NATIONAL REPORT

Marcus & Millichap

SELF-STORAGE

2H/23

Economic Soft Landing Helps Bolster Self-Storage Outlook

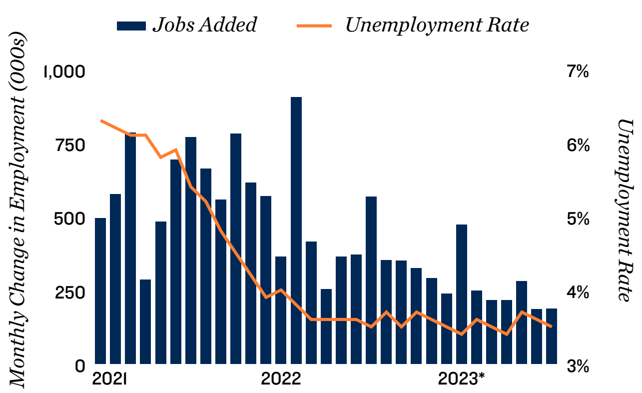
Economic forces normalizing demand. The self-storage sector is transitioning from the powerful tailwinds created by the pandemic and pent-up household formation to a more normal, seasonal demand climate. Elevated residential mortgage rates, which doubled in less than 20 months, together with reduced consumer sentiment, moderated household formation last year. The resulting reduction of population mobility has weighed on self-storage absorption. As a result, vacancy levels have been trending upward in many markets, while asking rents have declined. Nevertheless, there was roughly 200,000 more occupied square feet at midyear than in 2019. In-place rates among this larger pool of renters are continuing on an upward trend across most of the major operators, bolstering the overall sector. These trends will likely remain in play through the remainder of this year, while the prospect of an economic soft landing, together with stabilizing Federal Reserve policies, have the potential to reinforce current and future self-storage space demand as inflation lessens.

Resilient labor market aids second half storage outlook. As pre-pandemic seasonal cycles of storage use return, an improving economic outlook bodes well for the sector. A key factor has been the labor market, which, counter to some earlier concerns, has remained robust so far in 2023 despite the ramp up in interest rates. Employers are creating jobs at a moderating pace that let some pressure out of a tight post-pandemic labor market, without notably impacting unemployment. This balance is near ideal for the Fed's objectives, improving the prospect of a soft landing that should benefit the self-storage sector. Slow but steady economic growth, paired with income stability, will give both current and prospective future self-storage renters the financial confidence to utilize storage units.

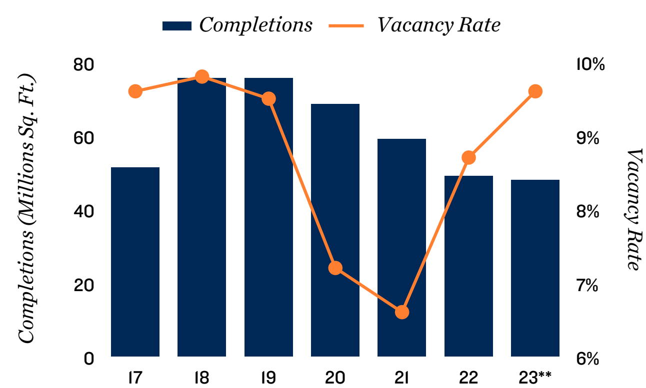
Consumers respond to improving conditions. Elevated inflation has challenged households since early last year, but upward pricing pressure is lessening. Both headline and core measures of inflation have fallen well below 2022 peaks, aiding consumer outlooks. Robust consumption activity also underscores long-term storage demand, as new purchases displace older belongings, joining seasonal items in occupied units. These factors reinforce the motivations for many who rented storage units during the pandemic to hold onto those spaces. Demand from current users is supporting higher in-place rents, and greater consumer sentiment may further aid household formations, which in turn would help stabilize vacancies and asking rents. Some operators have been adjusting street rates amid higher availability. While a resilient labor market and cooling inflation point to a brighter demand landscape in the near future, new supply pressure will be a challenge that some markets will have to contend with.

Development trends vary by region. Although the overall pace of development in 2023 will about match that of last year at just under 50 million square feet, construction levels are not uniform across the country. In rural locales, relatively low street rates have prompted a pullback in groundbreaking, given elevated material costs. The prices of steel sheet and aluminum both still exceeded the 2019 equivalent by over 60 percent as of June. High land and labor costs along major West Coast metros also constrain development in those settings. Elsewhere, the 2023 pipeline is still sizable. Cleveland, New York City and Northern New Jersey will all welcome atypically sizable delivery schedules. New supply pressure may pick up after this year as well, indicating that construction will be a future headwind worth consideration in some settings.

Labor Markets Tight as Hiring Decelerates



Self-Storage Supply and Demand Trends

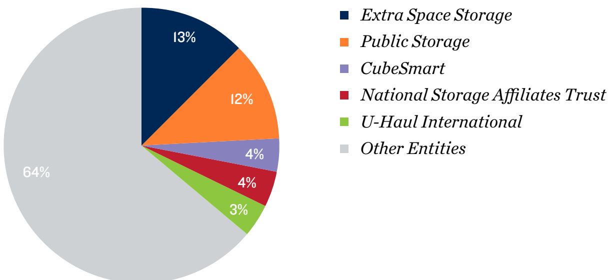


** Through July ** Forecast*

Sources: CoStar Group, Inc.; BLS

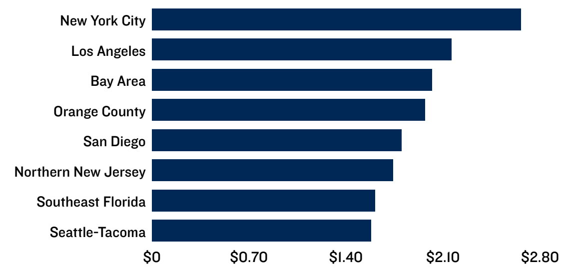
Two Largest Operators Account for a Quarter of Rental Space Nationwide

Mergers Expand Influence of Top REITs



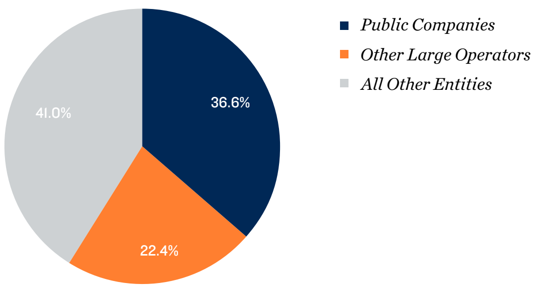
*Percent of Net Rentable Square Feet Owned Nationwide**

Top Markets by Asking Rent in 2023



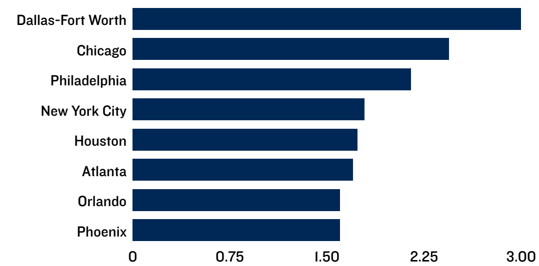
Average Year-End Asking Rent Forecast (Per Sq. Ft.)

Largest Operators Command Notable Marketshare



*Percent of Net Rentable Square Feet Pertaining to Each Category**

Top Markets by Space Additions in 2023



Total Completions Slated for 2023 (Millions of Sq. Ft.)

** Square footage totals based on 2023 Self-Storage Almanac data from year-end 2022*

Sources: Newmark; The 2023 Self Storage Almanac; Radius+; Marcus & Millichap Research Services

INDUSTRY MERGERS HEADLINE 2023

- **Extra Space Storage acquires Life Storage:** Originally announced in April, representatives for Extra Space confirmed the completion of an all-stock purchase of Life Storage, valued at more than $12 billion, in late July. While the 1,200-property acquisition expanded the REIT's presence to some tertiary markets like Buffalo, New York and Biloxi, Mississippi, the move primarily reinforces the organization's marketshare, expanding its rentable square foot holdings by more than 50 percent. The combined entity will surpass Public Storage as the nation's largest self-storage operator by net rentable square feet. Representatives for Extra Space also confirmed that some Life Storage locations will continue to operate under their old flag in markets where both brands overlap.

- **Public Storage targets Simply Self Storage:** Public made headlines in early 2023 following a proposal to acquire Life Storage, which was rebuffed while the latter firm courted other offers. In July, however, Public Storage would go on to purchase Simply Self Storage from Blackstone for $2.2 billion. With 127 properties comprising approximately 9 million rentable square feet, this purchase is of a much smaller scale than the Life Storage deal, and is unlikely to reclaim the REIT's status as the largest storage operator nationwide.

REGIONAL DEVELOPMENT HIGHLIGHTS

- **New York:** Self-storage operators looking to expand within the city's five boroughs face some of the highest barriers to development nationwide, translating to a notable supply/demand imbalance and the country's highest average monthly rental rate. Developers have still added more than one million square feet to the market during four out of the last five years and are adopting new strategies to expand, such as leasing traditional warehouse properties.

- **Philadelphia:** Although northeastern markets are known for stable populations and often lukewarm construction activity, this market has bucked regional trends, adding more than 1.3 million square feet per year on average since 2016. This construction is warranted, as the metro entered 2023 with just over 5.2 square feet of storage space per capita, one of the lowest figures among major U.S. metros.

- **Texas:** Construction significantly increased throughout the state this year, with three of Texas' four major markets slated to gain more than 1 million square feet of space before the end of 2023. These markets feature some of the highest amounts of storage space per capita nationwide, which could translate to more acute impacts on operations in this state than in other Sun Belt locales.

2023 U.S. Forecast

EMPLOYMENT

1.6% increase Y-O-Y

- Hiring velocity continues at a solid clip overall, despite certain segments seeing some attrition at the start of the second half. Recruitment during the first seven months of 2023 was bolstered by both the education and health services and leisure and hospitality sectors.

CONSTRUCTION

48 million square feet completed

- Developers are on track to finalize the lowest amount of square feet since 2016, though supply additions remain above the long-term average of 44 million square feet per annum. National inventory will expand by roughly 2.5 percent this year.

VACANCY

90 basis point increase Y-O-Y

- New supply arriving amid realigned demand is prompting an overall normalization of vacancy to pre-health crisis levels. The nationwide vacancy rate will close out this year at 9.6 percent, exceeding the level observed four years prior by just 10 basis points.

ASKING RENT

2.3% decrease Y-O-Y

- Vacancy approaching the 2019 level in most markets has translated to declining street rates in nearly all major metropolitan areas. Still, the mean asking rent of $1.25 per square foot will place the metric roughly 8.7 percent above the immediate pre-pandemic measure.

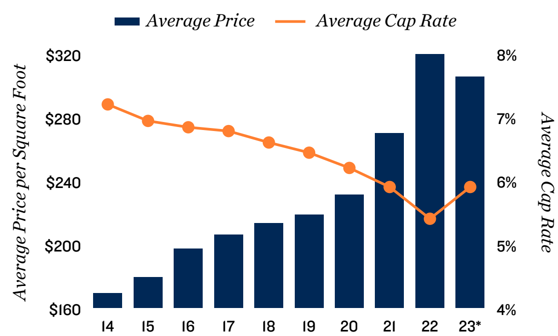
2023 INVESTMENT OUTLOOK

- **Storage sales activity cools after record run.** Although transaction velocity declined nearly 30 percent on an annual basis during the 12-month period ended in June, the preceding yearlong span noted all-time record deal flow. Buyers from other segments noted the sector's impressive performance and recession-resistant qualities. While many buyers have paused acquisitions as they process the impact of mounting capital costs, investment activity during the first half of 2023 was comparable to pre-pandemic levels.

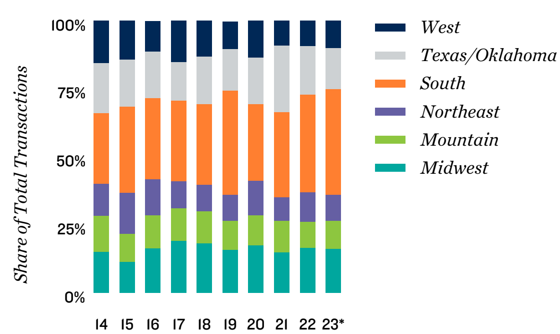
- **Value-add opportunities found in rural areas.** Rising construction costs have exacerbated existing development trends that concentrate an outsized share of projects in major cities over exurban zones. These areas are typically undersupplied relative to urban environments, and existing facilities often lack climate control and other amenities common in more densely-developed locales. Investors targeting markets with a dearth of incoming supply, or seeking to streamline operations at vintage assets, may find attractive options here moving forward.

- **Unique rental demand geography adds dynamism to investment market.** While some metros are seeing development continue at a feverish pace, because many self-storage renters seek a unit within five miles of their residence, neighborhood supply trends factor in more heavily. Inventory farther away will have less of an impact on existing operations than in other asset classes. Prospective buyers are likely to take this into account in Sun Belt metros with a large amount of incoming supply.

Investment Sales Trends



Sun Belt Dominance Remains Consistent



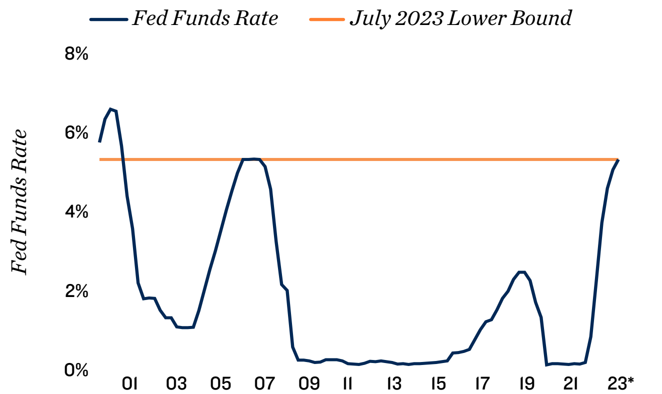
* Preliminary estimate for the trailing 12 months through 2Q
Sources: CoStar Group, Inc.; Real Capital Analytics

Storage Performance Props up Investment Amid Tightening Capital Markets

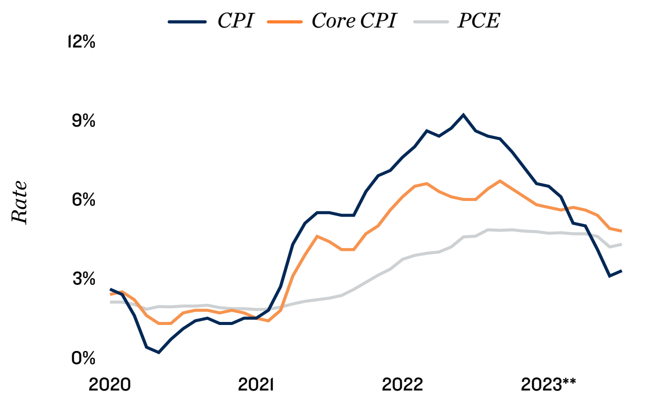
Path of interest rates in recent months defined by slower, steadier increases. The Federal Open Market Committee has taken a comparatively measured approach to raising interest rates so far in 2023. After multiple, historic 75-basis-point hikes were adopted over the course of the previous calendar year, only four increases of 25 basis points each have been enacted so far in 2023. Inflation has continued to decelerate, with core PCE down from its March 2022 peak of 5.4 percent to 4.2 percent in July 2023. Following the most recent interest rate hike adopted that month, the FOMC has held the federal funds rate at a lower bound of 5.25 percent, electing to pause increases for the second time this year during its September meeting. Chairman Jerome Powell reiterated the Fed's data-dependent stance during the following day's briefing. Another increase in November or December is not out of the question, although Wall Street currently favors a hold at each of those meetings. The FOMC additionally updated their long-term projections, increasing the median expected 2024 year-end federal funds rate to 5.1 percent. While that measure is not a binding statement of intent, it does indicate that the Fed believes it will not need to substantially cut interest rates for at least the near future. This could delay the long-term improvement to transaction velocity across CRE sectors that is just now beginning to take place. Preliminary third quarter data indicates initial interest from prospective buyers and sellers is improving, although it will take time for that to translate into closed transactions. Stable interest rates could help expedite that process, however.

Higher rates tighten the flow of capital, putting pressure on construction and acquisition financing. Compounding the effect of rising interest rates, high-profile bank failures in early 2023 prompted many financial institutions to tighten lending requirements, impacting deal flow in certain commercial real estate segments. Due to the storage sector's robust performance during the health crisis and unique, counter-cyclical demand drivers, however, lenders have been more amenable to financing acquisitions in this sector than trades of more challenged asset classes. Still, falling asking rents across most major metros could impact the financing process as rental demand continues to normalize. Rising interest rates have also put similar pressure on the construction side. Mounting capital costs have strengthened barriers to entry in markets where land and labor costs are higher, potentially exacerbating hurdles to construction in some regions where revenues are challenged. Nevertheless, New York City boasts 1.1 million square feet of projects in the planning phase, indicating that street rates in densely-developed, highly-populated locales are sufficient to warrant new construction, despite mounting financing headwinds and construction costs.

Federal Funds Rate Over Time



Inflation Notably Decelerates in 2023



**Through August ** Through July*

Sources: Marcus & Millichap Research Services; Federal Reserve; BLS; BEA

Self-Storage Division

Steven Weinstock
Senior Vice President, Director
Tel: (630) 570-2200 | steven.weinstock@marcusmillichap.com

Price: $1,500

Prepared and edited by:
Luke Murphy
Research Analyst | Research Services

For information on national self-storage trends, contact:
John Chang
Senior Vice President | Director, Research & Advisory Services
Tel: (602) 707-9700
john.chang@marcusmillichap.com

Sources: Marcus & Millichap Research Services; Marcus & Millichap Capital Corporation; Bureau of Labor Statistics; Bureau of Economic Analysis; CoStar Group, Inc.; Yardi Matrix; Radius+; Federal Reserve; The Conference Board; The University of Michigan