Self-Storage Construction Financing in a Post-Pandemic World

By: Steve Libert

While it has become somewhat more difficult to obtain financing for new self-storage construction in today's post-pandemic world, there is still plenty of capital for strong new development projects backed by experienced, strong sponsors.

Record-Breaking Self-Storage Pandemic Performance

While most of us in the self-storage industry held our breath a little bit and were not sure exactly what to expect in the early stages of the COVID-19 pandemic, we can now look back on 2021 and 2022 as two of the strongest years of self-storage financial performance on record. The unprecedented financial results were primarily fueled by increased demand/occupancies and the resulting ability to grow street rents, as well as existing customer rents, leading to double-digit NOI growth for two years straight. The self-storage industry demonstrated once again that it continues to out-perform virtually all other commercial real estate asset-classes in both good times and bad times.

As the world has mostly returned to "normal" after the eye of the pandemic storm has passed, self-storage operational and financial performance is also beginning to normalize. Rent growth is slowing, and occupancies are declining from record highs but have remained relatively strong. While street rents have begun to move downward, existing customer rate increases (ECRI) continue to remain strong as we approach the end of 2023. By most commercial real estate performance metrics, self-storage is still performing extremely well.

Interest Rate Increases

In the wake of the pandemic and the unprecedented governmental economic stimulus, supply-chain shortages, and the persistent inflation that followed, today we find ourselves in an interest rate environment that has changed dramatically in record time. In an effort to curb post-pandemic inflation, the Federal Reserve has increased the Fed Funds rate at a break-neck pace -- 11 times from March 2022 through July 2023 -- to the highest level in 22 years. As the Fed Funds rate increased 0.25%-0.50% to 5.25%-5.50%, other short-term rate indices increased in an almost lock-step fashion. From March 2022 to July 2023, the prime rate increased from 3.50% to 8.50% and 30-day SOFR increased from 0.05% to 5.00%. Longer term rates have also increased substantially, although to a somewhat lesser extent, resulting in an inverted yield curve, where short-term rates (typical of construction loans) are higher than long-term rates (typical of permanent loans).

The dramatic speed and extent of interest rate increases in a little over a year is likely the single greatest self-storage financing challenge we have seen since the Great Recession of 2007-2009. However, the major difference between then and now is that the Great Recession brought financing to a complete halt, while today there is still plenty of financing available, albeit at much higher rates than we have experienced over the last 10-15 years. Interest rates for self-storage construction loans have quickly ballooned from the 3% to 4% range that we enjoyed over the past several years to rates that today can often exceed 8% or 9%. Interest rates for permanent financing for stabilized self-storage facilities have

also more than doubled in a very short period of time, often exceeding 7% going into the fourth quarter of 2023.

Banking Credit Tightening

If the dramatic rise in interest rates was not enough of a challenge for self-storage borrowers, the banking sector has begun to pull back from commercial real estate lending as a direct result of the Feds interest hiking efforts. Simply put, the sudden and extreme increase in rates has had a material detrimental effect on the value of a bank's longer term fixed-rate assets. The sudden drop in value of a bank's longer term fixed-rate assets can generate losses for the bank if they must liquidate those assets to cover short-term liabilities (aka deposit withdrawals). The Silicon Valley Bank failure in March of 2023 was essentially the result of this mismatch between longer term fixed-rate assets and short-term liabilities. First Republic Bank and Signature Bank suffered a similar fate as their depositors rushed to withdraw deposits that eventually could not be covered by the banks' assets. While there were only four bank failures in 2023 (through September), there could have been many more had the FDIC not calmed the market down by covering both insured and uninsured deposits for all four bank failures. Banks are not only lending more cautiously today on commercial real estate, but as rates have increased, the cost of funds (deposits) for virtually all banks and credit unions has increased by as much as 500 basis points, as banks try to prevent depositors from pulling their money out. As of September 2023, it is not difficult for depositors to find a high-yield deposit account with an interest rate in excess of 5%.

Construction Lenders Still Like Self-Storage

The bad news is that the cost of debt is substantially higher than it was only a short time ago, and many lenders have become more conservative when it comes to commercial real estate lending. The good news is that self-storage is still considered by most lenders to be a very desirable asset class to lend on when compared with the other commercial real estate assets classes. As a result, the lenders that continue to have the appetite and ability to make new commercial real estate loans typically welcome the opportunity to consider self-storage loan requests. When evaluating self-storage construction lending opportunities, conventional lenders (like banks and credit unions) have become more discerning and are often reserving their lending capacity for existing customers, the most compelling projects, and the most experienced developers and operators.

Who is Providing Construction Financing to the Self-Storage Industry?

The most active construction lenders for new self-storage projects include:

- Banks
- Credit Unions
- Small Business Administration (SBA) Lenders
- Private Lenders / Debt Funds

Banks and Credit Unions

Pre-pandemic, local (community) banks, credit unions, and regional banks were major providers of construction loans to the self-storage industry. However, the recent interest-rate related stresses on the

banking sector have negatively affected the regional banking sector to a greater extent than community banks, causing many regional banks to put commercial real estate lending “on-hold” in much of 2023 and likely continuing into 2024. This leaves most commercial real estate lending to local or community banks and credit unions, who have historically done almost 70% of all commercial real estate lending in the country. It is also important to keep in mind that not all commercial real estate lenders have an appetite for construction loans. In fact, many lenders have put construction lending on “pause” for the time being. For reference purposes, the Federal Reserve defines community banks as those with less than $10 billion in assets and regional banks with total assets between $10 billion and $100 billion. Any bank with combined assets of $100 billion or more is considered a large financial institution (often referred to as a national bank), and these large financial institutions have never been a major source of construction financing to the self-storage industry.

Community banks and credit unions continue to be excellent sources of construction financing, but borrowers will likely have to solicit more lenders than in the past with their construction loan request to find reasonable construction loan terms. As mortgage brokers working for our self-storage developer clients, we have typically had to present our loan request packages to 10 or 15 targeted lenders to obtain favorable loan terms from many of them. Today, we often reach out to as many as 40 or 50 lenders to obtain a handful of attractive construction loan term sheets. In the recent past, most banks and credit unions would lend up to 75% or 80% of the total cost of a new self-storage construction project. However, today the same group of lenders will typically provide no more than 65% loan-to-cost, requiring the borrower to provide equity for the remaining 35%.

While some banks would waive personal guarantees for lower leverage projects in the past, today virtually all require borrower personal guarantees for project completion, monthly mortgage payments, and full repayment of the loan at maturity. Some lenders will reduce or eliminate (“burn-off”) these guarantees once the project is fully leased/stabilized and the net operating income (NOI) is more than sufficient to cover the mortgage payments.

Small Business Administration (SBA) Lenders

Starting In 2010, the SBA has made financing available to the self-storage industry. Since that time, the SBA has become a major source of self-storage construction financing primarily for smaller projects or for developers who may be newer to the self-storage industry. While there are some exceptions where lenders may offer companion loans, SBA loans typically top out at $5 million and are geared towards smaller projects. The fact that SBA construction loans have loan terms up to 25 years and could provide as much as 85% or 90% loan-to-cost has historically made SBA loans attractive for many self-storage developers. SBA construction loans are typically tied to the Prime rate (8.50% as of 9/2023), resulting in interest rates that exceed 9.50% (e.g. Prime + 1%) for most projects, making these loans much less attractive today. Today’s high rates not only increase the cost of interest carry, but also limit the maximum loan amount to much less than 85%-90% based on the projected debt service coverage ratio (DSCR) at stabilization – more on this later. As with most banks and credit unions, the SBA requires full personal guarantees from the borrower, including a completion guarantee.

Private Lenders / Debt Funds
Private lenders, including debt funds and other non-bank lenders can be a good alternative to the more traditional lenders mentioned above, primarily when seeking construction financing that does not require personal guarantees from the borrower. While ongoing personal guarantees are not required by many private lenders, virtually all will require a project completion guarantee. Most private lenders have minimum loan sizes in the $15 million range, focus on projects in primary and some secondary markets, and borrowers who have a proven track record of successful commercial real estate development. Interest rates are almost always floating and are often 200 to 400 basis points higher than more traditional construction lenders.

Self-Storage Construction Loan Underwriting
Each lender has their own underwriting standards and process, but they will all focus on these four major areas:

1. Project feasibility
2. The total construction budget
3. The operating pro-forma and projected net operating income (NOI)
4. The borrower's financial strength and experience

Feasibility
Regardless of the strength of the borrower, the cost of the project, or a compelling operating proforma, if the market supply/demand factors and market rents will not support a new facility in the subject market, a lender will likely not offer financing for the project. Most lenders today will require an independent third-party feasibility study primarily to supply or verify market supply/demand information, existing and planned competition, current market rents and an operating proforma for the proposed development that supports the borrower's operating proforma. There are several experienced self-storage feasibility study providers, including the national commercial real estate appraisal firms who have specialty self-storage valuation practices.

Construction Budget
A self-storage construction budget should provide all costs related to the new project including land cost/value, site work, off-site work, all hard costs, all soft costs (e.g., architectural, engineering, legal, zoning/entitlements, permit/impact fees, etc.), interest reserves for interest carry during construction and lease-up, operating shortfall reserves during lease-up, and a contingency for both hard and soft costs. As the ongoing costs of construction remain somewhat volatile, it is important to note that many lenders today require that the borrower enter into a guaranteed maximum price (GMP) contract with their general contractor to help mitigate major cost overruns.

Even if the market supply/demand factors and rental rates support a new self-storage facility, the total cost of a new development as it relates to the stabilized cash flow of the self-storage facility will be the ultimate test of project feasibility.

Projects that may have been feasible/profitable before the pandemic oftentimes may not "pencil out" today due primarily to increased cost of construction and increased interest rates. Pandemic supply-chain issues have mostly eased, but the severe increases in the cost of materials like structural steel, finished steel, concrete and many other building components remain. Labor costs have also increased in most parts of the country, as unemployment rates have remained low.

For a time, these increased project costs could often be absorbed with help from 3% to 4% interest rates and increasing self-storage market street rental rates. Today, interest rates have more than doubled and rental rate growth has slowed or reversed in many markets, not only providing little help for the increase in construction costs, but rather creating further feasibility challenges.

Despite rising interest rates and construction cost headwinds, there are still many self-storage new construction projects that can be very profitable, albeit fewer in number than before these challenges came into play.

Operating Proforma

The extent to which a new self-storage construction project can withstand the high costs of construction and interest carry is dependent upon the amount of cashflow or net operating income (NOI) the new facility can generate once it is fully leased. The stabilized NOI, in conjunction with the market capitalization rate (CAP rate), will ultimately determine the value of the self-storage facility. Only when the projected value is compared with the total development cost, can we determine the return on investment and the merits of moving forward with a new self-storage development.

Projected stabilized NOI is calculated by subtracting projected operating expenses from projected rental and ancillary income. There are many factors that go into both the revenue and expense sides of the equation, and construction lenders have become somewhat more conservative in their analysis. When analyzing projected rents, most lenders will no longer underwrite upwardly-trending rents from rental rates at the time of underwriting to when the facility is to open for business. In an environment where rent growth is slowing, or when street rents are decreasing, lenders will utilize current market street rents for the first year of operations and may only conservatively trend rents in subsequent operating years. The lender's stabilized occupancy assumptions may also be more conservative than the feasibility study or the borrower's projections.

On the expense side of the equation, lenders are much more focused than in the past on certain expense items such as real estate taxes and property casualty insurance. Throughout the country, real estate taxes for commercial properties have doubled or tripled in a short period of time, and lenders will look for a thorough analysis (usually from the appraiser) to underwrite real estate taxes at project completion and stabilization. Property insurance is another expense that has increased significantly over the past few years. Insurance companies have experienced record claims in many of the coastal areas of the country, and it is not uncommon for insurance premiums to have doubled or tripled for properties located in coastal cities. Substantial premium increases are also not unusual from properties located in landlocked areas of the country, such as the Midwest, as insurers look to spread the risk and increase their premium revenues across their entire customer base.

Ultimately, most construction lenders will rely upon the appraisal for their underwritten proforma operating income and expenses, NOI, CAP rate, and the resultant projected value of the completed and stabilized self-storage development project. In addition to projecting value, the projected stabilized NOI is also very important in loan sizing as it relates to underwritten debt service coverage ratio (DSCR). The stabilized DSCR is simply the ratio where the stabilized NOI is the numerator and the debt payment the denominator. Many lenders will limit loan proceeds such that the stabilized DSCR is at least 1.35 or more. As interest rates (and the resulting debt payment) increase, this minimum DSCR test – not the lender's maximum loan-to-cost – is more often the ultimate determinant of construction loan proceeds.

Borrower Financial Strength and Experience

To the extent that many lenders today have a limited amount of capital for new construction loans, many are reserving their funding capacity for their existing customers. That said, there are still many lenders who are willing to lend on construction projects for new borrowers. It is important to note that these lenders are becoming more selective in terms of borrower financial strength, self-storage development experience, and a proven track record. Lending to experienced developers helps to mitigate the risks that go along with new construction such as major cost overruns or extended project delays. Lending to borrowers with financial strength gives many lenders confidence that the borrower will have the capacity to provide additional capital support to the project if all does not go according to plan. Furthermore, as a bank's deposit base become more important and valuable in today's banking environment, many banks and credit unions require that borrowers also maintain deposits with the bank, separate and apart from the subject project they are lending on.

Self-Storage Construction Financing is Still Available

We all wish interest rates could have stayed low indefinitely, and self-storage rental rates and occupancies could have continued their meteoric rise, but all good things eventually come to an end.

While it has become more difficult to obtain financing for new self-storage construction in today's post-pandemic world, there is still plenty of capital for strong new development projects. A strong project is one that has a compelling projected return on investment after taking into account today's higher interest rates, increased costs of construction and the general slowdown in rental rate growth and occupancy in most markets. Borrowers with financial strength and self-storage development experience will have an advantage over those that may have less capital and/or experience in the self-storage industry.

Experienced developers with strong self-storage development projects and financial backing will always be able to find construction financing…they will just have to work a little bit harder to find it as we move transition from 2023 and into 2024.

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