European self-storage steps into the limelight

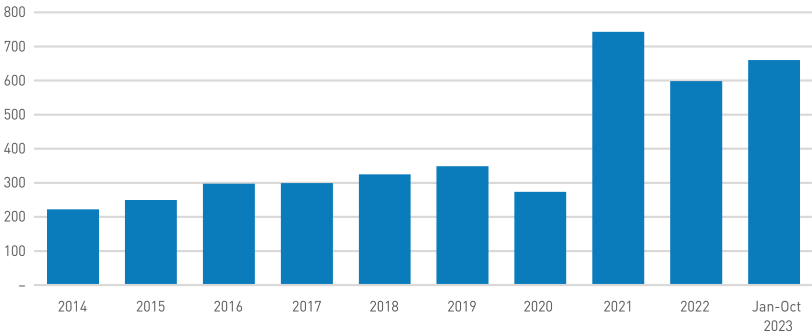
HEITMAN
A REAL ESTATE INVESTMENT MANAGEMENT FIRM

Zubaer Mahboob
Director of European Investment Research, Heitman

Long considered a niche sector in European real estate, self-storage has attracted growing interest from institutional investors since the pandemic. A flurry of large transactions in the last two years attests to the rising mainstream appeal of the sector.[1] These deals have been driven not only by the major Real Estate Investment Trusts ("REITS") that historically dominated the European investment market, but also by a widening array of large private buyers.[2] The geographical range of transactions is also expanding. Pre-pandemic, self-storage trading was concentrated in the UK market, occasionally augmented by sporadic deals in Western Europe (e.g., in Scandinavia or Benelux).[3] However, in recent quarters, sizable portfolios have traded in newer markets, such as Ireland and Germany, with more in the pipeline in countries further afield, such as Italy, Spain, and Poland.[4]

Going forward, we believe these trends may strengthen. Real estate investors today are faced with a complex set of challenges, such as persistent inflation and "higher for longer" interest rates, geopolitical tensions that make for a difficult growth environment, and, specific to property, an uncertain outlook for traditional sectors. In response, we have seen investors undertaking a long-term reallocation of capital, broadly moving away from traditional sectors and towards alternative sectors. Transaction data bears this out; alternatives have increased their share of European investment volumes from approximately 27% before the COVID-19 pandemic (2010-2019 data) to 35% post-pandemic.[5]

Chart 1: European self-storage investment volume, €m



Source: JLL Database, (2014-2022); CBRE (2023)

Self-storage appears to be one of the key beneficiaries of this ongoing process of capital rotation. As Chart 1 demonstrates, investment volumes in the sector have more than doubled from a pre-pandemic average of approximately €290 million per year to over €660 million per year in 2021-2023.[6] This upward trend is being supported by a significant expansion of the "investable universe" of self-storage assets, through both the total stock of storage increasing and owner-operators seeking out institutional capital to support their future growth. According to a Heitman research study for the period 2016-2021, the size of the European self-storage investable universe grew by more than 80%, reaching €19bn by 2021. This was driven by capital value growth of approximately 46% and growth in the institutionally held stock of approximately 26%.[7] The fundamentals of the self-storage sector, we believe, support the proposition that the sector is poised for further growth in Europe.

Sector fundamentals and dynamics

Demand in the self-storage sector is primarily driven by lifecycle events in a household, often summed up as the "Four Ds": death, divorce, dislocation, and downsizing. These drivers are generally delinked from the economy, and thus potentially offer a measure of protection against the vagaries of the macro cycle and property cycle. During recent downturns, including the Global Financial Crisis ("GFC") and COVID-19 pandemic, European self-storage demand proved to be relatively resilient.[8] Meanwhile, business use of self-storage is supported by structural trends such as e-commerce growth and supply chain reconfiguration, especially given the shortage of last-mile logistics across Europe. Self-storage is thus an extension of both the home and the supply chain.

The total stock of self-storage, on the other hand, is very low, as one would expect for a sector that is still emergent. According to the Federation of European Self Storage Associations ("FEDESSA"), stock per thousand people in Europe in 2022 was only 23 square meters ("sqm"), or 1/25 the figure in the US.[9] Excluding the UK, and considering continental Europe alone, that saturation figure falls even further to 15 sqm per thousand.[10] The comparable value in the UK is 71 sqm.[11]

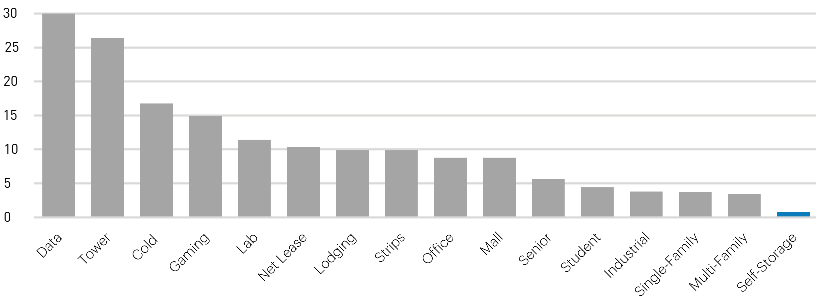
Some of the key demographic and societal factors that underpin self-storage usage are degree of urbanisation, population density in towns and cities, household income levels, housing market conditions (e.g., typical size of homes, shortage of new housing, etc.) and awareness of the self-storage concept. On many of these measures, the European market outperforms or at least matches the US.[12] Europe is a more heavily urbanised continent, population density in the cities is typically higher than in American cities, while European homes tend to be smaller with much less living space for families.

We believe that the fundamental conditions therefore already exist for self-storage to expand further into Europe's urban fabric. Maturation of the sector does not necessarily mean that European saturation levels will eventually catch up with the US. (In our view, such an outcome is unlikely in any event, due to factors such as land scarcity, stricter zoning laws, etc.) But even if the European sector were only to catch up to UK levels of penetration, that would imply a 5x increase of existing stock.[13]

Implications for the sector

For potential investors, the pertinent question is: what do strong demand and poor supply imply for performance on the ground, as measured by occupancy rates and rental growth? Quarterly data from the big REITs give us a good indication of current conditions in the market. Shurgard, the largest European operator with 266 stores in seven countries, reported same-store occupancy rates of 90% in Q2 2023, accompanied by rental growth of 5% year-over-year. Big Yellow, the UK's largest operator, reported occupancy of 85% in Q2 2023 while rent growth was 6%. These numbers are also supported by FEDESSA. Their latest annual survey (carried out in May-July 2023) shows that across Europe, only 1.7% of customers are more than 30 days overdue in paying their rental fees. 57% of operators meanwhile expect rental growth to exceed or match inflation over the next 12 months. The contrast with traditional sectors is instructive. For example, across Europe, average headline office rents are expected to decline

Chart 2: Estimated carbon emissions by US property sector, kgCo$_2$e/sqft



Source: Green Street Advisors, US Self-Storage Outlook, 2023

by -3% in 2023, with larger falls for effective rents.[14] There is also historic evidence of resilience from the well-established US self-storage market. During the GFC, American self-storage REITs experienced only a 3% fall in rents and a 2% fall in occupancy — comparatively better than that of traditional property sectors.[15]

Self-storage has additional features that deliver greater resilience compared to traditional sectors. Self-storage leases tend to be short and are typically renewed on a monthly basis. The tenant base is granular and diversified, consisting not only of numerous households but also small and medium-sized enterprises which take up around a third of all space in Europe.[16] These factors truly come into their own in an inflationary environment; shorter leases and granular demand lead to quicker and fuller inflation passthrough by operators. Analysis of US sector returns over a 40-year period reveals that self-storage offers a better hedge against inflation not only compared to the traditional sectors but even against the residential sector.[17]

Crucially, the quality of cash flow in self-storage is also very robust. Because of the nature of the assets, capex requirements in self-storage tend to be very low. UK self-storage REITs typically only need to use 7% of net operating income ("NOI") for recurring capex, far lower than the 16% reserved by industrial REITs.[18] On a related note, we believe that obsolescence risk is lower in self-storage, and its sustainability credentials better than other sectors. Data from Green Street Advisors shows that self-storage assets have, by a wide margin, the lowest emissions of any real estate category.[19] As seen in Chart 2, self-storage emissions are five times lower than multi-family and 43 times lower than data centers.

The final component of returns is cap rates. Throughout the past cycle, self-storage cap rates have been marked by their relative stability, especially compared to cap rates in other sectors, such as industrial.[20] If we look at economic cap rates—i.e., the net initial yield ("NIY") adjusted for recurring capex requirements—we find that institutional-grade self-storage assets in Europe have traded within a relatively narrow range of 4-6% over the last five years.[21] As of November 2023, Green Street's benchmark self-storage yield for the UK is 5.8%, which still represents a spread of 80 basis points ("bps") over industrial even after significant yield expansion in the latter sector.[22] After accounting for the strong NOI growth offered by self-storage, total returns rank favorably compared to other sectors.[23]

Market opportunities

We are seeing small and midsized portfolios coming to market with greater frequency, as the first generation of founders retire out of the business. Investors who are able to aggregate and consolidate these into larger portfolios may benefit from substantial portfolio premia, while experienced managers may enhance them through active value creation.[24] Deployment of search engine optimisation tools, better use of branding, sales and marketing, and implementation of dynamic pricing models are all examples of how an experienced management team may be able to unlock additional value. Current owners may be constrained in these areas by limitations of access to capital and know-how. In our view, this partly reflects a key feature of today's self-storage market—its many sub-scale portfolios. Across Europe, the five largest operators manage only 18% of all self-storage facilities.[25] The vast majority of self-storage firms in Europe are still smaller family-operated businesses, each running only a handful of stores within a narrow geographical range. The market is therefore ripe for consolidation and operational improvement.

> "Self-storage leases tend to be short and are typically renewed on a monthly basis, the tenant base is granular and diversified, consisting not only of numerous households but also small and medium-sized enterprises which take up around a third of all space in Europe."

What about financing? Debt costs have risen sharply in the wake of sustained rate hikes by central banks.[26] This is a relatively new challenge for all investors who had become used to the accommodative conditions of the last two decades. We believe that higher debt costs may also give rise to opportunities in self-storage. Many operators need additional capital to grow their platforms and to improve their operations but are finding debt markets more difficult and expensive to access. Equity investors may be able to provide liquidity in addition to the expertise needed for growth.

In the public markets, most European property sectors (including self-storage) are trading at discounts to gross asset value ("GAV") in the 10-20% range, suggesting further price corrections.[27] Cyclical and structural risks still challenge traditional sectors, but we believe that alternative sectors such as self-storage—supported by needs-based demand and favorable secular trends—can offer investors the opportunity to exploit specific market dislocation. The relative strength of European fundamentals is demonstrated by listed operators here trading closer to GAV than their US counterparts.[28] Not only did Europe reprice quicker than the US, but there are also key differences between the two self-storage markets, notably scarcer supply in Europe as well as higher starting yields.[29] The latter partly reflects premia for liquidity and operational intensity, but we believe that these are generous relative to the additional asset management involved. Indeed, the history of the US market shows that the yield spread over traditional sectors tends to narrow over time, as operators, lenders, and investors become more established in the sector.[30]

Research published by Heitman shows that established operators can charge rent premia of up to 35% over smaller operators, after controlling for market factors.[31] Historically, we have seen that periods of economic crises may lead to capital reallocation decisions that help to bring about the institutionalisation of newer categories of real estate. In the US, for example, the alternatives share of the Open-End Diversified Core Equity ("ODCE") index increased sharply during the GFC and COVID-19 pandemic.[32] As investors once again face a period of macro volatility and geopolitical uncertainty, self-storage may offer a compelling opportunity.

FOOTNOTE

1 Self-Storage Sector Update: Finely Balanced, Green Street Advisors, June 2023
2 The REIT share of European investment was 50% in 2022 and is currently at over 80% in 2023. Source: CBRE-FEDESSA, European Self-Storage Industry Report, 2023
3 European transactions database, MSCI Real Capital Analytics, accessed November 2023; and Deals Analysis by Green Street Advisors and Inside Self-Storage
4 "Shurgard acquires €69m German self-storage portfolio," React News, October 2023
5 MSCI Real Capital Analytics, European investment volume data, accessed November 2023. Post-pandemic defined as the period spanning 2022-2023
6 CBRE-FEDESSA, European Self-Storage Industry Report, 2023
7 FEDESSA Industry Reports, 2016-2021 (stock and average rent data); RCA, database, accessed June 2022 and publicly disclosed REIT, accessed June 2022 (institutionally-managed share estimates); JLL, database, accessed June 2022 (yield estimates). We utilized the data on rents and yields to estimate capital values per sqm over time. We utilized the data on total stock and institutionally-managed stock to estimate the investable sqm over time. Lastly, we multiplied these two figures together.
8 FEDESSA Annual Reports, 2014-2023
9 CBRE-FEDESSA, European Self-Storage Industry Report, 2022
10 CBRE-FEDESSA, European Self-Storage Industry Report, 2022
11 CBRE-FEDESSA, European Self-Storage Industry Report, 2022
12 Eurostat, Oxford Economics, databases accessed October 2023
13 CBRE-FEDESSA, European Self-Storage Industry Report, 2022
14 Green Street Advisors, database, November 2023
15 Based on historical data for US self-storage REITs CubeSmart, ExtraSpace, Public Storage, Life Storage and National Storage Affiliates during Q1 2008-Q4 2010. This was compared to rent and occupancy data reported for office, industrial, and retail properties as reported by CBRE
16 CBRE-FEDESSA, European Self-Storage Industry Report, 2023
17 NCREIF data, accessed September 2023. Based on a regression model to predict total returns where the independent variables were GDP growth and CPI inflation. During high inflation periods, the coefficient on the inflation variable was statistically significant for self-storage, industrial, residential and office, but not retail. For self-storage the coefficient was almost twice as high as in the other property sectors
18 Green Street Advisors, database accessed October 2023
19 Green Street Advisors, database accessed October 2023
20 Green Street Advisors, Database, November 2023. Based on a comparison of UK self-storage yields and industrial yields during the period of June 2022 through November 2023. This country is selected because time series data is available to make the comparison. Storage yields rose by 86 bps while industrial yields rose by 196 bps
21 Green Street Advisors, Database, November 2023
22 Green Street Advisors, Database, November 2023
23 Source: Green Street Advisors, Database, November 2023. Based on the long-term NOI growth rate of self-storage, which has been in the top quartile of European property sectors over the past decade
24 "Nuveen/TIAA Agree to Acquire Self Storage Group ASA of Europe," September 2023, https://www.insideselfstorage.com/europe/nuveentiaa-agree-acquire-self-storage-group-asa-europe
25 CBRE-FEDESSA, European Self-Storage Industry Report, 2023
26 DWS Real Estate Research, Europe Real Estate Debt Update, October 2023
27 Green Street Advisors Database, October 2023
28 Green Street Advisors, Database, November 2023. Based on a comparison of discounts to gross asset value between European and US self-storage REITS
29 Green Street Advisors Database, March 2022-June 2023
30 Green Street Advisors, Database, November 2023. Based on a comparison of the spread between US self-storage and industrial yields during the period of 2013-2023 for which consistent data is available
31 IPF-Heitman, The Determinants of UK Self-Storage Rents, May 2022
32 NCREIF, ODCE Index Report, Q2 2023