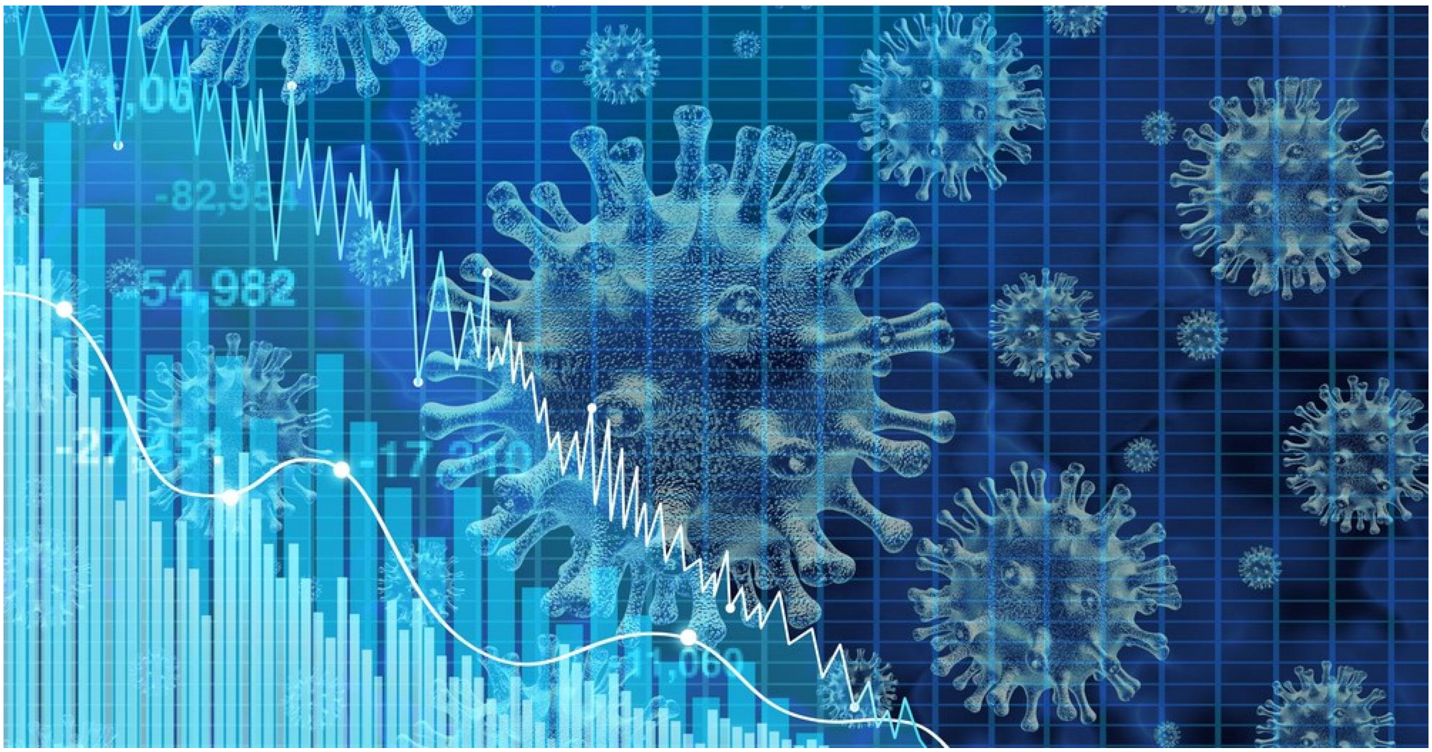
ISS INSIDE SELF-STORAGE



The State of the Self-Storage Capital Markets During the COVID-19 Pandemic

The commercial finance markets are changing rapidly in response to the coronavirus pandemic. Whether you already have a self-storage loan or are looking to obtain one, it's critical to understand the current lending landscape.

Shawn Hill | Apr 25, 2020

To borrow a catchphrase from Major League Baseball sportscaster Harry Carey, "Holy cow!" What a difference just a few weeks makes. After more than a decade of historically low interest rates, stability, and liquidity in the commercial real estate markets, things have changed quickly. If you're currently engaging in self-storage transactions, it's important to have patience and understand the market. I've summarized it for you below.

General Market Conditions

The lending landscape has changed dramatically in just a few short weeks. Generally speaking, this can be characterized as a shift from aggressive loan origination to conservation, asset management and preservation of capital.

The funnel of available capital is much narrower than it has been in quite some time. There are still lenders originating loans, but there are fewer of them and the criteria for qualified deals has intensified. Lenders that remain active are overwhelmed with requests and, in general, have the luxury to cherry-pick deals right now. Here are a few other observations:

- Despite the fact that the federal funds rate is virtually zero and the underlying indices are historically low, credit spreads have increased, and rates are moving up.
- Some lenders are pausing new loan originations, while others have completely stopped quoting until they get a better indication of market direction.
- When the pandemic will end and how much it will hinder our economy in the short and long term remains unclear. Until it comes in to focus, the lending markets will continue to be impacted.
- Transacting in the current market is difficult for obvious reasons. It's hard to get people on site to do the work needed to consummate a transaction. If you're going to buy, sell or finance real estate, it's critical to set realistic expectations around timing and contingencies needed around all sides of the transaction.

Balance-Sheet Lenders: Banks, Credit Unions and Life Companies

Banks generally remain well-capitalized and healthy, largely as a result of lessons learned during the last recession. That said, things are evolving quickly, and they're drinking from a fire hose dealing with requests for forbearances and loan modifications, struggling companies, processing Small Business Administration relief loans … you name it.

Balance-sheet lenders that are still lending are largely implementing rate floors or simply quoting an "all in" rate on new loan originations. Many of the life companies and banks I've surveyed have implemented rate floors in the 3.75 percent range and up. Anecdotally, in early April, one very consistent lender had a rate floor on new deals of 3.65 percent; a week later, it shifted up to 4 percent.

Lenders are pulling back to a more conservative mindset and focused on straightforward deals with solid fundamentals and sponsorship. This means lower loan-to-value, higher debt-service coverage ratio and debt-yield metrics, and solid market and sponsor profiles.

Many life companies and banks have temporarily exited the new-originations market to wait for more pricing clarity and, in the meantime, may be deploying capital into a higher relative value product or conserving it altogether. This trend will continue if the pandemic is protracted longer than anticipated.

Commercial Mortgage-Backed Securities

The commercial mortgage-backed securities (CMBS) market has been disrupted and is generally in a stall. Most CMBS lenders have stopped quoting deals until the market comes back into focus. Those lenders that continue to quote deals are doing so with many caveats, as the market remains fluid.

Pricing CMBS loans depends heavily on how deals are "pricing and trading," and that volume is essentially non-existent. It would be very difficult to accurately price a loan right now. CMBS spreads have widened significantly to offset the drop in the underlying indices.

If you're an existing CMBS borrower (or really any borrower) facing difficulty meeting your loan obligations due to the current circumstances, you'll find useful information from the Commercial Real Estate Finance Council regarding how to navigate with your loan servicer.

Bridge Lenders, Debt Funds and Private Capital

The bridge market is facing significant disruption. Debt funds that rely on repo lines or credit facilities from institutional partners are likely to pause originations while awaiting further guidance in light of general market conditions, the potential for margin calls and other factors. At the beginning of the year, there were several hundred bridge lenders in the market using a variety of strategies to fund deals. Today, there are a fraction of that amount actively pursuing and funding deals.

The current environment will likely shake out peripheral lenders who don't have solid capital platforms and equity partners committed to a long-term vision. Private capital sources with access to discretionary capital may see this as an opportunity to fill the short-term gap and increase their production until things stabilize. This will be risk-adjusted capital with a pricing premium.

Other General Observations

Some property types will be affected more heavily than others. Self-storage remains attractive as does multi-family, manufactured housing and industrial. Hospitality and retail face significant obstacles in the near term and maybe indefinitely. Despite the short-term disruptions expected from the "no eviction" mandates, multi-family and manufactured-housing properties will continue to benefit from the additional liquidity provided by lenders Fannie Mae and Freddie Mac.

Equity will be affected by alternative investment opportunities that have resulted from a general market correction. Deals that rely on "syndicated-type" structures seem most vulnerable as individual investors consider alternative options.

Bridge capital that's been available to take out construction loans on recently completed self-storage properties may become scarce. This could place pressure on maturing construction loans on projects that have been slow to lease-up.

The CARES Act

The programs and initiatives in the Coronavirus Aid, Relief and Economic Security (CARES) Act passed by the U.S. Congress are intended to help small-business owners with whatever needs they have right now. This legislation is extremely comprehensive, including the Paycheck Protection Program, emergency economic-injury grants, mortgage assistance via the small-business debt-relief program and other resources. This comprehensive guide from the U.S. Senate Committee on Small Business & Entrepreneurship can help you better understand what's available and how to get started.

Parting Advice

If you need to transact, get into the market as soon as possible, as the process is likely to be protracted because lenders are overwhelmed by loan requests. Borrowers need to be prepared for slower response times given general business interruption and distracted employees who are dealing with various iterations of the quarantine. Working with a mortgage broker can help ensure your transaction is being prioritized by lenders that remain active and any perceived market risks are being mitigated upfront.

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