Transacting in Turbulent Times: The Impact of Coronavirus Across All Segments of the Self-Storage Industry

RK Kliebenstein | Apr 06, 2020

The coronavirus pandemic creates challenges across all aspects of the self-storage industry. Learn how the crisis is affecting tenants, owners, managers, suppliers, developers, investors and lenders, and how communication is crucial to navigating circumstances successfully.

These times aren't entirely unique. In self-storage, we actually have a footprint to step into, left from 9/11. The coronavirus (COVID-19) crisis is familiar, even if the cause isn't similar to that horrific day in 2001. Consider the timing, for example. On 9/11, most self-storage rent for the month had been paid, since many operators charge rent on the first of month rather than the tenant's anniversary date. Large, multi-site operators using anniversary-date payments will feel the economic effects of COVID-19 before those using first of the month, since pandemic-related events unfolded after March 1. April, May and June will be telling for all operators, depending on the duration of work stoppages. We know the shelter-in-place orders will have the greatest initial impact on lower-income, paycheck-to-paycheck families who may not have savings.

The government's disaster-relief checks aren't likely to be used by consumers for self-storage rent. Bigger priorities like food, transportation and utilities are likely to take precedence. Some relief will come in the form of lower gas prices and, subsequently, lower fuel surcharges on utility bills. The problem is those pennies per gallon, especially with reduced travel and transportation requirements, won't amount to significant additional income. What happens if self-storage tenants stop making payments?

Let's consider how this global crisis is creating challenges across the full spectrum of the self-storage industry, from the operations side to development to investing and lending.

What the Crisis Means for Self-Storage Tenants

Self-storage tenants are now wondering, "Do I continue to make storage payments? Am I going to incur and accrue late charges if I don't? Will I have access to my space? Will the operator sell my stuff?"

When customers can't pay due to the financial hardship being created by this crisis, will self-storage operators pursue the lien process? Though it's way too early to tell, this discussion must be going on in boardrooms and owners' offices everywhere. Some goodwill and positive public relations is to be gained by announcing a suspension of late fees for say, 90 days. That doesn't necessarily mean the lien process is suspended, though that may be an option. A secondary decision is whether to allow tenant access during periods of non-payment.

Self-storage attorney Jeffrey Greenberger, partner at Greenberger & Brewer LLP, recommends that operators actively communicate with tenants who indicate difficulty paying rent. "I have encouraged my clients to work with every tenant who claims some hardship. This can be everything from waiving late fees, splitting up monthly payments into weekly payments, or even deferring some amount of rent as long as the tenant pays some of it," he says. "That said, we are unfortunately finding folks who simply want to take advantage of this crisis to see what they can get out of all of their creditors. Thus, we are asking for some sort of proof of layoff or cutback in hours as part of our willingness to compromise on full and on-time rent as required by the rental agreement."

Greenberger has also advised operators to have tenants sign an acknowledgement indicating that whatever payment compromise is reached is temporary and doesn't waive prompt repayment once the crisis is over. For tenants who don't communicate with operators and fail to pay, Greenberger advises moving forward normally, including overlocking and sending lien notices, though with an extended proposed sale date in June or July.

"This keeps tenants on notice that they have to still pay attention to their debt to the facility, that storage is not charity; and while we recognize we are not going to hold any lien sales in April, we keep their feet to the fire and deny access (as permitted), until they communicate with us," he says. "This avoids any waiver of rights under the rental agreement, helps promote settlements up to and including agreed vacate agreements, and also makes sure operators get something from their tenants. If we sit silently and do nothing, my fear is tenants will treat self-storage as the lowest priority and pay nothing."

My advice: Facility operators, be communicative. Prepare your frontline staff (even if they're working remotely) to answer questions. Will your response be "business as usual" or adjusted depending on circumstances? Likewise, have a conversation with your call center. Scripts should be revised. Open the door to a conversation with someone on staff who is articulate, compassionate and well-informed about the desires of ownership.

There are even more wide-reaching considerations for commercial tenants. The duration of this event will dictate the severity. For nonessential businesses—frankly, a larger group than most of us would like to believe—the issue may be a trickle-down effect, depending on payment receipts from end users to commercial entities. A one-size-fits-all policy may not work. For example, what works for a landscape business or grocery store may not befit a restaurant, daycare center or hotel.

What the Crisis Means for Self-Storage Owners

For self-storage owners, some pertinent questions to ask are:

- Do I open my offices to public traffic?
- Do I staff my offices or have employees remain at home? (There may be a fine line here if managers live on site.)
- Do I waive late fees?
- Do I move forward in the lien process?
- How and what do I communicate with the public and my tenants?
- Am I able to seamlessly conduct business from rental to payment?
- If cash flow requires disbursement prioritization, where do mortgage payments fall?

If tenants stop paying rent, it starts a domino effect. One of the first "tells" will be rejected autopay transactions. If your doors are closed in observance of stay-in-place orders, the first payments to go missed will be those typically paid at the counter. If you're allowing staff to work remotely, then you at least have a line of defense.

In reality, keeping the office open likely isn't critical as long as tenants—particularly business owners and hospitals—have access to their units. If self-storage is deemed an "essential" service in your area, then the decision of whether to remain open is up to the owner.

Does your rental agreement have a *force majeure* clause? This essentially covers unforeseeable circumstances that prevent someone from fulfilling a contract. Do you even need it? Apparently, such a clause is unnecessary in month-to-month leases, according to attorney Scott Zucker, partner at Weissmann Zucker Euster Morochnik & Garber P.C., who says it's more important in long-term leases that can't be fulfilled or specific event-related contracts.

"In self-storage, both the operator and the tenant have the right to terminate at any time during the term of the lease to limit the rental to one month," notes Zucker. "Force majeure defenses for failure to fulfill the purpose of the rental would seem unnecessary due to their limited duration."

Operational limitations caused by the coronavirus, such as a lack of onsite staff to sanitize common areas, provide retail services or patrol the property, aren't likely to trigger a need for force majeure, according to Greenberger, who says none of these operational changes likely would be substantial enough to make a lease termination necessary. "If tenants feel operators have abandoned their responsibilities, they can move out with little or no notice. This is why a [force majeure] clause simply isn't customary for a month-to-month agreement."

When it comes to new rentals, operators who offer online move-in capability have an advantage, as they're able to complete the rental process without human intervention or a wet lease. Closing your management office to face-to-face interaction is a higher level of compliance than is demanded in most shelter-in-place orders and is a good way to limit in-person contact with customers.

In addition to addressing operational considerations, some self-storage owners may face complexity over their mortgage payments. Those likely to be hit the hardest will are those with facilities in lease-up or that are over-leveraged. Well-capitalized, low-levered owners will have the greatest protection from the fallout. A diminution of profits is entirely different from mortgage default.

My advice: Owners, be communicative with prospects, tenants, staff, vendors and lenders. Fully comply with state, federal and local mandates regarding shelter-in-place orders. Continue to operate virtually as much as possible, using online rentals. Make informed choices rather than rash decisions. Make sure your messaging to customers and the public is consistent and embodies esprit de corps as we navigate unchartered waters.

What the Crisis Means for Self-Storage Managers

First and foremost, family and personal safety should take precedence over all other factors. Self-storage managers shouldn't succumb to fear from fiction, and don't let social media guide your choices. Use facts to make decisions about safety for you and your family. My family made the choice toward almost zero contact with the outside world. Our prescriptions and groceries are being delivered, and we don't pick up food from restaurants.

You have to make decisions consistent with your own health. If you have an impaired immune system or an auto-immune disease, make intelligent choices. This is a life-safety matter, not a bad case of the sniffles. Staying home from work may be a temporary cash-flow issue, but a life-ending decision would have much more long-term effects. Remember, being a self-storage manager is a job, not a lifestyle (sorry, owners). Likewise, you shouldn't endanger others.

If you're laid off due to a store closure, you should have rights to an unemployment claim, subject to the rules and regulations of your state. If you're an independent contractor and haven't been paying into the system, you may not have basis for a claim. Regardless, depending on the duration of this event, ownership will, in most cases, be anxious to get back to business as quickly as possible.

My advice: Managers, be communicative (are you seeing a common thread here?) with your family, friends and employer. Assess each risk and the potential reward. Stay informed and be ready to act. More than anything, protect your own health and that those with who you come in contact.

Keep your owners informed of increased or decreased traffic on the website and phone. Walk-in traffic should be nil. Also, watch rent-collection trends compared to previous periods (this is easier if yours is a stabilized store). Watch for rent payments from tenants that are typically paid in cash, and keep ownership informed of autopay cancellations. Carefully track rentals and receipts against prior periods. If you have an application like District Manager, turn on the alerts, so the team stays informed.

What the Crisis Means for Self-Storage Suppliers

If a vendor is in the new-construction supply chain, current realities may be different from the issues faced by purveyors of goods and services to established self-storage facilities. In both situations, there's inventory on the ground and in transit that will keep flowing in the short run. If predictions are true and the duration of the crisis is relatively short-lived (three to four months), the disruption will be a hiccup and not devastating.

Chinese-sourced materials are likely to be the most impacted, particularly as China wrestles with labor issues as well as transit and logistics challenges. Resellers may look to source from countries where the pandemic has had less affect. Domestic providers may struggle with potential labor issues and shifts in production to meet healthcare needs ahead of construction and industrial demands.

Expect nothing less than delays in the supply chain, from ordering to delivery. It's extremely encouraging that supply-chain giants like Amazon are gearing up, not down. There may even be opportunities within the crisis to support customer needs and keep businesses running. Consumers, personal and commercial, are creative. When the paper-goods crisis hit grocery shelves, second-source suppliers immediately saw the market shift to them, including office and industrial suppliers, which found themselves exhausting 90-day inventories in a matter of moments. In this case, demand created suppliers.

My advice: Vendors, communicate with your customers. If you can't supply due to sourcing issues, tell them what you're doing to restore the supply chain. If you have delivery issues, let them know how you're planning to deliver goods and services.

Be collaborative. Maybe you don't have a particular product readily available but your competitor does. Arrange to defer some sales traffic to them in exchange for your ability to meet customers' needs. Since stay-in-place orders differ from state to state, you may find that working with competitors rather than against them is more beneficial.

What the Crisis Means for Self-Storage Developers

Self-storage developers are in a unique situation. They need to be patient and see how this crisis plays out. What we do know is things are certainly changing. Move ahead, albeit more cautiously. Know this is a good time to reassess project assumptions based on debt, lease-up, operational metrics and industry movement.

The purchase and sale agreement (PSA) needs a good revision right now. Make certain that force majeure language is inclusive, and that if your loan commitment has MAC clauses, they dovetail into your PSA. Understand that the municipal approval process may be different. Some municipalities may not be technologically advanced enough to allow work from home.

Think about public hearings. These are designed to bring citizens and government together in a forum. What about now? It's certainly possible for a hearing to be held virtually. City-council members could Skype. A video podium could bring citizens to staff or council in a digital setting. Documents can be presented or sent via the Web. Nothing is impossible. PSA terms may need to be tied to the actual occurrence of meetings rather than timeframes for when meetings *should* occur.

If you're in the middle of construction, challenges with the supply chain or labor may stress your projections and delivery timeframes. This will impact loans and may affect stabilization periods. Adjust projections and weigh your options. The odd benefit of this crisis could be the slowing of new supply coming online by virtue of developers temporarily shelving projects. Working with a lender to delay construction and keep loan commitments alive is certainly better than collapsing the commitment—modification over termination.

My advice: Developers, keep lines of communication open with sellers, suppliers, consultants, lenders and the entire development world. Let them know what's happening with your project and how you're adapting to the environment. Savvy sellers will ride this out and not get reactive by terminating a PSA. The Plan B you thought was great may have to be pushed to the sidelines, so the deal in hand becomes much more valuable.

A delayed closing is likely better than no closing. If sellers think they sold a property too cheap, they may well want to measure what having no buyers looks like. If market recovery is long rather than quick, it could delay capital events indefinitely, so work it out!

What the Crisis Means for Self-Storage Investors

Sophisticated investors know there are cycles. We've known for a long time that this beautiful ride the industry has been on had to correct and come to an end. We had no idea coronavirus would be the cause, but we all know something had to occur. Most investors believe the situation is temporary and capital markets will restore. Those vested in equities felt the pain first, with the tumbling of the stock market.

Commercial real estate has yet to come anywhere near a crash and may be experiencing a smaller correction than residential properties. Lenders really control this market, as most investing has debt in the capital stack. A few investors are all equity-based, and this shift may create some unique opportunities for all-cash investors.

If investor yields were all based on zero debt, the current crisis would have no affect from a capital stack, unless and until there's a capitalization-rate (cap-rate) change, which may be imminent. If the buyer pool is challenged with changing debt, it'll logically affect cap rates and the capital markets in general. Changes in consumer behavior and operational metrics may cause reduced net operating income, thus changing valuation and so on. If cap rates don't change, values certainly will, if and when revenue changes.

The good news is this is cyclical. Just as the downward correction is certain, so, too, is the growth cycle on the other end. I've been advising those close to me for years that the smart money is on a "war chest" to execute when the market turns, to be cash-ready and in position to pull the trigger and buy. Timing really is everything.

This is a great time to have an open and sincere dialogue between buyers and sellers. Knowing the realities of market transactions, behavior becomes key to making good decisions. If you lose a deal, open communication may create an opportunity to revive a transaction when things get back to normal, even if it's under different terms and conditions.

If you don't *have* to sell or buy, then don't. We might take a lesson from lenders, which are likely to do nothing in times of instability. Take a deep breath and look at transactions from a different perspective. An all-cash buyer who's closing deals may be worth more to you now than a prospective buyer in an unknown future at an unknown price.

My advice: Investors, be communicative and flexible. Assess the need to close today against the realities of the market. If you push a buyer/investor away, will it entice him to close now, possibly with an incentive, vs. in the future when conditions improve for everyone? Be willing to extend closing deadlines or even allow parties to walk. If you're holding assets, be patient. Let the crisis play out for a while, and don't make rash decisions you'll later regret. Be collaborative. Look for win-win solutions, not battles.

What the Crisis Means for Self-Storage Lenders

We’re closely watching the debt markets and how they react to the crisis. This is different from the global financial crisis of 2008 and somewhat similar to 9/11. It’ll take time to see the trickle-down effect, if any, from unpaid rents. We know there’ll be an impact if operators can’t collect rent. Whether they choose to withhold mortgage payments is yet to be determined.

This crisis will certainly test lenders’ analysis of required reports and, hopefully, they’re in direct and consistent communication with borrowers. It’s easy to pepper the files with required financial reports when things are good and then panic when an event like COVID-19 occurs. Lenders should be consistent in their reviews and discussions with borrowers. We’re beginning to see some react to federal stimulus packages and measures to keep the economy moving. The natural reaction to unstable markets is to pull back and wait. This would mean lenders aren’t likely to issue new commitments, which is a stance the commercial mortgage-backed securities (CMBS) market seems to be taking.

One noticeable reaction is a change in underwriting as lenders perceive greater risk in the commercial real estate market. This is evidenced by increased debt yield, debt-service coverage and rising floors on interest rates for new loans.

Governments have, so far, showed signs they’re willing to step in to help keep the real estate industry and the country afloat. New York announced it’ll suspend mortgage payments for those with financial hardship, while trade groups like the Housing Policy Council have recommended banks allow borrowers to stop their payments during the crisis. The federal agency overseeing Fannie Mae and Freddie Mac, the government-operated buyer of mortgage debt, recently ordered a suspension of foreclosures and foreclosure-related evictions for at least two months. The initiative is designed to keep families in their homes and avoid a housing squeeze like the one that followed the mortgage-driven financial crisis in 2008. These measures don’t directly affect self-storage loans, but they do set a precedence and give us insight to the thinking and actions of regulatory agencies.

There are also similarities to the residential-lending market. Commercial loans are packaged into mortgage-backed securities (MBS) just as they are for residential mortgages. The CMBS market is almost $200 billion, while the residential MBS market is somewhere around $9 trillion. Nevertheless, the CMBS market seems to be at a standstill for the time being. Calls to brokers indicate that new commitments for CMBS loans are on hold and existing deals are certainly changing.

Below is a recap of lending sources and their current state of affairs provided by Neal Gussis, principal at mortgage-banking firm CCM Commercial Mortgage:

CMBS. Until recently, CMBS lenders were quoting and closing non-recourse loans in the low 3 percent range, allowing cash-out often with interest-only periods, followed by 30-year amortization. Lower leverage—60 percent were able to obtain 10 years of interest-only financing.

The cost of CMBS is based on the pricing and trading of bonds. Two deals that were supposed to be securitized were recently pulled from the market because the bond market is frozen. Bond investors are reassessing risk and pricing. Also, New York City is pretty much shut down.

Loans that were under application with CMBS lenders aren't being honored thanks to the Material Adverse Conditions (MAC) clause—not even rate adjustments. When CMBS starts up again, spreads likely will be higher, which will reflect higher bond pricing. In addition, self-storage loans will be highly sought after because they'll look better than before compared to other commercial real estate property types. There may be a period during which CMBS lenders aren't competitive with banks, credit unions and life companies. Sources indicate a likely range of 4.5 percent to 5.5 percent, with no assurances.

Banks. They're open for business and have low cost of capital, with rates generally in the 3.25 percent to 4.5 percent range. They're offering fixed-rate terms up to 10 years, often through separate swap agreements. A swap agreement can be .5 percent cheaper in rate that a fixed-rate loan not utilizing a swap. Non-swap, fixed-rate loans likely have a step-down prepay penalty, and swaps need to be unwound at a premium or discount.

Banks will be more conservative then CMBS lenders, with 20- and 25-year amortization typical. Many will also limit loan to value to 70 percent. Unless lower leverage, bank financing will be recourse.

Expect disruption along with slower response and processing times. Many are still trying to figure out the logistics of bank personnel working remotely. As the weeks pass, bankers also will be focusing on existing customers, many of whom will be having problems making mortgage payments. Some third-party services may be delayed due to local government direction.

Credit unions. They're still open for business, quoting rates 3.7 percent and higher. They may offer some interest-only based on leverage. Most loans are 25-year amortization. They're offering full recourse, no prepayment penalty, and they have the same disruption issues as banks.

Life-insurance companies. They lock deals at application and continue to honor deals that were locked prior to the crisis. Some have chosen to stop new originations until there is some settling in the market. Interest-rate floors are close to 4 percent.

Most life companies transact above $20 million. A select few lend in the $5 million to $10 million range. Some lenders are reducing loan-size requirements because they want to limit risk. As a result, there may be more life companies willing to look at deals in the $5 million to $10 million range. Life companies are very selective with respect to quality of asset, location and sponsorship. This latest disruption will only make criteria even more selective.

Bridge lenders. The market has been flooded with mortgage real estate investment trusts, debt funds and private money looking for yield. Prior to the crisis, bridge loans were priced at 250 to 450 over LIBOR on a non-recourse basis. Loan size was based on the lender's underwritten, stabilized cashflow. Many of these funds may no longer have access to capital or attractive capital to continue to provide bridge loans. Obtaining bridge financing on lease-up deals has certainly become harder and more expensive.

Here are Neal's three key takeaways based on current lending-market conditions:

- There's plenty of liquidity and capital available, particularly from banks and credit unions. The main issue will be if lenders have the time and resources for new loan production.
- Seller expectations should be tempered since due-diligence periods could be longer. Sellers may need to be a bit more patient and flexible.
- While other commercial real estate will be reeling from dark space and lost rents, self-storage is poised to come out looking relatively well. Owners will need to work with a percentage of tenants on rent-payment issues and late fees, but it looks like move-ins are generally up, while move-outs are generally flat.

My advice: Lenders, be communicative. The Federal Deposit Insurance Corp. has encouraged banks to make payment deferrals or convert loans to interest-only. This is surely good news to self-storage borrowers uncertain of rent streams. Creditors should be in close contact with debtors to keep lines open and work through the crisis. If the past helps us predict the future, self-storage should remain a strong asset class, except for the current over supply and higher than precedented saturation levels.

A Good Time for Everyone to Assess

These are certainly interesting times, times in which a person's character is easily revealed. Greed will be evident, and it may be ugly. Collaboration—a willingness to work together with give and take, rather than just take—may win many favors in the future. This is a good time to re-evaluate relationships and shed yourself of the dead weight created by one-sided, "what's in it for me" partners and clients. Concern over the personal health of others, not just financial health, may be key to driving future relationships.

RK Kliebenstein is principal of Coast-to-Coast Realty Advisors LLC. He has more than 30 years of self-storage industry experience, from creating business strategies to disposing of mature assets and everything in between. He's the author of several books, including publications on how to invest and make money in self-storage. He's also a frequent speaker at industry events, For more information, call 561.797.2721; e-mail rk@askrk.com; visit https://askrk.com.