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REAL ESTATE

Storage likely to remain an outperformer

Ongoing lifecycle changes create persistent demand drivers for households needing storage

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Melissa Reagen,** managing director and portfolio manager with Nuveen Real Estate, about the outlook for the storage sector. Following is an excerpt of that conversation.

Can you walk us through why storage has historically been an outperformer relative to the NFI-ODCE benchmark, and what are the sector's key demand drivers?

A big reason for the historical outperformance in storage has been the demand drivers of storage, which tend to be lifecycle events — getting married or moving, the birth of a child, a climate disaster, divorce, or any life-changing event drives the demand for self-storage. Whether or not the economy is in a recession, the demand for storage tends to be there. That doesn't mean the sector is immune to anything happening in the economy. Of course, it's not. But storage is a little bit more insulated because those life-changing events are happening all the time, and this dynamic helps storage outperform.

The NCREIF ODCE benchmark has historically been driven by the four main property types. Storage in the past 10 or 15 years has been on the radar of many institutional investors. But it's still a small allocation in most investors' portfolios and is still nascent in that respect, as part of a pure institutional allocation.

Do you think storage will remain an outperformer going forward, whether that is the next 12 months or 24 months?

Yes, given the nature of storage being driven by these life events. In 2005, 9 percent of all U.S. households rented storage. If you roll that forward to 2020, 14 percent of all U.S. households rented storage. During the past 15 or 20 years, the demand by households has grown, and we think it will continue to grow. Part of that growth is a function of population growth. The need for storage during the pandemic, when you had to rearrange your house to make room for an office, increased the demand for storage. But now, many households are in starter homes. People may not be able to get out of a starter home for quite a while, given where mortgage rates are, and they are probably going to need some storage.

Through 2027, occupancy rates are forecasted to remain above their historical average. Historically, occupancy rates for storage have been around 90 percent to 91 percent. They're going to be closer to 92 percent or 93 percent, going forward. Certainly, from a historical perspective, occupancy rates will remain strong. From a rent-growth perspective, it has moderated from the abnormally high COVID-19 levels and will likely be 3 percent to 4 percent, going forward, which is in line with the historical average. Supply is another big component. Supply is forecasted to be below the historical average through 2027, which has been about 3.6 percent new supply per year. It's expected to be around 3 percent for the next four or five years. That is another good tailwind for storage to remain a strong outperformer, going forward.

Haven't the storage fundamentals been slowing recently? If so, why would storage continue to remain an outperformer?

Storage fundamentals have slowed recently, especially compared to the abnormally high COVID-19 spikes we saw in rents and occupancy. The pandemic drove dramatic changes in lifecycle events. People moved out of urban areas very quickly. We saw rent growth and double-digit NOI growth in the mid-teens to upper teens during the pandemic and occupancy rates were close to 96 percent, well above historical averages. That has certainly slowed, but we see it as a moderation back to historical levels, or even in some cases, above-historical levels, whether you're looking at supply occupancy or rental growth. The headlines can miss this important nuance.

Our research has revealed to us that a lot of households — 50 percent of all homes that were bought between 2000 and 2022 — were less than 2,400 square feet. If you bought a home in the past couple of years and it was on the smaller side because, say, you had just gotten married, as your family grows, you need more space. But mortgage rates remain high, and many households are not going to buy a new home until mortgage rates fall.

They may hope to get a bigger home someday, but in lieu of that, they are going to need some storage. We believe that will be another driver of outperformance, at least in the medium term.

And then, as more institutional investors want storage in their portfolios due to its strong historical outperformance, the demand will increase from a pricing perspective. You can expect cap rates to move lower as we get more capital flows into storage as a sector overall.

What are the biggest risks for the self-storage sector?

New supply is a big driver of risk. In today's environment, there is not a lot of lending available for construction, which has meant a big pullback in the amount of storage that's going to be built. While it is a risk, it is probably not a near- nor medium-term risk. Another risk to storage, as with other property types, may be higher property taxes or higher insurance costs. But I believe the biggest risk would be, if anything, change in the demand patterns for storage — if millennials suddenly didn't need all the storage they have, for instance. There's nothing suggesting that will happen, but it's an unknown.

People thought millennials were not going to store "stuff" in storage. Did that thesis ever materialize? What about Gen Z?

There was a lot of talk 10 or 15 years ago around whether millennials would need storage, given their focus on experiences rather than things. Today, millennials are the largest storage renter cohort, making up 38 percent of all storage renters, which is the largest percent among any of the cohorts. They do like their "stuff." With Gen Z, if their preferences are dramatically different from prior generations, and they want a minimalistic lifestyle, then certainly that could be on the horizon. At this point, we do not have enough data points. It's too early to have any idea what their preferences will be.

Your strategy is to acquire mom-and-pop owned storage assets, but haven't most institutional investors already bought up all those assets? How many more exist to acquire?

About 50 percent of the universe is still mom-and-pop storage assets. If you drove around any city, you would see a lot of these family-owned businesses that have not been acquired by a REIT or institutional investors. Buying mom-and pop-storage has a long runway. The big benefit of buying these assets is that rents and occupancy are far below market, offering the opportunity to go in and increase rents and occupancy. Noninstitutional owners of storage tend not to increase rents every year or every couple of months. Further, these assets also need capital improvements, such as new signage, doors, roofs, asphalt — all which are great opportunities to add value to these assets. You need to replace the signs, the doors, the roof, the asphalt, which is another great opportunity to improve and revitalize that asset.

What is the risk and reward for developing storage in today's environment versus just acquiring existing assets?

Currently, acquiring existing assets provides a higher risk-adjusted return versus developing new storage assets because land values are just now starting to correct. We suspect land values will continue to correct through 2024 and into 2025. At that point, there will be some good development opportunities available because land prices have corrected. We've seen the most amount of value decline on the value-added storage assets, relative to core assets, but this will change as the cycle evolves.

Is financing available for storage in today's environment? And if storage financing is available, is it accretive in today's environment?

Storage financing is available, but it is not widely available. The spreads are lower for storage assets that are much more stabilized in nature, where you're not having increased rents, but they are well stabilized. Spreads are higher for unstabilized, value-added assets.

How much has self-storage repriced since the first quarter of 2022?

That's really when the Fed started to raise rates and when storage values peaked, along with most real estate values. According to Green Street, storage values are down about 14 percent from quarter in 2022, and all property is down about 19 percent from that point. From here, the movement in storage values will largely depend on whether the fed cuts or hikes rates.

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As portfolio manager, Melissa Reagen oversees all the investment and portfolio allocation decisions for the U.S. Strategic Alternatives Strategy. Prior to the portfolio management role, Reagen led a team of research and strategy professionals focused on the U.S. real estate market at Nuveen Real Estate, which helped inform all investment decisions. During her time as head of U.S. research at Nuveen Real Estate, she has worked and collaborated closely with the company's portfolio managers, helping them make accurate investment recommendations across their portfolios. The result was a material shift toward the alternative property types across the platform.

COMPANY PROFILE

Nuveen Real Estate is one of the largest investment managers in the world with $149 billion of assets under management. Managing a suite of funds and mandates, across both public and private investments, and spanning both debt and equity across diverse geographies and investment styles, we provide access to every aspect of real estate investing. With more than 85 years of real estate investing experience and more than 800 employees* located across 30-plus cities throughout the United States, Europe and Asia Pacific, the platform offers unparalleled geographic reach, which is married with deep sector expertise. Nuveen Real Estate is an investment affiliate of Nuveen LLC (Nuveen), the investment management arm of TIAA. For further information, please visit us at **nuveen.com/realestate.**

*Includes more than 395 real estate investment professionals, supported by a further 400 + U.S. Nuveen employees. Source: Nuveen, Sept. 30 2023 GWP-3481389CR-Y0424WX

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