

MAKING SENSE OF SBA LENDING RULES

How New Changes In Legislation Affect Self-Storage

By Shawn R. Hill



There has been much discussion recently about potential changes to the Small Business Administration (SBA) loan program, and more specifically the impact it will have on self-storage. In my best Dr. Seuss, rumors and rumblings have been running rampant with reckless abandon in industry rags, on message boards and trade show floors. The rumors would suggest that these changes are going to be extremely meaningful, providing additional access to capital and helping to solve many of the financing problems self-storage owners face today.

The truth is that there have indeed been substantial modifications to the SBA 504 lending program and, in fact, self-storage, or “mini-warehousing” as the SBA refers to it, is no longer an excluded property type. In practicality, however, the jury is still very much out on how meaningful these changes will be and what, if any, impact they will have on our industry.

For those who are not overly familiar with SBA lending, it is currently administered by a manual of guidelines referred to as the Standard Operating Procedures (SOP). The SBA released its first version of this SOP manual, Version 50-10 5, in August 2008. The SOP has been updated several times since, and the SBA now plans to update the SOP annually.

In the second most recent version of the SOP 50 10 5(b), on page 106, Mini-

Warehousing was a named exclusion under a section paragraph that reads:

“Mini-warehouses, office suites, shopping centers, flea markets, and mobile home parks, are not eligible unless they provide sufficient services. Sufficient services shall be deemed to exist when more than 50% of the business’s revenue for the prior year is derived from the services provided rather than from rental income.” (SOP 50 10 5(b): Subpart B, III, Section D (Ineligible Types of Business), 3,c,7))

So, in addition to specifically naming “mini-warehouse,” there is really no way that a self-storage property would ever meet this “sufficient services” test; clearly most self-storage operators would agree that deriving more than 50 percent of income from services other than rental income is not feasible and nearly impossible.

To solve this problem, this specific paragraph, which clearly excludes “mini-warehouses,” and which formerly had appeared in all previous versions in some fashion, has been deleted from the newest Version SOP 50 10 5(c), effective October 1, 2010. Indeed, neither the “sufficient services” test nor the named exclusion now exists. As a result, it would definitely appear that loans under the 504 program for this type of small business will now be permitted.

But wait ... not so fast.

In the newest version SOP 50 10 5(C), it would appear that one major hurdle clearly still exists. In fact, although the part of paragraph 7 that specially named mini-warehousing was deleted, along with the “sufficient services” test, paragraph 3 of that same section on Ineligible Types of Business in the new version of the SOP very clearly reads:

“Businesses that are primarily engaged in owning or purchasing real estate and leasing it for any purpose are not eligible. For example, shopping centers are not eligible and businesses that lease land for the

installation of a cell phone tower or wind turbine also are not eligible; however, the business operating the cell phone tower or wind turbine is eligible" (SOP 50 10 5(b): Subpart B, III, Section D (Ineligible Types of Business), 3,c,4))

OK, at this point I am confused, and you must be too. Anyone actively engaged

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in the self-storage business would agree that we are very much in the business of "owning and purchasing real estate and leasing it." Furthermore, throughout the past, the industry as a whole has been actively engaged in trying to educate lenders of the very opposite—incessantly beating the drum that self-storage is a sophisticated commercial real estate play just like apartments and retail shopping centers, both of which are ineligible for SBA financing.

And if you think you are confused, imagine how your local lender must feel. I don't know about you, but I am sure that most local lenders don't have a very good handle on the nuances of the ever-changing versions of the SBA SOP. The first mention of the particular changes I've been referring to occurs on roughly page 106 of the current version of the SOP, a document that can literally make your head spin trying to follow the twists and turns.

Redefining The Definition

There is little argument that the intent of this new version of the SOP is to make SBA loans more available to certain types of business, including self-storage; the elimination of the named exclusion, along with the "sufficient services" test, make that abundantly clear. But the fact that businesses engaged in owning real estate for the purpose of leasing it to generate revenue are excluded certainly makes things less clear, and leaves us in search of more answers.

It turns out, upon further review, it all boils down to an "it depends" question; it

really depends on one's interpretation and definition of the term "primarily engaged." Apparently, the SBA's interpretation of the self-storage business is not the same yours or mine might be. In fact, to the contrary, the SBA interprets that self-storage owners are "primarily engaged" in the provision of mini-warehouse services, and not the leasing of real estate. Wow! Who knew? Regardless, if that's the case, it's certainly good news, right?

Oh, and one more thing ...

In the past, even if there was a way to get around all of the hurdles related to self-storage, there was one other minor obstacle that may have largely eliminated SBA financing as a viable alternative for many self-storage transactions. Unfortunately, one of the eligibility requirements of the SBA 504 program is that program cannot be used for "consolidating or repaying debt, or for refinancing." So, essentially, only construction or acquisition loans are eligible, not refinance loans, which, aside from being a major segment of the business, is the major obstacle facing owners today.

Except ... in another moving piece of bureaucracy, on Sept. 27, H.R. 5297—the Small Business Jobs and Credit Act of 2010—became law. This important legislation waives this restriction and temporarily allows refinance transactions for the next 24 months. This commercial real estate program resides outside of the SOP.


Theory Versus Practicality

Technically, and in theory, the door is now open to self-storage borrowers to access SBA loan proceeds. There are unfortunate realities, however, that have the potential to make the effectiveness more minimal than meaningful in practical application. At the end of the day, it boils down to the fact that this is a government program with a lot of red tape and bureaucracy involved. The following are observations based on experience, which I believe are practical impediments that will stunt the effectiveness of SBA lending for our industry:

- Despite their best efforts, the dynamic nature and complicated nuances involved will invariably result in confusion in the

market. Many lenders will simply not be up to speed on what is allowable, and will therefore be ineffective in helping to execute on this transaction structure.

- The complex nature of these programs creates apathy and fatigue among participants, often leaving transactions stuck in the "life is too short" category.
- One of the major driving forces behind the effectiveness and acceptance of SBA programs is job creation. The more jobs that are tied to the business, the more desirable and effective the SBA loan is. The average self-storage facility does not employ a large number of people.
- There are loan size restrictions and other requirements that will limit the number of eligible participants in our industry.
- The full scope of restrictions and eligibility requirements are still being drafted. There still seems to be some question as to whether the program will apply to investment properties that are professionally managed by a third party. In the past, owner occupancy has been a major SBA requirement, and it is very conceivable that only owner managed properties will ultimately be eligible.

The bottom line is that it does, in fact, appear that self-storage, mini warehouses, or whatever you might call them are now eligible for SBA financing. The intent of the federal government in making them eligible is clearly to help owners of these properties have more options with respect to financing. Kidding aside, the federal government is trying to do a good thing here to help the small business owner and has obviously recognized that there are many good, hardworking Americans who have a lot on the line in this high-stakes game of recession "Jeopardy." It also shows that our beloved self-storage industry is on their radar. Both of these are very good things, and no one is joking about that. 



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