

Resurrecting CMBS





By David Lucas

Last summer, Park Bridge Financial, a commercial real estate advisory firm, obtained approval from the Federal Reserve Bank of New York for self-storage properties to be leveraged in eligible commercial mortgage-backed securities (CMBS) transactions with backing by the government's bailout financing. Then in December, Bridger Commercial Funding announced it would resume originating new commercial real estate loans to be underwritten for securitization under the federal program. Bridger's offer of new loans from \$2 million to \$20 million is targeted for qualifying property types that include self-storage.

Around the same time, several investment banks announced that they were firing up their conduit lending programs and beginning to originate loans for multi-borrower securitizations. After nearly two years of inactivity, investors were lining up to buy into a new round of CMBS offerings.

What Will It Mean **For Self-Storage?**

For many in self-storage, seeing the term CMBS was like getting a call from a long-lost friend. Just a few years ago, CMBS offered attractive financing vehicles for self-storage acquisitions and refinancing because of their favorable terms.

As lending became more competitive, standards grew looser, and overly aggressive underwriting of the real estate took place. Market unrest forced CMBS facilitators to widen loan spreads and tighten the underwriting standards. The use of CMBS loans reached a feeding frenzy, as lenders threw money at properties with overly optimistic financial projections.

"What started to happen as we got closer to the top of the market, lenders started to reach," says Shawn Hill, principal with the BSC Group in Chicago. "The market was so competitive, they found the way to get business was to try to get creative and figure out ways to fit things in the box that another lender didn't think of."

In 2007, investors purchased some \$230 billion of CMBS securities. By 2008, however, that number had dropped to \$12 billion after the real estate bubble burst and investors became skeptical of all asset-backed securities. Eventually, the credit crunch, declining real estate values, and a financial industry teetering on the brink virtually killed the CMBS as a source of financing.

Now that CMBS is back from the dead, what will it mean for self-storage?

A CMBS History

CMBS, or conduit loans, are securitizations of mortgage loans backed by commercial real estate such as hotels, apartment buildings, office and industrial buildings, and self-storage. According to the "Borrower Guide to CMBS," these loans are pooled in a CMBS transaction and transferred to a trust that issues a series of bonds. Rating agencies then assign credit ratings to the various bond classes. Investors who purchase the CMBS bonds receive monthly principal and interest payments from all of the pooled loans.

The process enables lenders whose loans go into the CMBS to restock their coffers and make more loans.

While CMBS seemed like a very trendy financing instrument three or four years ago, self-storage CMBS can be traced as far back as the late 1990s, according to Hill. "They became more prevalent in storage and much more

compelling because of the cost of capital—deals were so phenomenal," Hill says.

Comparing a CMBS loan with other financing available at the time, a typical bank would offer a five-year term loan with 25-year amortization requiring a personal guarantee (recourse). A CMBS non-recourse loan during the same period likely would have been a 10-year term loan with 30-year amortization, which translates to a lower payment than the bank's loan. "At the top of the market in '05, '06, and '07, the yield curve was inverted, so I could actually borrow money for 10 years cheaper than five years," Hill says. "The rate on five-year deals would have been in the sixes [percent]; the rate on 10-year deals would have been in the fives."

The significance of the CMBS activity in the last quarter of 2009 is that not only are self-storage properties now eligible to be pooled in CMBS, but it signals a softening of the credit markets. "Recent

activity in the CMBS market is signaling that the credit logjam plaguing commercial real estate lending for the past two years is starting to break," says Peter Grabell, Bridger executive vice president. "CMBS bond yields have fallen throughout the year to the point where newly originated CMBS loans are becoming a viable financing option once again for borrowers."

In an attempt to loosen credit and jump-start the economy, the Federal Reserve created the Term-Asset Backed Securities Loan Facility (TALF) to support securities collateralized by small business loans and other debt. The Fed expanded the program to provide assistance to holders of other asset-backed securities, including CMBS. TALF funds can increase liquidity and provide confidence to future investors.

This encourages investors to purchase CMBS because there is already an AAA buyer in the market—the Fed. As investors gain confidence, interest rates are hoped to lower as demand for CMBS increases, and money will return to the commercial real estate market.

According to Park Bridge Financial, the Fed's approval enables large, low-leverage borrowers to access the capital markets in a single-sponsor loan transaction and it allows CMBS lenders to originate smaller, moderately higher leverage loans secured by self-storage properties. Lenders can then place the loans in multi-borrower pools and securitize them in TALF-eligible CMBS transactions.

"The new deals being talked about now are going to be multi-borrower pools, so I think that's a good sign that there's a securitized market that is trying to get going again," says Aaron Swerdlin, managing director of Holliday Fenoglio Fowler's Self Storage Group in Houston. "It's going to have to be the best quality real estate, the best quality sponsors, and the best quality operators."

Hill believes the initial CMBS transactions likely would target the self-storage REITs and other large operators. "Lenders that have come back into the market to do CMBS are taking the lowest hanging fruit," Hill says. "These are properties that have performed for the past

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Continued from page 27

says. "The larger life companies that are offering the best terms are not going to do \$2 to \$3 million loans. They're doing \$75 to \$100 million transactions."

No Help For Troubled Borrowers

The recent CMBS flurry may not help owners facing refinancing prospects on properties that have declined in value and suffered occupancy losses and reduced cash flow. "Even if I had five years of paydown on my loan, there's no way I can refinance my existing loan balance today unless equity is put into the deal," Hill says. "On a \$3 million deal, I have to come up with between \$300,000 and \$500,000 to refinance that deal. The owner who has a \$3 million deal doesn't have \$300,000 or \$500,000 sitting in the bank. That's the equity gap."

To illustrate further, an asset worth \$10 million a few years ago may only be worth \$7 million today. Five years ago, a \$10 million property would warrant 80 percent

loan-to-value, or \$8 million of debt. Now at \$7 million, the lender might offer 65 percent loan-to-value, or less than \$5 million in debt. That equity gap has to be made up by the owner, who likely will find it difficult to come up with capital to pay down the debt and renew it.

"The old rate was 5.5 percent; now it's 7.25 percent," Sonne says. "What is someone to do? Do they have \$2 million in cash laying around? If they don't, they may face a default situation because they can't refinance."

It is a situation that many highly leveraged property owners have faced during the recession. The CMBS delinquency rate, which was less than one percent earlier in the decade, is expected to reach six percent this year, according to Fitch Ratings. What's even more startling is the overall CMBS delinquency rate is projected to peak at 12 percent by 2012. That's because maturing debt was originated near the historic peak of real estate values.

Fitch Ratings in July said it expected 2006 through 2008 vintages of commercial mortgage-backed securities to "substantially underperform" earlier vintages. Fitch notes property values fell from their peaks and cash flows from these vintages suffered as a result. Fitch expects 93 percent of loans in the '06 through '08 vintages are at risk of default.

"Technically on paper you look like you're facing a massive default scenario, but I think they are going to work it out and wait for the tide to rise with inflation to raise all boats," says Sonne. "The last thing banks want to have is massive foreclosures."

The banks' solution has been to extend loans for a period of months or even years, hoping that economic conditions would improve. "Rather than foreclose and have a guy walk away, they kept extending the loan one year at a time, or six months at a time," Sonne says.

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Because of the massive federal debt that is accumulating, some experts believe higher inflation is inevitable. That means cheaper dollars in the future that will pay down today's debts. Sonne characterizes the banking philosophy this way: "If we get inflation, we'll keep extending in one-year increments and in five years, everybody will be whole. You're still getting a return, everybody's paying, and maybe there are one or two bad loans that we have to foreclose."

Investors may seek more real estate holdings if higher inflation hits, which would likely bring higher property values down the road.

Smaller Plays For CMBS

So how long will it be before smaller players can take advantage of the new CMBS rollout? Don't expect it very soon, according to the experts. "I definitely think that CMBS will return to self-storage. I couldn't tell you if it's going to be one year, three years, or five years," Hill says. "If CMBS comes back two to three years down the pike, I would expect that [smaller] owners might be candidates for some CMBS loans."

The scenario might play out as it did a few years ago, but with much more fiscal restraint. "As the market comes back to more of a sense of normalcy, as more securitization happens, and we see more competition in the market, there will be more lenders that will come," Hill says. "As that happens, they start to lower their standards. There's not going to be as much of that high quality stuff, so now they have to feed the machine. They start to lower their loan amounts." He says his loan minimum is not \$10 million anymore; now it's \$7 million or \$5 million. The lower the loan amounts get to and the more they start to expand their scope, the more likely storage goes into the funnel," Hill says.

Self-storage owners may eventually enjoy the fruits of CMBS, but it may not be obvious immediately. "It could be as early as this year and maybe two to three years out, but I envision it will be widely available to most people; they just won't be aware of it," Sonne says. "Their bank will create a


loan for them and the bank will sell it to a CMBS, like your mortgage loan has been transferred to another entity."

For the near future, borrowers will have to look elsewhere for funds. "The banks are still the best place to go, but interest rates are higher, and it's usually recourse," Swerdlin says.

CMBS loans, if and when they become available, offer much more attractive terms. "Usually you'll get more leverage; the interest rate is probably going to be lower because they're usually benchmarked off treasuries, and as long as treasuries stay low, your interest rate is going to be lower," Swerdlin says. "The most advantageous part of CMBS was the non-recourse nature of the loan and the leverage—you could always borrow more from a CMBS lender than you could from a life company."

Like the rest of the financial market, lessons have been learned with CMBS instruments. What level of activity can we

expect? "It's not going to be close to the \$250 billion gaping hole that the departure of CMBS left in the capital market," Swerdlin says. "We're talking about \$2 billion in executions so far, so that's one percent of where we were. But it's the first step in proving there is a market for securitized paper."

And self-storage may take a special place in the CMBS mix going forward. "We're seeing a slow return of the CMBS market," Sonne says. "I don't think we'll return to the heady days of 2006 for years, if ever. Underwriting is much more disciplined this time. Over time, I think we'll see self-storage rise as its own asset class and you'll start to see an entire CMBS devoted to self-storage." 



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