SpareFoot Storage Beat

Tom Sherlock Q&A: What the fed hike means for self-storage loans

by Alexander Harris on January 4, 2016

Storage Beat: Looking at all the various sources of capital to the self-storage industry, how would you assess each one heading into 2016?
Tom Sherlock: The CMBS lenders are currently in a rising rate environment and facing increasing regulatory pressures. The life insurance companies don't face the same regulatory pressures, and with the start of a new year, they have new allocations available to lend. Banks are also dealing with regulatory issues. For development loans, the underwriting is getting tougher and the capital requirements are making the loans more expensive. Credit companies are working on and hope some non-recourse offerings this year, which they didn't have before.

Storage Beat: Which of those lenders do you expect to dominate the self-storage lending markets in 2016?
"From the measurement of dollars, banks and CMBS are the two primary sources of capital to the industry. I think that will continue to be the case. Life companies are definitely active and interested in the product, but they self-select into more conservative leverage levels with higher debt service coverage levels and tend to focus on major markets."
Storage Beat: As everyone should know by now, the Federal Reserve raised short-term interest rates a quarter of a percentage point, with gradual increases expected in the future. Bottom line, what does this mean for the self-storage industry?
Tom Sherlock: Rates that were in the low-fours early last year are now in the high-fours to five percent right now. With rising interest rates, debt service coverage ratio has become a more constraining factor again in sizing loans. The net affect is that there are limitations on the dollars that can be borrowed.

Storage Beat: Could you provide an example of that?
Tom Sherlock: A lender says "I am going to lend you up to 75 percent as long as your debt service ratio meets this threshold." Before, when interest rates were so low, the debt service coverage ratio (**NOI / total debt service**) threshold was not coming into play. That dynamic has changed because of the rising interest rates. Cash flow in relation to the mortgage payment is becoming much more important for sizing loans.
Higher interest rates mean larger mortgage payments. So if you have a million dollar NOI and an annual mortgage payment of $800,000 with a four percent interest rate, your debt service coverage ratio is 1.25. If you use the same NOI and the higher interest rate in today's market, that debt coverage would drop.
The easiest ways to increase the coverage ratio are either increase the amortization, which is not what lenders usually want to do, or lower the loan amount.

Storage Beat: Do you expect that dynamic to have a large impact on lending activity in the space?
Tom Sherlock: We still have an extraordinarily active lending market. The lenders are all hungry for more volume; they want to be doing self-storage loans. So it is an advantageous time for a borrower to be in the market, but lenders aren't going to be as aggressive as they were before as a result of the higher rates.

Storage Beat: Any parting advice for would be borrowers in 2016?
Tom Sherlock: It would be more advantageous to be closing loans in the beginning of 2016 rather than in the second half.