Assess the Self-Storage Landscape

Finding the right lender in this specialty-property market often comes down to size

By Ken Schutter

For operators of self-storage businesses, the hurricane catastrophes that struck Florida, Texas and Puerto Rico this past August and September have become business-altering events. In the immediate aftermath of the storms, many operators faced a wave of insurance-related questions from all sides.

Long-term fundamentals for the self-storage sector are positive. Self-storage occupancy and rental rates have generally stayed steady or risen over the last several years. Existing and new operators alike see the potential for expansion, and the next challenge may be how to finance self-storage facilities while demand remains high. That creates opportunity for commercial mortgage brokers who take the time to understand the market and can successfully pair borrowers with the right lenders.>>

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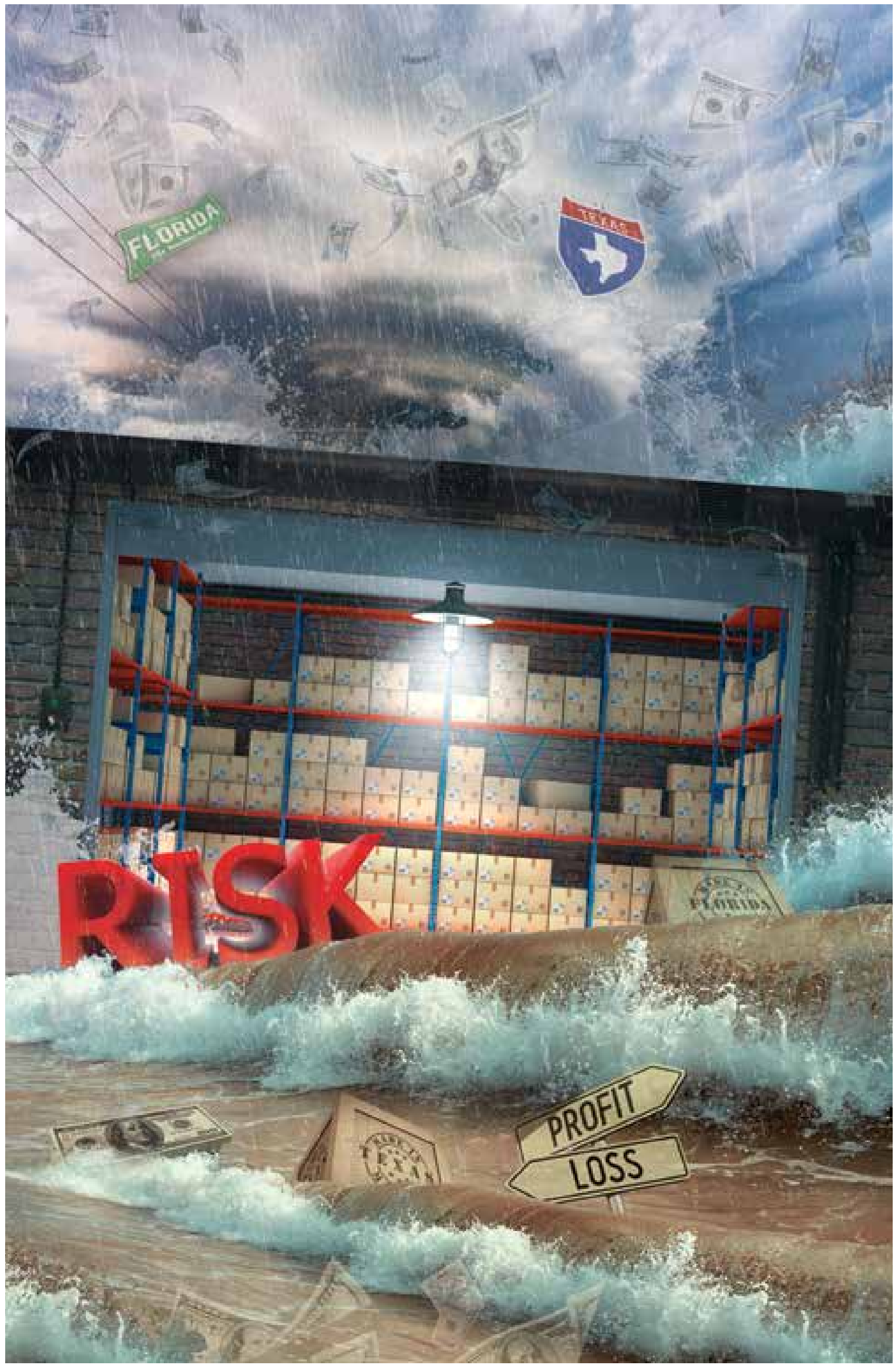

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Where flood damage is reported, customer satisfaction is always job one. On another front, self-storage space is an urgent prerequisite for homeowners starting the post-storm clean-up and repair process. The demand for storage space has pushed prices up in the cities most severely affected by hurricanes Harvey and Irma, for example.

In Miami, the average monthly rent per square foot for a 5-by-5-foot storage locker rose from $1.40 at the end of 2016 to $3.07 in mid-September, according to SpareFoot, an online storage-facility data provider. Vacancy rates for storage facilities are expected to decrease in Florida as demand heats up. In addition, Hurricane Irma forced a number of the largest national companies to temporarily close some Florida self-storage operations. Meanwhile, in Houston, where analysts expect vacancy rates to drop as well in the wake of Hurricane Harvey, per-square-foot rents for the same-sized storage locker went from 90 cents at the end of 2016 to $1.47 as of mid-September SpareFoot reports.

Marketplace financing

Clearly, the primary objective for borrowers in the self-storage industry is to secure the lowest rate of interest on any financing. There are other important issues to consider, however. Those other factors include the following:

- **How to structure** terms to specific properties and risks;
- **The trade-offs** between recourse and nonrecourse loan guarantees;
- **The restrictions** that some lenders impose on existing self-storage sites; and
- **Loan-closing** and servicing costs.

As a result of these issues, obtaining loans, especially for the small, independent operators in the self-storage sector, can be a long, arduous and uncertain process. To understand why, we need to look at one of the most widely-tapped pools of capital: the commercial mortgage-backed securities (CMBS) market. The $100 billion CMBS market supports everything from office towers in Dubai in the United Arab Emirates to strip malls in Dubuque, Iowa.

CMBS challenge

In the self-storage sector, CMBS volume exceeded $3 billion in 2015, up a remarkable 73 percent in just two years. The CMBS market is generally open to loans for stabilized properties that are above the range of $3 million to $5 million.

Ten-year maturities in the CMBS loan market are the standard. The drawbacks of CMBS loans, however, are not always apparent at first glance, but for growing businesses they can be a major handicap. Smaller loan amounts usually don't command the most favorable terms in the CMBS market. In fact, depending on size, some loans may not qualify for securitization at all, and for those that do, the closing costs can be quite high.

In addition, CMBS loans generally have a very complicated and expensive prepayment provision known as defeasance, which typically involves the borrower purchasing and posting government securities as collateral for the loan in order to obtain a release of the lien on the property that originally served as collateral.

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Perhaps most importantly, CMBS loans normally restrict certain material changes to sites while the loan is outstanding. These restrictions are meant to ensure that the CMBS investors have a stable set of assets backing their securities. Unfortunately, borrowers who want to make improvements, including new construction and expansion, are often unable to move forward without complex, costly and time-consuming legal work — or maybe not at all.

Risk management

There are other risks in turning to the CMBS market for financing. Weaker properties or less creditworthy borrowers, for example, may not be attractive to CMBS investors, especially in periods of market volatility when investors are more cautious. To rescue the deal, CMBS underwriters may have to increase yields, thus raising the borrowing costs.

The self-storage operator who receives assurances of low-cost, fixed-rate financing via the CMBS market can be caught off guard once committed to the process. At times, loan providers may have to renegotiate loan terms later in the process, or financing collapses altogether because CMBS underwriters are unable to place deals.

Most self-storage operators, however, need lenders who can help them manage risks, navigate the process and serve as long-term partners. That type of lending partnership can be difficult to foster in an industry made up largely of smaller operators. Most are looking for loans of between $2 million and $4 million, transaction sizes that usually do not qualify for the most favorable terms in the CMBS market. Consequently, such financing deals attract primarily local banks, rather than national lenders invested in the CMBS market.

Maturities can be an issue, too. Most self-storage businesses are based on 10- to 20-year hold periods, but some lenders may balk at extending such long-term financing. For terms beyond five years, a bank may charge an "illiquidity premium," or may prefer to provide

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floating rather than fixed interest rates, especially if their balance sheets can't support long-term, fixed-rate paper. Finally, the vast majority of bank loans require a full or partial personal recourse guaranty, and banks also frequently require that the borrower maintain deposit accounts with them.

Servicing concerns

Negotiating satisfactory loan terms at a reasonable interest rate can be just the beginning, however. Before deals reach the finish line, transaction fees can add up quickly. Many lenders subcontract out some of the fundamental functions necessary to close a loan, including basic underwriting due diligence. Borrowers and their mortgage brokers are well-advised to look for a lender with in-house experts in underwriting and legal matters.

Lastly, the ongoing costs of servicing a loan can't be ignored. Here, too, borrowers and their mortgage brokers should be thoughtful. Lenders who service their own loans maintain direct contact with their borrowers. That's good for borrowers who often need ongoing advice and collaboration.

Lenders benefit, too, as the servicing relationship can lead to new business with the borrower and help manage unforeseen payment challenges before they affect the borrower's credit. Unfortunately, servicing is another outsourced function for many lenders, who can't — or elect not to — provide this important component of relationship banking to their borrowers.

Finding a partner

Financing self-storage operations has become an increasingly complex business, especially as capital providers compete to work with large real estate investment trusts, or REITs, that control hundreds of self-storage locations and own millions of square feet of property. Lenders tailor deals for these corporate self-storage brands and routinely deliver the lowest cost of capital to them.

For the vast majority of self-storage operations that are locally owned and managed, however, financing is not routine. There are thousands of independent operators in the self-storage sector. Many manage a single site, perhaps renting out less than 50,000 square feet.

These businesses are faced with costs for incremental investments in facility upgrades, new computer technology, accounting and customer-service programs, or are dealing with consolidating existing loans. As borrowers, they may need only $2 million, not $20 million, but they also need lenders that are just as flexible and competitive as those institutional capital providers that serve the REITs and largest self-storage brands.

There are lenders that specialize in serving this "middle market," and as a commercial mortgage broker, it pays to seek them out for borrowers in the self-storage market. These lenders understand the risks as well as the opportunities of small businesses and are eager to help them to build and grow. The middle-market lenders represent true lending partners who are willing to work closely with an individual self-storage business, hold the loans on their balance sheets, service those loans directly and foster long-term relationships with the borrowers. ■