Storing value

European self-storage can deliver resilient cash-rich returns

by Zubaer Mahboob

The European self-storage sector is at an earlier stage of development compared to its US counterpart. Institutional investment in the sector has yet to take off in a meaningful way, despite strong underlying fundamentals and attractive investment performance. Between 2015 and 2018, just €1.2 billion was invested in the sector, less than a tenth of the amount channeled into US self-storage over the same period.

This is due, in part, to the limited range of institutional-grade assets available for purchase and the highly fragmented nature of the market, which together have deterred private institutional investment on a large scale. However, there are other examples of property sectors in Europe, such as the private rented sector, where institutionalisation was slow to start but has since picked up rapidly. A close analysis of the market points to similar potential for convergence in self-storage operations and investments.

Zubaer Mahboob
Heitman

Current conditions

In 2018, the total self-storage stock in Europe stood at 10 million square metres. This stock serves a population of nearly half a billion people. The US, by contrast, with a population that is a third smaller, has total storage GLA of 300 million square metres. Within Europe, the UK stands head and shoulders above the rest, accounting for 46 percent of all stock and 40 percent of all stores. The largest countries on the continent, France, Spain, Germany and Italy, are notably undersupplied, despite appearing comparable to the UK on key demand metrics.

Based on our more than 20 years of experience investing in self-storage, storage demand is highest in dense settings, occupied by a mobile population seeing income growth (the absolute level of income is less critical). These conditions are in place across many parts of Europe, prompting strong growth in storage demand.

The countries of northern Europe tend to be heavily urbanised, especially regions such as Benelux and Scandinavia, where the urban share of the population approaches, or exceeds, 90 percent, according to World Bank data from 2018. Even among land-rich countries with more dispersed populations, urbanisation rates are high. Moreover, the largest mainland European cities, such as Paris, Milan and Barcelona, are much more densely populated than comparable UK or US cities.

Demand for self-storage is also positively correlated with population mobility. Eurostat data shows that countries in the north, especially the UK and Scandinavia, have higher rates of mobility compared to the southern "sun-belt" and so are more favourable locations for storage assets.

The city-country gap

The economic environment also supports the storage sector. The EU-wide unemployment rate fell to a multi-decade low of 6.3 percent in mid-2019, while disposable household incomes have improved in tandem, supporting demand for a product viewed by some as a discretionary expenditure. In addition, the most populous European cities — the logical focus for storage investment — have significantly outperformed in economic terms. The typical income gap between city and country ranges from +10 percent for Frankfurt and Dublin to +40 percent for London.

At the same time, Europeans occupy some of the smallest homes in the Western world, driving many households to seek external storage. The average size of a new-build home in the UK (76 square metres) is only a third of the size of a new-build in the US. Even accounting for differences in household size and accumulation of material goods, there is strong evidence of Europeans being under-housed by developed-world standards.

European storage also benefits from an active business sector. Retailers, tradespeople and start-ups account for over 30 percent of storage use. In the UK, this share is even greater at 40 percent.

All of these factors have helped drive storage demand higher. Supply, by contrast, has been unevenly distributed. Rapid growth of stock in several countries contrasts with slow growth or stagnation in other markets. For instance, during the last five years, the stock has nearly doubled in Spain, but it has grown by only 10 percent to 12 percent in the Netherlands and Sweden.

The need for new stock

A number of factors inhibit a rapid build-up of large-scale storage facilities, some of which will be familiar to investors in the logistics sector: lack of available land, zoning restrictions, local authorities' preference for alternative uses (especially residential), environmental considerations, and a limited choice of credible operating partners. As a result, occupancy in more mature markets, such as Belgium or France (with more established stock and less elastic supply), now hovers around the 90 percent mark, in line with US levels. It would require a quadrupling of stock in Western Europe to bring it up to UK levels of storage penetration. Given the myriad constraints, it is prudent to expect that development will proceed at a moderate pace.

The strong operating conditions for European storage are manifest in Heitman's experience in the sector. Growing demand and limited supply helped to drive performance at Shurgard, Europe's largest operator, which was co-managed by Heitman for over 10 years until its IPO last year. Same-store occupancy stabilised at a high level, enabling strong growth in rental rates. Due to the widespread shortage of product, newer developments in the UK, France and Germany experienced rapid lease-up, in some cases reaching stabilised occupancy in as little as 12 to 15 months.

For the institutional investor, European storage offers several attractive features: returns that are delinked from the fluctuations of the economic cycle; a strong cash component; significant upside to current EBITDA; consolidation potential in a fragmented market; and the opportunity to engage with a sector that is in the early stages of institutionalisation.

However, that is not the whole story. The storage sector's diversification benefits are also compelling. US data shows that storage returns have low levels of correlation with those of other property types. Storage also delivered more robust returns during the GFC. This is partly explained by the inelastic nature of demand, which proved to be resilient even in recessionary environments. In the US, it is often said that self-storage demand is driven by the four Ds: death, divorce, dislocation and downsizing.

The sector's relatively high yields are attractive in the context of record low yields in most other sectors. In the UK, high-quality, mature, freehold assets trade on yields of 5.25 percent to 5.5 percent, compared to prime London office yields of 3.75 percent to 4 percent and prime industrial yields of 4 percent. The prospect of long-term growth in storage, as well as the potential for institutionalisation, suggest that yields will compress over time, thus narrowing the current spread versus commercial yields.

Dealing with fragmentation

For investors seeking to gain exposure to European storage, the sector's fragmentation presents both opportunities and challenges.

European storage operators can be broadly divided into two categories: large, professional, brand-name operators and small, independent, and often family-run businesses. The former, with national or pan-regional portfolios of modern buildings, maximise the use of technology in their facilities and operations, and adopt the latest tools in pricing and marketing. However, they are few in number. The top 10 operators control less than a quarter of all stores.

The vast majority of operators fall into the second category. These businesses typically manage fewer than five buildings and are often too small to maximise the use of professional pricing and booking systems in their operations. As a result, they manage toward maximising occupancy or rental rate, rather than optimising income and EBITDA. Europe has very few mid-sized firms with modern portfolios that achieve a wider regional or even cross-border footprint. The challenge for operators and/or investors is to bridge this gap, to bring forth the "missing middle", either by developing from scratch or by supporting the conversion/expansion plans of suitable operating partners.

In the UK, a number of such deals have taken place in recent years, including the purchase of 15 Big Box–branded stores for £100 million (€112 million), by Missouri-based StorageMart at an estimated cap rate of 6.5 percent. Investment activity has increased in Europe too, with notable deals occurring in Italy and Spain during the past year, where family office–backed operator Bluespace continues to consolidate its position as the market leader. Overall, though, investment activity remains patchy, and consolidation is occurring slowly and sporadically. A key issue is the reluctance of mom-and-pop owners, who regard their properties as cash cows to sell to more professional operators.

Other challenges include the sector's inability to make a genuine breakthrough in customer awareness in mainland Europe and the ongoing threat of technological disruption through the introduction of pick-up-and-delivery storage. In the longer term, possible changes in the consumption habits of millennial and Generation Z cohorts could adversely impact demand for storage.

Nevertheless, European storage is an exciting sector that will reward investors with resilient cash-rich returns as we approach an inflection point in the property cycle. For more ambitious owners, there is the potential to extract significant efficiencies through both scale and simple improvements to operations, as well as the opportunity to generate alpha via conversion and development strategies. ❖

Zubaer Mahboob is a vice president within the European research team at **Heitman.**