Lenders Learn to Navigate Today's Student Housing Market

*Elizabeth Murphy and Ross Kelley**

Traditionally viewed under the broad umbrella of multifamily real estate, student housing is now being seen as a standalone asset class—one with its own unique challenges and opportunities. The authors of this article discuss today's student housing market.

For most college students today, gone are the days of cramped, outdated apartments with shag carpeting, creaky floors, absentee landlords, and square pools. New construction student housing boasts hardwood floors, granite countertops, Vegas-like swimming pools, and amenities to spare. Alongside strong economic gains in the U.S. stock market, student housing has skyrocketed in areas surrounding America's colleges and universities. Foreign and domestic investors have been flocking to student housing.

Since 2014, foreign investors alone have accounted for an overall investment in student housing of over $28 billion.[1] In 2016, Singapore's sovereign wealth fund reported a record $16.2 billion of student housing purchases and an additional $3.3 billion in Q1 of 2017.[2] Student housing was also named by Green Street Advisors as one of the top three performing commercial real estate sectors in the past 12 months—boasting a 10 percent increase in overall values.[3]

In 2017, the top student-housing developers planned to add approximately 47,000 beds in off-campus projects nationwide, matching each of 2015 and 2016.[4]

Background

With an influx of capital and construction, commercial real estate lenders are seeing opportunities. Historically, the government-sponsored enterprises Fannie Mae and Freddie Mac have dominated multifamily lending, and the student-housing sector is no exception. Collectively, the agencies loaned $5.4 billion for student housing in 2017.[5] The $3.8 billion in Fannie Mae originations in 2017 marked a 52 percent year-over-year increase for the agency.[6]

And while investors and developers remain bullish on the student-housing market, student housing requires management expertise, significant capital expenditures, and an eye for the market and competition. If an owner or manager fails in just one of those categories,

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the property could immediately face trouble that, once a college semester begins, will take months or maybe an entire school year to recover from.

Although traditionally viewed under the broad umbrella of multifamily real estate, student housing is now being seen as a standalone asset class—one with its own unique challenges and opportunities. Prominent among those challenges, given its youthful clientele, student housing must endure more wear and tear than most other multifamily properties and faces significantly higher tenant turnover. One-third of Americans in their twenties move once every year,[7] and so students are frequently signing leases for just one-year terms. Given those objective observations, it makes perfect sense that student housing of past generations boasted only the cheapest carpeting, linoleum, and appliances—all of which could be trashed and replaced at minimal cost to the owner with every move-out and move-in.

However, today's market for student housing is extremely competitive, forcing developers to lure prospective tenants with high-end finishes and amenities. Much of that competition comes from the property's biggest demand driver—the colleges and universities themselves. Institutions are constantly striving to improve their national rankings, and one factor that contributes to those rankings is the quality and availability of on-campus student housing. And if these challenges are all too much for a student-housing owner, the unique layout of most student-housing units is not readily convertible to traditional multifamily use. Generally, student-housing units are designed to maximize the size and number of bedrooms. If a student-housing property seeks to later lease to more traditional multifamily tenants, the bedroom-focused layout is not particularly attractive to non-student tenants seeking sizable common living space.

Capital Investment

All of these considerations demand significant and nearly continual capital investment to keep a student-housing property competitive and attractive to the latest batch of prospective tenants. Putting further pressure on the market, the post-secondary education enrollment growth of the 2000s is tapering off and is now outpaced by the influx of new student-housing supply.[8] Lenders financing student-housing properties are forced to structure for these unique traits by requiring meaningful capital investment to ensure that the property will be able to compete and adapt over the loan term. With rising interest rates and compressed cap rates, and with oversupply threatening to saturate even the most established college markets (think Tier 1 colleges and universities), there is a renewed focus on tailoring loan documents to anticipate changes in the student-housing market. While millennials demanded grandiose amenity packages, lenders need to appreciate the environmentally friendly, shared-economy appetite of Generation Z. Ideally, lenders should be structuring their deals with significant capital expenditure reserves to meet the latest, and ever-changing, demands of college campuses.

However, real estate mortgage investment conduit ("REMIC") requirements for commercial mortgage-backed securities ("CMBS") lenders do constrain this needed flexibility over the course of a seven- or 10-year loan term. To start, a REMIC requires that in determining whether a mortgage is a qualified mortgage that can be held by a REMIC, the only property that is taken into account for that test is the value of collateral related to real estate interests[9] (such value excludes the value of any personal property such as the furnishings of a fully furnished student-housing complex). On the tail end of the life of the loan, a REMIC holding foreclosure property must carefully navigate the guidelines established under the Internal Revenue Code, lest it risk its REMIC status. Particularly important here, a REMIC may not engage in any construction, other than completing improvements that were more than 10 percent constructed pre-foreclosure. Without the tools or capabilities to up-fit an undesirable student-housing property owned by a REMIC post-foreclosure, CMBS investors can quickly face steep losses when student-housing property loses its appeal.

Cue the bridge and balance sheet lenders. These lenders are primed to provide the capital infusions needed to revitalize an aging building or reposition an obsolete complex. For those bridge lenders who place their loans in commercial real estate collateralized loan obligations ("CRE CLOs"), although CRE CLOs come with their own tax law servicing restrictions,[10] in foreclosures those vehicles do have flexibility to engage in construction, significant renovations, and even demolitions if such activities are warranted by the applicable servicing standard.

Ratings

While some view student housing as "recession proof" or "recession resistant"—the idea being that people go back to school during economic downturns—the rating agencies have shown concern over student-housing performance. In a recent Fitch review of 288 student-housing loans in CMBS 2.0, Fitch noted that "factors such as occupancy, market competition, university enrollment and proximity to campus make student housing net cash flows more volatile."[11] According to Fitch, "although the overall multifamily delinquency rate still remains the lowest of all of the property types [0.46 percent], student housing delinquencies have continued to increase."[12] Kroll Bond Rating Agency ("KBRA") has identified 55 KBRA Loans of Concern in the student housing sector, representing 9.8 percent of outstanding student-housing loans.[13]

Competition

"If the sector is recession resistant, it is certainly not new-supply resistant," says Steve DeRose at Starwood Mortgage Capital. Market saturation has led to increased competition and slowing leasing velocity. In May of this year, student housing properties were 74.4 percent preleased for the fall semester, down 0.76 percent from the same time last year.[14] "Competition is ruthless" notes Dan Lamont of Commercial Mortgage Servicing at Wells Fargo, and "there is a near-constant drive to pre-lease—you're always planning for next year." Unlike their multifamily cousins—where leases are staggered across the entire year—student housing is always one slow semester away from disaster. To fight new competition, a property needs a superb property manager—one with significant experience in the student-housing industry and one that understands the relentless marketing, capital improvements, and experiential amenities students will demand in the coming lease year. New properties will do anything they can to put heads in beds—reducing rents and offering new and creative leasing incentives. However, this race to the bottom is putting downward pressure on an already cash-intensive property.

What Does That Mean For Student-Housing Lenders?

Lenders are urged to stick to sound fundamentals—low leverage, non-cash out financing, good historicals, robust capital expenditure reserves, and recent capital infusions are harbingers of quality loans to sponsors committed to their investment. Financial triggers should also be tailored to reflect the actual leasing schedules at the property: a trailing 12-month debt service coverage ratio test, tested only on a quarterly basis, may cause last year's strong occupancy to mask future performance concerns given a subsequent semester's slow leasing velocity. Financial triggers for cash management and for kicking out existing management should be thoughtfully drafted in loan documents to timely catch management or economic missteps at the premises—before it is too late. However, even with proper attention being given to loan documentation, consistent and strong underwriting remains the order of the day.

Conclusion

Despite these obstacles, a properly structured student-housing loan can be a successful real estate investment. Investors and lenders alike rightfully see value in a carefully managed, well-located, and fully occupied student housing. With the right education and counseling, lenders in student housing can avoid being taken to school.

NOTES:

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[6] Fannie Mae Press Release: "Fannie Mae Multifamily Closes 2017 with Record Volume of More Than $67 Billion." Jan. 25, 2018. http://www.fanniemae.com/portal/media/corporate-news/2018/multifamily-volumes-6660.html.

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[9] *See* 26 C.F.R. § 1.856-3

[10] *See* "The Imminent CRE CLO Tsunami: What Servicers Need to Know to Ride the Way," Elizabeth Murphy and Rachel Temple, *Real Estate Finance Journal*, Winter 2017.

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[13] KBRA: "KBRA Releases Monthly CMBS Trend Watch." Sept. 10, 2018. https://www.marketwatch.com/press-release/kbra-releases-monthly-cmbs-trend-watch-2018-09-10/print.

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