

# Esoteric explosion

Insatiable demand for connectivity is fueling a rise in data centre securitisation issuance. **Simon Boughey** tracks the market's development.

**D**emand for data centres outstrips supply by a hefty margin and, as more and more regions join the established areas of data centre building, the need for financing shows no sign of abating. While some developers seek funding from the traditional loan market, the securitisation market is at the forefront.

"The data centre space is benefiting for strong fundamentals. Demand has been outpacing supply and, as a result, rents are rising and market vacancies are low," says Fred Perreten, a md in KBRA's CMBS ratings group in New York.

Growth in the US data centre securitisation market in recent years has been "exponential", says Stuart Litwin, a partner and co-head of the structured finance practice at Mayer Brown; no one disagrees. Such is the scale of the market, and its potential size, that it has now perhaps moved beyond the definition of 'esoteric'.

While some possible obstacles to future growth are discernible, the insatiable capacity for greater and greater connectivity and digital access is the dominant and probably irresistible trend. "Major markets and most secondary markets have reached a state of supply and demand imbalance – the current and near-term supply is not capable of satisfying demand," says a Jones Lang LaSalle (JLL) report on the industry at the end of 1H23.

In 1H22, for example, the demand was for 1200 megawatts (MW); yet only 800MW was ▶





Fred Perreten, KBRA

built. Most of the supply that will be delivered in the last two quarters of 2023 has already been pre-leased and much of that which will become available next year has also been pre-leased, providing – as the JLL report notes – limited options for those users that have not been in the market a long time before their go-live date.

The surge in demand during the lockdown period and the shift to remote working clearly gave the sector an enormous fillip, yet there hasn't been much slackening of the pace in the subsequent years. The development of AI – as yet, in its earliest stages – and the continuing shift to cloud-based services will pour more petrol on the fire.

The securitisation of assets to secure financing for data centre developers began around 2017/2018, following the development of the wireless tower and digital fibre networks.

"I've done about 35 deals in four and a half years, starting at the end of 2018. The growth in the data centre space has been very rapid and the ways the developers choose to finance has been very diverse," comments David Ridenour, a partner in King and Spalding's corporate, finance and investments practice in DC, who mainly represents financial institutions.

According to KBRA, retail colocation ABS deals and hyperscale ABS deals totalled US\$7.3bn in 2021 and 2022. In addition, since 2013, there has been US\$9.9bn of issuance in the CMBS market which have been partially or totally collateralised by data centres.

Not only are these numbers set to rise significantly due to demand, but the bank loan market is also becoming less accessible. The stringent capital regime imposed by US regulators will get

yet more onerous if the so-called Basel 3 end-game stipulations introduced at the end of July are imposed once the comment period is over.

Rising rates have also created competition for investment among those lenders, such as insurance companies, which are unaffected by the new capital requirements. The spread between data centre cap rates and 10-year Treasuries has narrowed from over 400bp in 1Q19 to less than 150bp.

Finally, the significant capital outlay required for turnkey sites (those that require little, if any, infrastructure expenditure by the tenant) is better satisfied through the ABS and CMBS markets.

Hyperscale data centres are defined as those that have several, or perhaps only one, large tenants. These will be the users with the largest needs and whose business models largely revolve around internet usage, such as Google, Microsoft and Meta. The property capacity is around 40MW or more and leases are generally for 10 years, with five-year renewals.

There are six major issuers in this market: Aligned Data Centers, EdgeConneX Data Centers, Sabey Data Center, Stack Infrastructure, Vault DI and Vantage Data Centers.



Stuart Litwin, Mayer Brown

rule, in the retail model, the landlord supplies most of the equipment and maintenance. As a result, operational expenses are much higher than in a hyperscale facility and rents reflect this difference.

Net rental per revenue in a retail facility is often twice as high as at a hyperscale and could be over US\$2m per MW. Management fees are also

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Then there are retail, or colocation, centres, which have a large number of tenants, sometimes up to several hundred. The overall capacity is lower, somewhere between 1MW and 40MW, while the power allocation per tenant is in the region of 3KW to 5KW.

Leases are shorter, between one and three years, and automatically renew. Tenants are comprised of users that need digital capacity, but whose business models are not solely devoted to internet usage, and who might need it for a limited period of time.

These smaller users may also want to outsource their digital management and, as a general

significantly greater. Both of these features reflect much greater capex than other property types.

"Data centres, particularly retail colocation properties, require significantly more capital expenditures than traditional real estate assets, such as office or industrial. For example, normalised annual capital expenditures for a colocation facility could be US\$10 per square-foot, compared with less than US\$1 per square-foot for the other property types," says Fred Perreten.

Three issuers dominate this space: DataBank, Cologix and Flexential. However, given the trajectory of the industry, hyperscale deals are likely to dominate the market in the coming years.





David Ridenour, King and Spalding

Issuers bring deals in both the public 144a market and in the private 4a2 market. The former is preferred, as pricing is generally more competitive, with better access to a broader range of investors. However, some issuers will prefer the private 4a2 market if the tenant requires confidentiality, or if the deal is unrated and investors need more time to become acquainted with the risk.

Deals are normally between US\$500m and US\$1bn and tend to feature five- or seven-year maturities. Sometimes they are tranchised into class A to C notes, but often have only a single senior tranche.

For the highest rated tranches, yields of between 2% and 3% were common in 2020 and 2021, but in the last years rates of 7% and higher have become common. Notes are generally priced as fixed rate assets as a spread over Treasuries.

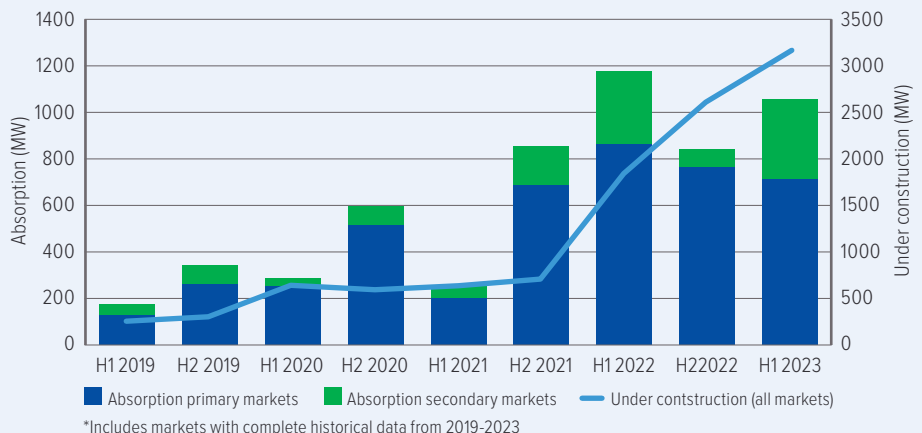
Traditional asset managers, such as PIMCO, and insurance companies, like AIG, are active investors in the market. However, with C tranches now yielding over 10%, a new class of investor is being drawn to the sector.

“As rates have increased, private credit funds have started to come in. We’re also seeing crossover from equity investors in the more subordinate tranches, who are pursuing a hybrid strategy and see this as a way to get an equity-type stake,” says Michael Urschel, a partner in Milbank’s alternative investments practice in New York.

The latter comprises data centres, wireless towers and digital fibre networks.

Even in the A class, returns are competitive, when considering both the alternatives and the strength of the assets. “When you look at the reliability of the asset, the quality of the underlying

United States data centre absorption and construction



Source: Jones Lang LaSalle

collateral, the likely appreciation performance, the unlikelihood of tenants leaving and the fact it pays a premium because it’s a new asset class, it’s a good time to be an investor,” says Ridenour.

The names typically seen on the top left of deal documents are prominent – banks such as Barclays, Citi, Goldman Sachs and Morgan Stanley. But everyone pays tribute to the role Guggenheim

The lease terms are different, involving, for example, triple-net leases and modified leases; the risks are different, there are cashflow triggers, there are resiliency factors to be considered and the type of tenant is very different to a CMBS tenant. The one striking similarity to the CMBS market is that there are annual LTV appraisals, recognising that the building has value.

“WE’RE SEEING CROSSOVER FROM EQUITY INVESTORS IN THE MORE SUBORDINATE TRANCHES”

Securities played in the development of the market and its continuing prominence within it. Guggenheim declined to comment for this piece.

The data centre securitisation market is often compared to the CMBS market, and indeed CMBS deals have been priced which incorporate data centre collateral. It is easy to see why observers see the CMBS market as a close cousin. There is a property, there are tenants and deals securitise the rents.

But to those who know the market well, this is not an apt comparison. They point out that rating agencies don’t use CMBS terms.

The one market data centre securitisation most closely resembles is the now established wireless tower sector, and bankers and lawyers which have experience of that market generally understand the exigencies of the data centre market more clearly than others. In turn, securitisation of digital fibre networks has leant very heavily on technology established by the data centre market.

From an issuer’s perspective, one of the virtues of the market is that once a master trust is established, it can be drawn upon without much extra work – much like the credit card ABS





Michael Urschel, Milbank

market. “That is the beauty of these structures. They’re off-the-shelf, and very flexible. It’s plug and play,” says Ridenour.

There are, inevitably, a few obstacles to future growth in the market. The demand for more data centre space is almost unlimited, but these buildings are not terribly ESG-friendly.

They consume vast quantities of water for cooling and staggering amounts of electricity – by far the greatest amount of which is generated by fossil fuels. Indeed, data centres now consume fully 2% of the entire US electricity usage.

This is a little out of step with the Biden administration’s vocal commitment to green energy, and the industry is under some pressure to present better alternatives. Moreover, the industry’s sudden explosion is straining the existing infrastructure. For example, Dominion Power, which is the major utility provider for a large section of Northern Virginia – the current hub of the data centre industry – has announced it needs both significant investment and regulatory approval to satisfactorily feed further development.

On the face of it, it would seem logical to accommodate growth in a state where land is cheap and plentiful, local energy supplies are abundant and temperatures are colder than average – such as North Dakota. However, it’s not as simple as that. The current stage of technological development dictates that data centres have to be relatively close to the user for full and prompt digital service to be provided.

This is one reason why northern Virginia has been the leading market for the industry, accounting for 39% of total US capacity. An estimated 70% of the connectivity of the US passes through the region.

Leading software firms, such as Microsoft, are located nearby and, of course, it is close to DC, the centre of government and the military. State authorities have also encouraged development with various business-friendly incentives and tax breaks.

States like Ohio and Illinois are growing fast, as are cities like Phoenix and Austin. The Atlanta area – home to Coca Cola, CNN, Delta Airlines, several universities, the US HQs of Mercedes Benz and Porsche and a burgeoning TV and movie industry – is also in the midst of an unprecedented boom.

than their green alternatives. It is worth noting, moreover, that the great bulk of environmentally-friendly initiatives are devoted to using existing energy supplies more efficiently, rather than using non-fossil fuels.

Furthermore, the pull to reduce the carbon footprint of data centres runs counter to the push of another declared aim of the Biden administration: to extend the availability of broadband connectivity throughout the US. This requires more data centres as cheaply and efficiently financed as possible.

At the end of 2022, there were around 2,700 data centres in the US, accounting for one-third of the entire global capacity. By mid-2023, this had grown to perhaps 3,200. Total capacity is estimated to be 8,900MW.

There is no sign that this growth will abate. Increasingly, digital reliance points in only

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Net absorption is 120MW, yet another 152MW is under construction and no less than 571MW is planned. But this is all reasonably close to the metro area, such as in nearby Bartow County, 50 miles to the northwest. Georgia, of course, is very hot in the summer months, taxing cooling facilities even more.

There is consequent pressure on the industry to develop more energy-efficient alternatives. Some green data centre bonds have been priced, which collateralise rents in a building committed to reduce energy usage and waste. Aligned, for example, has developed a new and more efficient cooling system.

At the moment, however, the great majority of data centres use traditional sources of energy, which are both more plentiful and cheaper

direction, and the enormous supplies of capital required means a central role for the structured finance market. This is not only true of the US, but it is also true and will become even more so for the world beyond it.

“There’s no stopping this growth. Most of the globe doesn’t have smart phones. Americans may slow down, but the rest of the world won’t,” concludes Ridenour. ▶

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