THE

LeClaire

GROUP

MIDYEAR 2018
THE SELF-STORAGE OUTLOOK

Marcus & Millichap

The Self-Storage Outlook

Midyear 2018

Economic Growth Lifts Demand for Self-Storage as Properties Adapt to Changing Market Conditions and Consumer Tastes

Economy gets a boost from tax reform. Economic growth surpassed 4 percent in the second quarter, lifted by strengthened consumption and business investment. The new tax law has stimulated the economy by increasing after-tax earnings and pushing consumer and business confidence to near-record levels. This combination has sparked elevated spending and accelerated job creation. Through the first half of 2018, the economy added over 1.3 million jobs, driving unemployment below 4 percent and boosting wage growth to 2.7 percent, its highest level since the onset of the recession. As a result, personal disposable income has grown by 5.4 percent over the last year, dramatically outpacing the 3.5 percent average growth rate over the past 10 years. The combination of low unemployment and more disposable income has translated into particularly strong consumption. Through the summer, core retail sales growth surged to 5.6 percent, well ahead of the 10-year average of 3.1 percent.

Rising inflation and higher interest rates could cool momentum. Accelerated growth brings with it some new challenges. Core inflation has nudged upward to 2.3 percent, raising caution at the Federal Reserve. To rein in inflationary pressure, the Fed has already signaled that it will tighten monetary policy by raising the overnight rate a total of four times in 2018; this will push up short-term interest rates. The challenge for the Fed is that long-term interest rates have been range bound, with the 10-year rate hovering near 3 percent for the last six months. Unless the Fed can push long-term rates up, its monetary tightening policies could invert the yield curve, raising short-term Treasury yields above long-term Treasuries. An inverted yield curve is a commonly perceived sign of an impending recession, raising the risk of a slowing economic outlook.

Self-storage properties well positioned for current economic conditions. Today's economy is strengthening self-storage in three main ways. Consumer spending is up, aiding demand through the greater accumulation of possessions. More households are forming, many into apartments, and tenants often store seasonal items such as holiday decorations and camping gear. Finally, many new hires are moving to cities for jobs, requiring storage during their transition. In the eventuality of a downturn, the possibility of household consolidation will also increase the need for storage space as residents move in together.

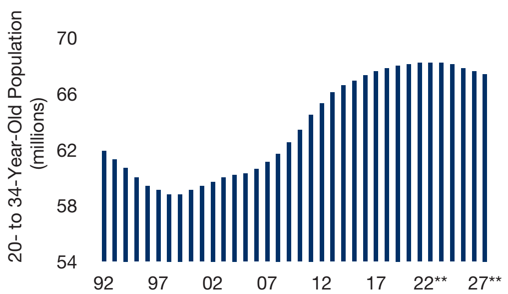
Altered consumption patterns prompt innovation. What people expect out of any type of service provider, including self-storage, is changing. To more directly engage with customers, developers are locating more facilities in central, urban locations, which is also leading to new building layouts. Operators are also using technology in new ways, from online reservation systems to electronic kiosks in lobbies. In some cases businesses are offering new services, such as providing the on-demand collection or drop off of stored items.

Companies are looking at new ways to use land and reduce costs. Relocatable self-storage facilities can be advantageous in certain parts of the country through a lower tax burden and greater land-use flexibility. These portable structures, which otherwise function similarly to rooted buildings, are classified as personal, and not real property. As such, owners are subject to a personal tangible property tax instead of a real property tax. Relocatable units can also fit on smaller footprints, while being subjected to fewer land-use restrictions compared with fixed structures in some states.

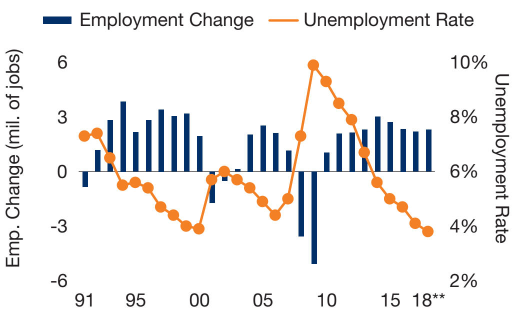
Executive Summary

- The rising cost of homeownership directs many to apartments, where storage space is limited. The greater propensity to rent is creating a strong foundation for future storage needs.
- A wave of deliveries is outpacing demand and impacting operations in many metros this year. Storage buildings are discounting rates to fill units, hindering rent growth in the short term but raising longer-term revenue when supply-side pressures abate and rents can be raised.
- Self-storage assets have sustained appreciation as property performance and competition for the limited number of available assets drive values. The upward price momentum over this cycle has supported cap rate compression. The national average rate fell 160 basis points over the past eight years and has been in the mid-6 percent zone since 2015. Investors interested in higher yields are considering opportunities in secondary and tertiary markets.

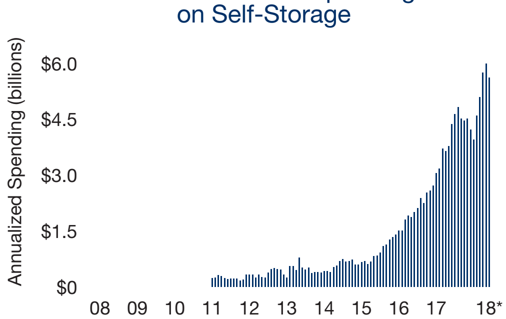
Millennial Wave Incoming



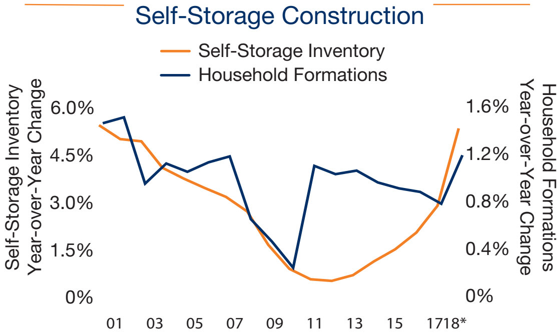
Employment vs. Unemployment



U.S. Construction Spending on Self-Storage



Household Growth vs. Self-Storage Construction



* Trailing 12 months through second quarter
** Forecast
Core retail sales reported as trailing 12-month average.
Sources: Bureau of Labor Statistics; Marcus & Millichap Research Services; U.S. Census Bureau

Tax Reform Brings Significant Changes for Real Estate Investment

Retention of key real estate tax provisions just scratches the surface. The new tax law kept three of the most important rules for real estate investors: tax deferred exchanges, real estate depreciation and the mortgage interest deduction. Beyond this, the new rules deliver a host of important changes that could reshape investor strategies. Three important changes investors should consult their accountants about include:

- **20 percent pass-through deduction:** For active investors using a pass-through entity such as an LLC, the new 20 percent pass-through deduction will boost after-tax yields. This new deduction has a variety of restrictions based on income and asset base but offers substantive upside for those who qualify.
- **Bonus depreciation:** This temporary provision will phase out after 2023, but it enables investors to immediately expense personal property in real estate assets acquired after Sept. 27, 2017, boosting immediate cash flow. A Cost Segregation Study enables investors to identify the deductible components.
- **Restrictions on business interest deductions:** Companies that have loans on purchased locations they operate from have historically been able to deduct the interest on their real estate. Under the new rules, companies with average annual gross receipts of $25 million or more face limits on their overall interest deductions. The new rule can make the sale-leaseback of locations more beneficial for companies from a tax standpoint because leases remain a deductible expense.

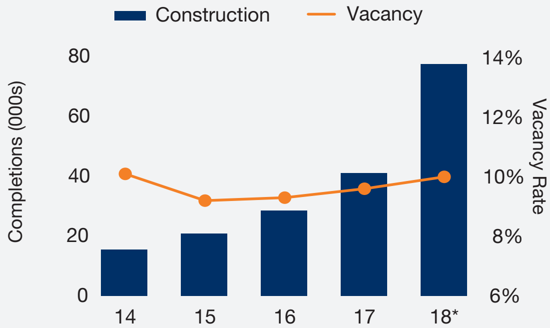
Supply Overshadows Healthy Demand

Economic and demographic forces bolster long-term demand for storage units. Unprecedented employment growth is a major driver behind the demand for self-storage properties. More people earning incomes will improve consumer spending and household formations. The rising cost of single-family dwellings places homeownership out of reach for many, driving additional renting, especially among the younger segment of the population. The shrinking nature of floor plans, combined with a higher number of renters, facilitates a greater need for storage. Increased self-storage demand is also coming from baby boomers, who are showing a higher propensity to rent apartments as well. The oldest among the cohort are now 69 years old, and as these individuals retire, many will downsize their living situations while not necessarily doing the same for their possessions. That trend, combined with the lifestyle patterns of the rising millennial generation, leads to a long-term need for storage space.

Wave of development creates headwinds for sector. Years of strong self-storage demand growth have motivated developers to deliver more space in 2018 than in any other year over the past two decades. Though self-storage construction is following household growth to where the need for storage is rising, the sheer magnitude of completions this year is outpacing demand in many metros such as Denver and Dallas/Fort Worth. To lease up available units, operators will offer more concessions in order to sustain occupancy for the benefit of longer-term revenue. Not every city will face these effects to the same degree. Numerous arrivals are inbound to metros with fewer historical completions, including Las Vegas and Los Angeles, while some well-supplied cities like Cincinnati and St. Louis are seeing their construction pipelines shrink. Ultimately, the effects of elevated development will be short lived. Underlying demand factors remain strong, and rental revenue will improve in conjunction with the tenure of customers.

Supply Surge Creates Speed Bump For Property Performance

Supply and Demand Trends



U.S. VACANCY:

40 basis point increase in vacancy

Rush of arrivals interrupts vacancy declines. Multiple years of balance between supply and demand have pushed the national vacancy rate down from the 2009 high of 17.4 percent to 9.6 percent in 2017. The influx of completions for 2018 will raise the rate to 10 percent as these new units lease up.

U.S. CONSTRUCTION:

77 million sq. ft. will be completed

Developers test market. The 2018 forecast for total deliveries exceeds what was completed over the previous two years combined. Long-term demand characteristics remain solid, but several metros face short-term absorption risk.

U.S. RENT:

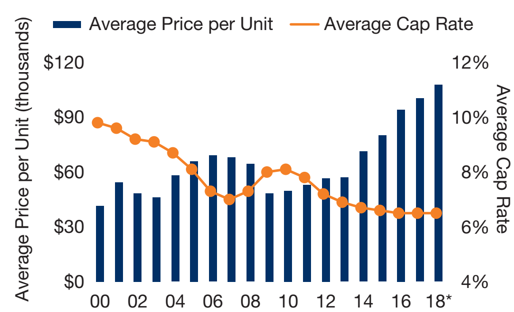
0.8% increase in asking rents

Rent growth slows as the use of concessions edges higher. Rents are forecast to appreciate by a lesser degree this year than last as more properties increase incentives or cut rates to attract renters amid a flurry of new additions. The national average rate is projected to rise to $1.21 per square foot.

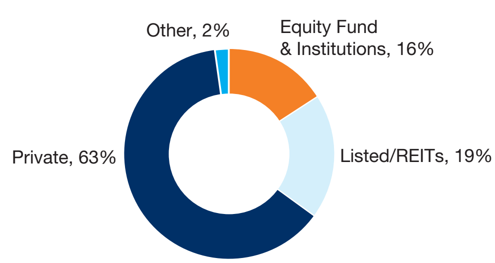
2018 Investment Outlook

- **Value appreciation continues despite performance headwinds.** Supply-side impediments to vacancy and rent growth have not deterred investors, as average sale prices continue to appreciate in most parts of the country. Favorable property demand metrics for assets that feature fewer operational expenses than some other property types are likely enticing buyers, while the lack of listings maintains competition over available deals. In order to find higher yields, many buyers are turning more toward secondary and tertiary markets.
- **Two decades of cap rate compression reflect growing market maturity.** First-year yields over the past three years have stabilized at a national level, settling on average into the mid-6 percent zone. In 2000 the average cap rate approached 10 percent. The decline in initial returns is in large part a function of steady value appreciation.
- **Different regions offering varying opportunities.** Sales velocity has declined nationally by approximately 15 percent over the past 12-month period ending in June, with deal flow remaining concentrated in the South and West regions of the country. Investors seeking greater initial yields at lower entry costs may consider Midwest properties, where cap rates are some of the highest in the country. In California, notable barriers such as stricter regulations including zoning laws, a more complex approval process, and high cost of land are limiting construction in the state, adding appeal to existing facilities.

Price and Cap Rate Trends



2018 Self-Storage Acquisitions By Buyer Type

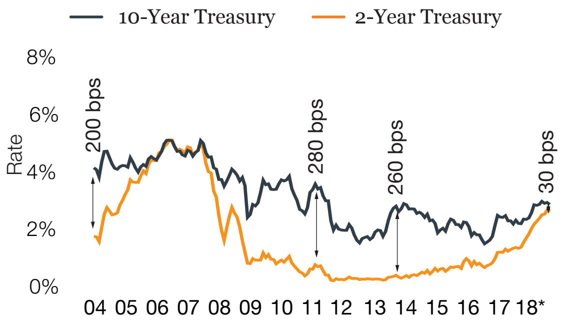


* Forecast

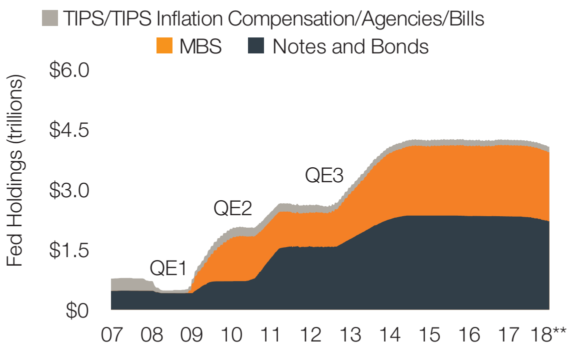
Sources: CoStar Group Inc.; Real Capital Analytics; Marcus & Millichap Research Services; Union Realtime; Yardi Matrix

U.S. Capital Markets

10-Year Treasury vs. 2-Year Treasury Yield Spread Tightens



Fed Balance Sheet Normalization



* As of Aug. 17

** As of July 20

Lenders Pursue Deals as Capital Plentiful; Caution Enforcing Underwriting

Fed watchful as economic surge raises inflationary pressure. Strengthened hiring amid exceptionally low unemployment levels has boosted wage growth, placing upward pressure on inflation. Amid this trend coupled with rising trade protectionism and tariffs, the Federal Reserve appears determined to head off inflation risk by continuing its quarterly increases of the overnight rate. These actions are lifting short-term interest rates while the 10-year Treasury rate remains range bound near 3.0 percent. Should the 10-year remain steadfast, Fed tightening could create an inverted yield curve in which short-term rates rise above long-term rates. Although this event has preceded every recession of the past 50 years, many economists suggest such an inversion this year could be an exception to the rule. Because of distortions caused by regulatory changes and quantitative easing, this inversion could be different. Nonetheless, the Fed's stated path does raise recessionary risk levels because it could weigh on confidence levels and restrain spending by consumers and businesses, thus slowing economic growth.

2018 Capital Markets Outlook

- **10-Year Treasury still "sticky" at 3 percent.** After surging at the beginning of the year, the 10-year Treasury has been range-bound near 3.0 percent. To create some headroom for its escalation of short-term rates, the Fed has tried to exert upward pressure on long-term interest rates by unwinding its balance sheet. This quantitative tightening has had little influence, particularly as foreign investors have enjoyed a yield premium relative to their native 10-year rates.
- **Potential rapid interest rate escalation a downside risk.** Although capital remains plentiful, lending could tighten quickly for a short period if interest rates rise rapidly. As experienced in late 2016 when the 10-year rose by more than 80 basis points in 60 days, and again at the beginning of 2018 when there was a 60-basis-point surge, market liquidity could tighten if rates jump. Considering this has happened twice in the last two years, borrowers will likely benefit by taking a cautious approach with their lenders and lock in financing quickly.

National Self-Storage Group

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The information contained in this report was obtained from sources deemed to be reliable. Every effort was made to obtain accurate and complete information; however, no representation, warranty or guarantee, express or implied, may be made as to the accuracy or reliability of the information contained herein. Note: Metro-level employment growth is calculated based on the last month of the quarter/year. Sales data includes transactions valued at $1,000,000 and greater unless otherwise noted. This is not intended to be a forecast of future events and this is not a guaranty regarding a future event. This is not intended to provide specific investment advice and should not be considered as investment advice.

Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Experian; Moody's Analytics; Real Capital Analytics; Yardi Matrix; Union Realtime; U.S. Census Bureau