KeyBank

Making the Grade in Student Housing Finance

Student housing has moved from the back row of the multifamily sector to the head of the class.

The past few years have seen a wave of new high-end development on campuses across the country, coupled with intense interest from institutional investors. On the other hand, though the momentum is strong, debt markets are cautious. Owners and developers must demonstrate that they can make the grade, to be offered the most favorable terms.

In a recent panel discussion about financing for this "hot" sector, Todd Goulet of KeyBank Real Estate Capital® and other finance professionals commented on the recent history and imminent future of student housing finance, from the point of view of lenders, including banks, sponsors of commercial mortgage-backed securities (CMBS), and government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. The panel was part of the recent Interface Student Housing conference, where it was revealed that 45,000 units of off-campus student housing will be delivered this year, and nearly as many are under construction for completion in 2017. With new deliveries even higher in 2013 and 2014, a phenomenal 300,000 units are being added to the market over six years.

That's a lot of new student apartments—and there's strong demand to match, according to the experts.

Key takeaways

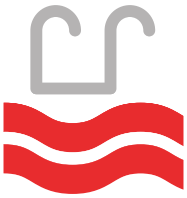
Lending caps imposed on Fannie Mae and Freddie Mac have had little impact on student housing loan volume.

CMBS lenders are not currently competitive for student housing loans, except for those failing GSE standards.

Life companies are selective in their financing of student housing, usually pursuing deals connected to large, prestigious schools.

Lenders are becoming more cautious about construction loans where sponsors lack experience with student housing.

Academic amenities, attractive revenues



As panelists noted, many of the new off-campus housing developments include resort-style amenities to attract higher rents than the student housing market has seen in the past. Despite the higher cost and greater competition, student housing is filling up faster this year than ever before. In short, the student housing sector is benefiting from many of the same trends as the larger multifamily market, with the added advantage of historically steady performance during recessionary periods.

The combination of Class A new development, occupancy and rent growth has also drawn many more institutional investors to the sector in recent years. Not surprisingly, lenders are also pursuing student housing deals more aggressively. Fannie Mae, Freddie Mac, CMBS underwriters, banks and life companies are all competing for properties that fit their criteria. However, recent turmoil in CMBS and global capital markets, as well as new constraints on lenders, have caused lenders to sharpen their pencils in underwriting new student housing deals. The supply of debt is still abundant for multifamily borrowers, but lenders have become more selective about which properties deserve the most favorable terms.

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Fannie and Freddie double down

The agencies historically have been the most active and consistent capital sources for student housing. As such, there was some consternation in the market when it appeared that Fannie Mae and Freddie Mac might scale back their investment in 2015. At the start of that year, the Federal Housing Finance Agency (FHFA)—which oversees agencies Fannie Mae and Freddie Mac—imposed a $30 billion cap on the amount of multifamily loans they could purchase annually. Many people, even within the agencies, were concerned that the cap would constrain multifamily lending overall, and market niches like student housing in particular.

They needn't have worried: In 2015, Fannie Mae nearly doubled its volume from the year before, acquiring about $1.5 billion in student housing loans in 2015, while Freddie Mac took in a record $1.8 billion from the sector. FHFA raised the cap to $31 billion at the start of 2016, and in May raised it again to $36 billion, based on an increase in the overall size of the multifamily debt market. Volume for both agencies appears to be strong again this year, although Freddie Mac doesn't expect to match last year's total.

CMBS: Priced out—for now

Volatility in the global capital markets made 2015 a rough year in the CMBS markets. The uncertainty hit the high-yield debt sector particularly hard and CMBS investors fretted about erosion in underwriting quality. B-piece buyers started to kick out deals with substandard underwriting quality, and some originators lost money on transactions that could not be profitably sold into CMBS pools.

With CMBS experiencing uncertainty, many borrowers are looking to Fannie Mae and Freddie Mac.

At the time of the Interface conference, CMBS players were effectively priced out of the market by high spreads relative to the agencies. However, panelists noted that deals that fail to meet the criteria set by agencies might fit into the more flexible CMBS model. For example, properties that need long-term interest-only loans can find a home in the CMBS arena more easily than agencies or institutional lenders.

Financial institutions filling in the gaps

Banks are willing to originate student housing loans for their balance sheets, but in general this approach is not considered the best execution for borrowers who can access agency financing. For loans up to five years, a bank may offer competitive terms to finance a property that needs seasoning or that can't get sufficient proceeds from Fannie Mae or Freddie Mac programs.

Banks are extremely cautious about taking on high volatility commercial real estate (HVCRE) debt, in part because of a Prudent Risk Statement issued by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve—known collectively as the Banking Agencies—in December. The Statement warned banks against relaxing underwriting standards in their pursuit of commercial real estate loans.

Banking panelists noted that construction loans on their balance sheets don't qualify as HVCRE debt as long as loan-to-cost ratios are in the range of 70–75%. At the same time, banks have become more selective about the developers they favor. As investors' appetite for student housing has risen in recent years, so has the number of developers focusing on the segment. Developers who lack student housing experience might miss nuances of the market that could endanger pro forma rent and occupancy levels.

Life companies are active players in takeout loans and refinancing of Class A student housing properties, offering the best terms of any capital source for deals they want. However, they are highly selective, often limiting their interest to large colleges and universities in cities with strong job growth. A property serving a small rural college may have limited access to financing from life companies, regardless of the quality of metrics such as loan-to-cost and debt service coverage ratio.

Identifying the best solution

Faced with this range of potential debt capital providers, owners and developers of student housing should be able to structure deals that best meet their needs, without losing precious time going down blind alleys. A relationship approach to lending can help keep a deal on track, as the lender involved has a perspective that is about more than just getting to the closing.

Key is a designated lender for Fannie Mae and Freddie Mac, an active CMBS underwriter and a balance-sheet lender, with many life company relationships as well. This multi-option environment helps owners and developers take advantage of the rising demand and many development and acquisition opportunities in this sector.

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