

Transaction Activity Accelerates

The outperformance of self storage in comparison to other property sectors during the pandemic is attracting additional capital to the industry. The flow of capital into the industry and subsequent increasing competition for assets is causing cap rates to compress for stabilized properties. And, the spread in cap rates is narrowing between core markets and secondary markets.

- Late summer experienced a notable acceleration in self storage investment activity. Investor confidence strengthened as solidifying operating performance became widespread. The resiliency of the industry during the COVID-19 pandemic is attracting additional capital to an already crowded bench of self storage investors. Favorable risk-adjusted returns appear compelling compared to alternative investments. Competition to place capital into the desirable sector is compressing cap rates for stabilized assets as well as later stage lease-up assets. Acquisitions during the second half of 2020 and into 2021 are likely to experience elevated volumes.
- A consistent theme from investors during the pandemic remains the voracious appetite from investors for stabilized assets. The lower perceived risk profile of existing self storage as compared to other property types creates a deep pool of buyers seeking to deploy capital. Institutional capital allocations targeting commercial real estate investment has rotated towards self storage. Additionally, underwriting assumptions shifted from projecting only flat growth early in the pandemic to more historical growth levels as operating fundamentals improved quickly. The combination of these factors generates a highly competitive environment for stabilized assets in gateway and secondary markets. Cap rates compressed 20-25 basis points in the best markets compared to pre-pandemic pricing.
- The gap between cap rates in core markets versus secondary markets compressed further as operating performance in those markets exceeded the performance in core markets throughout the pandemic. A plethora of private capital established strategies to acquire higher yielding assets in secondary and tertiary markets. The space is crowded with prospective investors driving increased competition and lower cap rates. The spread between core and secondary markets compressed to an average of 50 basis points from an average of about 100 basis points previously. The sustainability of this trend shall be closely watched as spreads between core and secondary markets approach levels that may not account for the potential risk differential between the markets.

- The increased flow of capital into the industry is also bolstering the interest in lease-up deals in select markets. The interest level for assets in lease-up depends on the position within the risk spectrum. Assets that are generating strong investor interest are located in markets with favorable supply/demand fundamentals with elevated leasing velocity and accelerating achieved rates. Assets in the early stages of lease-up are most vulnerable with greater perceived lease-up and rental rate risk. Determining eventual stabilized rents and timeframes for reaching stabilization continues to challenge underwriting for deals in lease-up. There continues to be a disconnect between most seller expectations and the discount required from investors to compensate for the increased uncertainty.



Part of Life Storage 25-property portfolio acquisition

- Portfolio sale transactions are reemerging with investor confidence growing from confirmation of pricing data points and robust operating results. Low costs of capital from public and private investors has produced significant 'dry powder' to pursue portfolio offerings. Examples of the low costs of capital raising include CubeSmart's \$450 million senior debt offering at 2.0% due in 11 years replacing senior notes with interest rates at 4.8%. Additionally, Life Storage completed a \$400 million senior debt offering at 2.2% for ten years helping to fund a recent portfolio acquisition. The 25-property acquisition for \$326.7 million consolidated two existing joint ventures. The estimated cap rate was in the low-5% range. The portfolio acquisition sets the stage for additional activity. We anticipate more portfolio offerings with a wider investor pool.
- Stabilization of the debt capital markets facilitates the resurgent transaction market. CMBS, life companies, banks, and debt funds are all actively quoting acquisitions, development and refinancings. Terms are more restrictive than pre-pandemic pricing with additional scrutiny of both the sponsors and underwriting assumptions.

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Prospects for an Extended Leasing Season

- Labor Day traditionally marks the end of the peak summer leasing season. Although, this season pandemic impact may have created a shift in customer behavior. Pent-up demand from months of limited customer mobility unlocked elevated move-in activity during the summer and is extending into the fall. Additional demand drivers are emerging from the pandemic. An uptick in demand is coming from several different sources, including: office contraction and relocation, home office conversions, and movement of millennials moving back home. Self storage is the rare property sector that may have benefited from instability created by the pandemic.
- Occupancies continue at record-high levels. Robust move-in activity coupled with limited move-outs contribute to improved occupancies for public and private operators.

REIT OCCUPANCIES	Occupancy 6/30/20	Occupancy 7/31/20	Occupancy 8/31/20	8/31/20 YoY Increase
NSA	89.8%	91.1%	91.4%	150 bps
Extra Space Storage	94.5%	95.7%	95.9%	180 bps
CubeSmart	94.0%	94.5%	94.3%	130 bps
Life Storage	91.9%	93.0%	93.0%	250 bps
Public Storage	94.6%	96.0%	NA	NA

The public REITs report continued robust leasing activity into August and September. Year-over-year occupancy increased 130 to 250 basis points in August. The absence of seasonal move-out activity and steady move-ins are dynamics that operators are hopeful will extend into the fall.

- The suspension of auctions during the early stages of the pandemic increased delinquency volume and prevented the process of re-entering units back into the leasing pool. Operators are now focused on negotiating with delinquent tenants to either reset rates or break leases to free up delinquent units. Additionally, the resumption of auctions in most parts of the country is freeing up additional inventory to re-lease. The combination is returning delinquencies to normal levels and providing additional units to match demand.

Customer Behavior Unchanged by Resumption of ECRI's

- The implementation of existing customer rate increases (ECRI's) is a major driver of revenue growth. Moratoriums on implementing rent increases on existing tenants in certain states early in the pandemic combined with reluctance to raise rents during a crisis limited a primary lever of revenue growth. The resumption of ECRI's throughout the summer was met with little resistance - consistent with customer behavior regarding rent increases pre-pandemic.
- Early success from initial conservative rent increase strategies implemented in May and June emboldened operators to return to more aggressive ECRI strategies. Operators returned to high single-digit and low double-digit increases to existing tenants. The breadth of tenants receiving increase notices is expanding in an attempt to regain revenue footing absent during the first months of the pandemic.

Development Cycle Continues at a Slower Pace

- Yardi Matrix' Fall 2020 Self Storage National Outlook highlights the impact of the current pandemic-crisis on future self storage deliveries. It is anticipated that current projects under construction will be completed, but with three to six-month delay due to the shutdown of construction sites early in the pandemic and delays in material deliveries. Prospective new projects abandoned has increased an estimated 25%. Projects in planning that have been abandoned has increased by 50%.
- Yardi Matrix projects reductions in self storage deliveries in 2020 and beyond. Deliveries are projected to drop an estimated 10% in 2020. Development activity is projected to decrease about 40% over the next five years. The pipeline is expected to slow in coming years as the availability of construction financing and increased scrutiny of underwriting continues. Yardi estimates for 2020 include 526 new builds, 106 conversions, and 121 expansions. Total new supply is estimated to reach 54 million square feet for the year.