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Is self-storage boom too much of a good thing for lenders?

By Andy Peters
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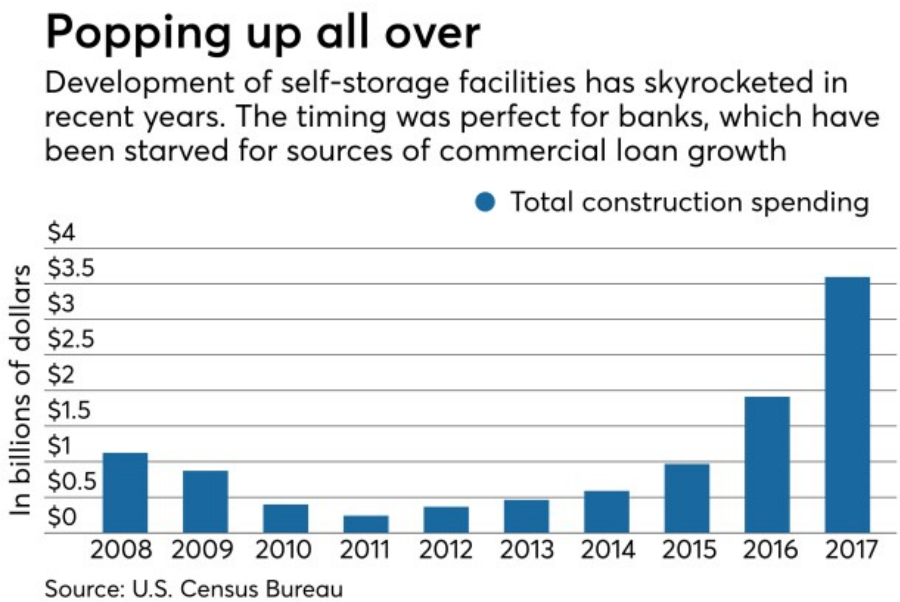
The storage wars are on in the real estate world, as is the debate about whether banks will emerge victorious or with wounded loan books.
Commercial loan demand has been in a prolonged holding pattern, so any loan category with vibrant growth characteristics was bound to attract bankers. Lately that category has been financing self-storage facilities, as many Americans shift from single-family homes to apartments but are still carrying as much stuff as they always have.



The economics of the self-storage industry are attractive. After initial construction costs, self-storage facilities require little overhead. Customers rarely move out if rent increases. And a self-storage business can be structured as a real estate investment trust, providing the owner with tax benefits.
No wonder bankers have rushed in to make loans for self-storage construction.

“There are a lot of banks we talk to today that wouldn’t have done a self-storage loan five years ago” when the market had not yet taken off, said Eric Snyder, a principal at Talonvest Capital, which arranges bank loans for self-storage construction. “Now there are a whole lot more banks who really like the product.”

One banker says it may have become too popular. The $3.4 billion-asset Live Oak Bancshares in Wilmington, N.C., gets an increasing number of loan applications for self-storage facilities that fail to pass muster, said Terry Campbell, general manager of the bank’s self-storage lending division.

“We’re seeing a lot deals come to us that aren’t cash-flowing,” Campbell said, meaning that they would not generate adequate cash flow to meet debt-service requirements. “We’re getting more applications than we used to, but we’re turning down more, too,” he said.

Live Oak in December closed its 165th loan for self-storage, representing more than $350 million in total financing. Most of Live Oak’s self-storage credits are backed by the Small Business Administration and range between $350,000 and $12 million.
Other banks with active self-storage lending groups include the $23 billion-asset TCF Financial in Wayzata, Minn., where self-storage loans made up 8% of its total CRE lending at March 31; and the $10.2 billion-asset WesBanco in Wheeling, W.Va., which had $26 million of exposure to self-storage at Dec. 31, both in construction loans and commercial mortgages.

So far, there are few signs of deteriorating credit quality in commercial mortgages on self-storage facilities that have been packaged into mortgage-backed securities, said Tom Fink, a managing director at data provider Trepp. “Loan-to-value ratios seem to be fairly stable, and debt-service coverage ratios remain high,” Fink said.

The construction side of self-storage also appears healthy, said Tom Sherlock, who like Snyder is a principal at Talonvest. The Irvine, Calif., firm is currently working on 19 different construction financing deals. In one of its latest deals, Talonvest arranged the refinancing of a $13.4 million loan on a self-storage facility in North Bergen, N.J.
Still, Live Oak’s Campbell says there are worrying signs. For one, construction costs have risen in recent months, as there are so many self-storage units being built and developers must pay up to find contractors. “Construction costs are so high, you’re going to have to put down a whole lot of money” to make it work,” Campbell said.
Construction costs may rise further still, due to the Trump administration’s tariffs on steel imports.

Lenders and developers are starting to cut corners, Campbell said. Some banks have stopped requiring a feasibility study to determine if a specific neighborhood can support a new facility. Other lenders have loosened underwriting standards, such as accepting high loan-to-value ratios.

There is also concern that supply has surpassed demand in some cities. Life Storage, one of the largest self-storage operators, has oversupply concerns in Dallas, Houston, Denver and other cities, CEO David Rogers said during a November conference call with investors.

The pace of self-storage construction has skyrocketed. Total spending on the construction of storage facilities rose 88% to $3.6 billion in 2017 compared to the previous year, according to the U.S. Census Bureau. About 800 self-storage facilities opened in the U.S. last year, according to Colliers International.

But Talonvest’s Sherlock and Snyder said there is still room for more. Self-storage facilities tend to draw from a very tight geographic area — typically within two or three miles of their location. That means you can find specific neighborhoods in most U.S. cities that do not have self-storage units. “You’ve got to look in every micro-market in each city,” Snyder said.

Snyder declined to name any of the banks that have entered self-storage lending in recent years, or his firm’s specific bank partners. But he said that the “vast majority” of banks that make loans for self-storage are regional and community banks, not megabanks.

“The money-center banks don’t want to make a $7 million or $12 million, one-off loan when there won’t be a long list of financing projects lining up behind it,” Snyder said. Talonvest arranges primarily construction loans, which count toward a bank’s commercial real estate exposure. Once construction is completed, Talonvest seeks insurance companies or securitization pools to convert the construction loan to a mortgage, Snyder said.

“Self-storage owners want a 10-year, fixed-rate, nonrecourse loan, to lock in today’s rates,” Snyder said. “Banks don’t do that” kind of financing.
Even if the market is getting crowded, banks may still have new opportunities to do self-storage lending as the industry adjusts to trends in real estate development. Mixed-use projects, for example, have recently added self-storage to the typical mix of retail, office and residential units, Sherlock said.

In one such deal, which did not involve Talonvest, the $3.8 billion-asset Ocean Bank in Miami made a $43 million loan last year for a shopping center in Miami Gardens that includes self-storage.

In other words, there should be plenty of self-storage loan opportunities for banks, even if it seems the space has become crowded, Fink said. “I don’t see anything that shows concern about overbuilding or an impending credit crunch,” Fink said.