A Slowdown Is in Store for the Self-Storage Business

A flood of new supply is crimping growth in the self-storage sector

Gotham Mini Storage in New York City in May 2016. Earnings in the self-storage sector are still increasing, but no longer at the double-digit rates many companies enjoyed between 2010 and 2015. PHOTO: JASON ANDREW FOR THE WALL STREET JOURNAL

By

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The party is coming to an end in the self-storage business.

For most of the current economic expansion, the sector has been beating all other major commercial property types in earnings growth and stock performance. Real-estate investment trusts like Life StorageInc., Extra Space Storage Inc. EXR 0.56% and Public Storage have been able to push through stratospheric rent increases thanks partly to the scant supply of new development.

But growth is slowing as markets get flooded with new supply. Earnings are still increasing, but no longer at the double-digit rates many companies enjoyed between 2010 and 2015.

Stock valuations, meanwhile, are falling back to earth. Self-storage companies are trading at a 2% discount to the estimated market value of the properties they own, compared with an average 16% premium over the past five years, according to Green Street Advisors.

Self-storage company executives point out that the business remains prosperous and continues to hold its own against other property types. The only major REIT sector trading more favorably is industrial, which is trading at a 4% premium to asset value. Malls and office REITS are trading at discounts of 13% and 9%, respectively, Green Street says.

“When you have five or six blowout years and you get back to normal, it just looks slow,” said David Rogers, chief executive of Buffalo-based Life Storage, which has 700 facilities in 28 states.

But the supply pipeline is expected to stay fat for some time. “We are seeing few signs of a slowdown in new projects,” said Baird Equity Research in a report published in late November.

Demographic trends, meanwhile, raise concerns about the strength of future demand. Aging baby boomers can be expected to absorb a lot of new supply as they leave large houses for smaller apartments. But household formation has generally been slow in the U.S. economy. Also, urban-living millennials have tended to accumulate less stuff than their parents up until now.

“When you live in urban settings, you live small,” Mr. Rogers said.

Mr. Rogers and others said they see signs millennials are beginning to form families, move to the suburbs and accumulate patio furniture, pool toys and the other items that ultimately seem destined for self-storage. “We missed a five-to-six-year period, but we’re catching up,” Mr. Rogers said.

The self-storage business generally has enjoyed strong growth over the years thanks to the emotional and occasionally nonsensical love affair between Americans and their stuff. Once people rent out a unit they become a captive audience for rent increases.

“This is why it’s such a great property type,” said R.J. Milligan, a Baird analyst. “Say you’re paying $100 a month and they increase your rent $5—which in commercial real estate is a significant increase. You’re not going to move your stuff on a Saturday to a place that’s charging $95.”

The biggest self-storage companies have adopted a wide range of new technologies such as data analytics and search-engine optimization to find and keep customers. “Our ability to outperform the mom-and-pop [self-storage facilities] has gotten bigger and bigger," said Joseph Margolis, chief executive of Extra Space, a Salt Lake City-based REIT that operates more than 1,500 properties.

Profits also have been plentiful for self-storage operators for most of the recovery from the 2008 crash because new supply has been limited. Roughly 2,000 self-storage facilities were developed annually between 2000 and 2009, Mr. Margolis estimated. That declined to a few hundred per year in the years after the downturn, he said.

But development has spiked. The Census Bureau reported that in November the annualized rate of new construction in the sector was about $4.6 billion on a seasonally adjusted basis. That's more than double the level of November 2016 and more than triple the level of November 2015.

Public Storage, the largest REIT in the sector, has 5 million square feet under construction, compared with an average 3.5 million square feet over the past four years, according to Jon Cheigh, a global portfolio manager with Cohen & Steers, which has about $38 billion in real-estate assets under management. "New development has overwhelmed certain key markets" like Phoenix, New York City and Orange County, Calif., he said in an email.

Private-equity firms in the business include Brookfield Asset Management and Carlyle Group LP. TPG, another private-equity firm that had been active in self-storage, sold its business in 2016 for $1.3 billion to the REIT that later changed its name to Life Storage.
The new capital that has flowed into the sector has kept private market values of individual properties high, especially those that are well leased. High-quality self-storage operations are more than 90% occupied in most markets at near-record rent levels.

But there's doubt that the market will be able to sustain such high levels with the new supply being added. Green Street is projecting that net operating income growth for the self-storage sector will be below the broader REIT industry.

"That typically hasn't happened historically," said Ryan Burke, a Green Street analyst. "It speaks to the fact that self-storage as a business is in uncharted territory over the near term."

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