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Stashing Success

The Growth of Industrial Outdoor Storage (IOS)

By Deborah Smith

Industrial outdoor storage (IOS) may have once been an obscure abbreviation, but this subcategory of industrial real estate has now emerged as an intriguing and evolving niche product. While the asset class still has some way to go before becoming fully institutionalized, its increasing importance in last-mile distribution makes it a topic worth discussing and placing on investors' radars. At a high level, IOS properties serve as essential storage facilities for large equipment, vehicles, and materials and are often located near transportation hubs, highway corridors, and ports of entry. Among other things, these facilities exist to provide secondary storage capacity for logistics operators.

The IOS sector reminds us of the evolution of the SFR and Self-Storage sectors. We know how those stories played out. It's early stages but worth paying attention to.

So What Is IOS?

IOS properties are not the kinds of glamorous properties that commercial investors typically pay much attention to, as they are outdoors and not always aesthetically pleasing to look at. At a basic level, these sites are low-coverage industrial land, generally in the three- to 20-acre range. Buildings typically comprise zero to 20 percent of the site.

The property type's primary value comes from outside storage capabilities of the excess yard. IOS facilities feature a significantly lower floor area ratio (FAR) relative to warehouse properties, which are typically above 50 percent.

Investment criteria tend to favor land sites where the existing building(s) is vacant, requiring minimal or significant rehabilitation or demolition work but which still have strong outdoor storage capacity. Yet the utilization that IOS offers is unique. Truck terminals, trailer storage, container storage, or pallet storage, as well as construction, repair, or heavy equipment yards — these are some of the ways that IOS facilities are used. Third-party logistics companies heavily rely on IOS assets to manage their vast trucking and truck parking requirements, particularly in the context of last-mile deliveries. Then there are the less obvious users: construction, landscaping, utilities, maintenance, and equipment rental businesses. These tenants rely on IOS facilities for storing large machinery, materials, and vehicles. Lastly, pure-play e-commerce users look for strategic locations near ports and major industrial corridors to optimize supply chain operations and store inventories.

While big national credit tenants are often the center of dialogue, an entire world of local and regional users of IOS properties exists. These tenants may not all be on the cover of magazines either, but they do ensure the world functions and that these properties remain in high demand.

Market Overlay

This niche sector is far from new. However, its growth is being spawned by market catalysts including e-commerce, last-mile deliveries, and supply chain disruptions which are fueling demand for IOS facilities. In addition, a strengthening supply-demand imbalance has been driving lower vacancy rates and higher rent growth within the sector since 2018. According to data from Marcus & Millichap, rents at IOS properties across the country have soared 30 percent since the end of 2019, which outpaces that of general industrial rents over the same period. The vacancy rate at IOS facilities fell to a mere 3 percent in mid-2022. We have seen the industry size number of $110 billion but also numbers circling $200 billion — regardless of the bookends, these numbers give us a sense of the sizable magnitude of growth.

Because IOS is an emerging niche asset class, there is a lack of third-party resources specifically focused on tracking the sector, like other more mainstream property types. In the absence of readily available IOS data, for both buyers and sellers alike, more effort and time is required to understand and underwrite these properties at both macro and micro levels. Enter the heightened importance of having knowledgeable people with the requisite experience and capabilities to underwrite IOS properties – spanning site selection, underwriting (with regard to rents/net operating income, leasing velocity, closing costs, and exit cap rates), as well as broader asset management - all in a rising interest-rate environment. While it seems simple on its surface, experienced teams are critical – and in a niche asset where the pool of sophisticated sellers and buyers is relatively small; these teams are not always easy to find.

Supply Side Constraints

Firstly, construction tends to be restricted by local regulations such as zoning; in many locations, obtaining proper entitlement and zoning for construction of new IOS facilities can be challenging. Many communities view low-density developments unfavorably, and few cities and municipalities want to encourage

these types of projects in their neighborhoods. If zoning and permits are granted, municipalities may require developers to overbuild the site so it looks aesthetically better via concrete/asphalt paved yards. Secondly, the issue of "higher and better use" limits supply, as conversion to traditional warehouses also harms the supply side. Many infill urban sites that would be suitable for IOS usage are already occupied by warehouses and/or are prime for redevelopment into other uses. This further limits supply expansion of IOS properties.

The Economics

From an institutional capital perspective, the appeal of IOS lies in its potential for higher-yielding investments. The IOS market is less mature than other commercial asset classes, including the various subcategories of industrial product, so there are many inefficiencies in pricing and evaluating risk and return.

Underwriting for IOS is similar to other asset classes at its basic level. There is a basis, going-in cap rate, potential market rent (and potential capital improvements to get that market rent), and a stabilized yield on cost for a typical five-year holding period. Capital expenditure (capex) improvements are where things may be a bit different. Capex activity could be as simple as regrading potholes, repairing fencing, adding lighting or access, or upgrading security. Building another small structure could also qualify as a capex move. By definition, IOS isn't capex-intensive. The downside obviously is the absence of depreciation (i.e. — minimal buildings). The lack of tax advantage is also a factor.

These properties rent on a per-acre per-month basis, not traditional per-square-foot basis. Why? Because often, it's simply land space that is getting rented. Since IOS assets command higher rents per square foot of building area than their more traditional industrial counterparts, the additional value that tenants derive is all in the outdoor storage component.

It is common to see triple-net leases with lease terms for IOS properties in the five to seven-year range, which is often shorter than traditional net-leased warehouse space. What's interesting though is the stickiness of these tenants. It is not uncommon to find tenants with actual occupancies passing the 20-year mark, which translates to higher renewal rates.

Simplistically, IOS is relatively low-cost to maintain, generates reliable steady cash flows, and has favorable supply-demand characteristics.

Market Players

To date, there has been limited competition from institutional investors on one-off acquisitions due to the smaller transaction size, which are often in the $1 million to $10 million price range. The market is highly fragmented and characterized by an eclectic mix of mom-and-pop investors, real estate entrepreneurs, and a smattering of institutions. Major players on the institutional side include J.P. Morgan, Brookfield, Stockbridge, Meadow Partners, and Catalyst Investment Partners.

It’s a small group of institutions making the press today — and therein lies the opportunity. SFR and Self-Storage were not institutional real estate classes either — until they were. Thinking about the parallels of their evolution relative to where the IOS sector currently stands illustrates the high ceiling for growth.

Where to Now?

How does a market become institutionalized? It’s a consolidation opportunity that will probably not occur today, but within the next two to five years. The projects are smaller, and institutions struggle with balancing small deals with a need to deploy larger quantities of capital. The industry needs more smaller operators acquiring smaller properties, in the process creating portfolios and paths to scale where none currently exists. Once the sector reaches that point, it will be ripe for a consolidation play. The winners will be the operators who took the risk and toiled the hours to build the portfolios today, as well as the risk-taking investors who are now showing up to back them. These players are getting out in front and setting the tone as market leaders. Institutions will win too, but they will likely pay a spread to the operators who took the risk first, which is a familiar story in real estate. We are still in the early innings of this cycle, so there is plenty of room for participation, and that’s part of why real estate is an entrepreneur’s paradise. The opportunities keep on coming, and they keep showing up to play. It’s what helps make the world go round.

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