Excluding Public Storage, the remaining top 10 operators in the industry control approximately 6.9% of the total self-storage facilities in the US. [3]

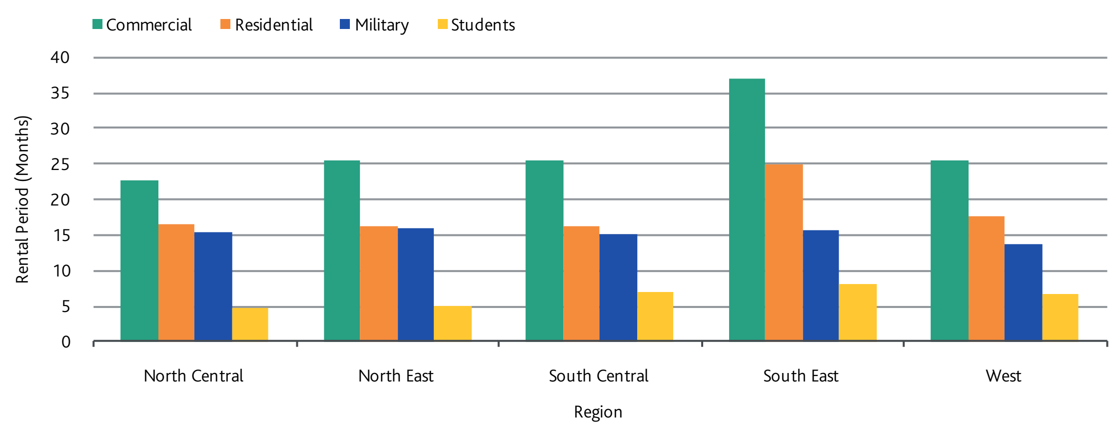
Acquisitions Will Benefit the Largest Players

Acquisitions will continue in the sector, though likely at a conservative pace, and the larger companies are poised to see the biggest benefit. Smaller, private operators can struggle with a lack of capital to compete in the fragmented market, particularly in paying for advertising in the competitive industry. The publicly traded REITs also enjoy economies of scale and greater operating efficiencies.

Facilities in high-growth markets, generally defined as urban areas with high population densities, are likely to be the most highly desirable for potential acquirers because they command the longest average rental length of stay. Facilities in major metropolitan areas also command higher average rental rates than suburban or rural assets. As illustrated in Exhibit 2, the Southeast has the longest average rental periods in the country for commercial, residential and student renters.

EXHIBIT 2

Average Rental Period by Region



Source: 2013 Self-Storage Almanac

The 2011-12 period saw several major deals involving REITs. In one of the largest, publicly traded REIT CubeSmart acquired 22 properties from New York-based Storage Deluxe, Inc in late 2011. The deal accelerated CubeSmart's efforts to expand in core, urban markets characterized by strong demographics, significant barriers to entry and high rents. As of this year's first quarter, CubeSmart is the largest self-storage company by number of properties in the greater New York City area.

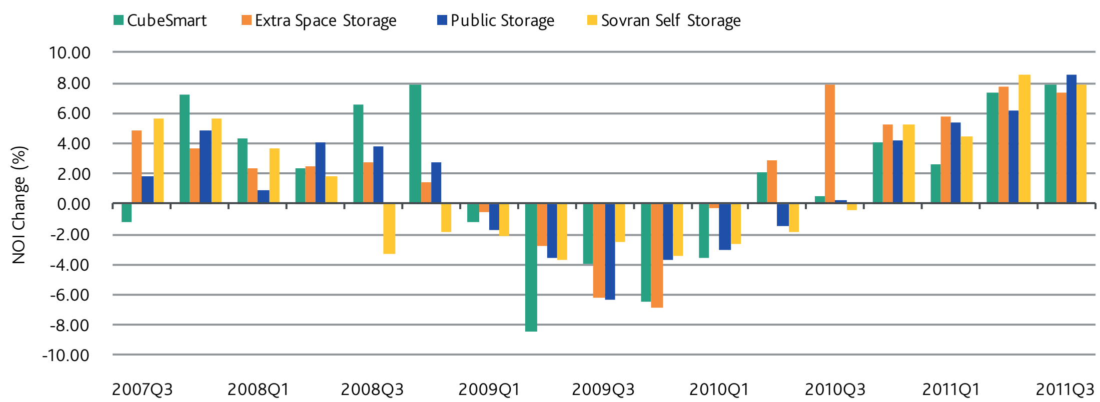
[3] Self-Storage Almanac 2013

Recession Performance Points to Sector's Resiliency

The industry's resilience during the Great Recession of 2008-2009, as compared with the performance of other real-estate asset classes, shows that self-storage companies can weather economic trouble relatively well. Exhibit 3 shows the NOI growth/decline for the four publicly traded self-storage REITs from the third quarter of 2007 to the third quarter of 2011. While other real estate asset classes sustained double-digit drops in NOI during this period, self-storage REITs only registered mild declines in revenue and bounced back much quicker from the recession compared with other sectors. Self-storage posted a 19.4% total return in 2012 and a 35.2% return the prior year, making it one of the top-performing sectors of all US REITs.[4]

EXHIBIT 3

Same-store NOI Change (%)



Source: SNL Financial; Company Reports

[4] National Association of Real Estate Investment Trusts: REITs Continue to Outperform Equity Market in 2012

Moody's Related Research

Industry Outlook:

» [US REITs: Industry Outlook, April 2013 (152967)]

Rating Methodology:

» [Moody's Approach for REITs and Other Commercial Property Firms, July 2010 (126268)]

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Report Number: 156386

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