



SELF STORAGE SALES NETWORK

# Market Monitor

"America's Premier Self Storage Brokers"

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***A Note from Mike McCune:*** I am pleased to introduce you to Steve Bye and Steve Clifford of NorthMarq Capital, Inc., a major mortgage banking firm with offices in 28 major cities. At my request they have written the following summary of recent changes in the commercial real estate lending market that I felt were important for Market Monitor readers to know about. They have also prepared a more detailed analysis that is available on [selfstorage.com](http://selfstorage.com) and by fax. You may contact either of "the Steves" at 303-225-2100.

## **Change Is In the Air** by Steve Clifford, Assistant Vice President and Steve Bye, Executive Vice President/Senior Managing Director

There have recently been subtle changes in the lending market that may actually be much more material than an initial glance might reveal. We want to give you some insight into what the changes are, what their impacts are, and the potential for further changes. In recent years, one of the favorite loan types for self storage facilities has been the CMBS (Commercial Mortgage Backed Security) loan. The reasons these loans have become popular is that they are non-recourse, usually have low interest rates, high loan amounts and somewhat lenient underwriting standards. These loans are unusual in that they are created by financial intermediaries and then sold to Wall Street firms that pool many of these loans, obtain credit ratings on the resulting package of loans, and then resell the cash flow and the interest from the loans to investors.

However, for the first time the rating agencies have become concerned that the intermediaries that have been making the CMBS loans have been underwriting the loans in ways that do not provide enough security for the ultimate investors. This has an impact on the Wall Street firm's ability to sell the loans to investors and so they have demanded underwriting changes from the intermediaries making the loans, impacting both Wall Street and the ultimate borrower. While this does not directly impact other lenders such as banks and insurance companies, they are also taking a serious look at their underwriting standards as well. The changes that are apparent now in the underwriting standards result in an increase in the spread of about 0.2% above the ten year treasury bond rate (thus increasing the interest rate) and a much more stringent underwriting analysis of the loan to value ratio and the related loan coverage rate.

The other significant change over the past 30 days has been the increase in U.S. Treasury yields upon which the CMBS loan pricing is indexed. For example, the 10 year U.S. Treasury was 4.63% on May 1st and reached a level of 4.95% on June 1st, an increase of 32 basis points (0.32%).

While the changes seem both modest and practical, the impacts are decidedly negative and material to the borrower and ultimately to sellers as well. The impacts generally fall into the categories outlined below and we have briefly described the nature and magnitude of each change. The analysis assumes a project with an NOI of \$200,000. Due to the constraints of space in the *Market Monitor*, we are presenting only a brief description and the results. If you would like to see a more thorough analysis and all of our assumptions, we have prepared a more detailed review and numerical analysis that are available to you at [www.selfstorage.com/argus/northmarq.pdf](http://www.selfstorage.com/argus/northmarq.pdf) or call 1-800-55-STORE to request a fax.

It should be noted that the results outlined below are presented as though the impact was the only thing that changes. The reality is that they are cumulative and the sum of the impacts is greater than just adding up the results below. The changing size of the loan may significantly increase the equity requirement and thus could have a dramatic impact on the equity required for a purchase or refinance of a facility.

**Impact on Return (cash on cash):** The 25 basis point increase (0.25 %) in the spread, coupled with the 32 basis point increase (0.32%) in the treasury yield benchmark results in interest rates on mortgages to increase by the same amount (0.57%) which, in turn, causes the cash flow to decrease and the cash on cash return on equity to decline from 8.6% to 6.8% using the example mentioned above. Furthermore, the ability to achieve payments on an interest only basis for 2 or 3 years has now been eliminated, which had added another 5% annually to the cash on cash equity return (during the 2 or 3 year interest-only period) before the capital market correction.

**Increase in Cap Rates:** Since the interest rates are effectively increasing because the spread and interest rate have increased, a potential buyer would have to raise the cap rate from 7.5% to 8.0% in order to achieve the same rate of return that was previously available. While that doesn't sound like much, in our example it amounts to a decrease in purchase price of \$125,000 or about 5% of the initial price level. The need for an interest-only component would have made these hurdles even higher.

**Reduced Debt Levels:** Not only do the interest rates and cap rates impact the amount of loans available, but another closely watched underwriting parameter called debt service coverage (or the amount that existing NOI exceeds the debt service) has been modified. In the relatively recent past, coverage has been in the 115 % range computed using a 30 year amortization. Today the common formula would likely be 125% based on a 30 year amortization. The net result would be that the loan would be less and the equity requirement on the part of the buyer could increase by an additional 5-10%!

**Is This Change Temporary?** This is the first time since 1995-1996, or the early years of the CMBS market, that the rating agencies have interceded in the loan underwriting process, and as a result, the market is taking the situation quite seriously. The rating agencies have stated publicly that they will take whatever further steps are necessary to make sure that the security is there to protect the investors. The jury is still out on what the ultimate "tightening" could be, but it is apparent that in the short run the new standards will not change.

In summary, it is clear those recent events within the CMBS market and the resulting underwriting and price changes will have an impact on the investment decisions of self storage owners. The purpose of this article is to point out some of those impacts in order to provide our borrowers with information that is necessary to make informed investment and financing decisions. The CMBS market has been and will continue to be a terrific source of debt for self storage owners. Looking at the "big picture," ten year, fixed rate loans at less than 6.50% are still attractive, especially to the investor that has been around long enough to have weathered previous market changes.