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# Bytes to basis points

Evan Lorenz writes:

At the intersection of technological progress and monetary backsliding stands the income-producing entities known as data-center REITs. Vulnerable to digital competition and no great shakes in the yield department (thanks for that, Federal Reserve!), they are valued for neither disability. In preview, *Grant's* is bearish on some of them, indifferent toward others—but we remain impressed by the relatively generous income on offer in another corner of the REIT market.

To start with, a brief word about that corner. In it, we find the AGNC Investment Corp. Series F 6¹/₈% perpetual preferred shares, which are priced 6 cents below the $25 par value and have a yield to worst of 6.4%. Admittedly, that's a shadow of the 14.1% that was available at the March 18, 2020 panic lows (*Grant's*, March 20, 2020), but it's more than any yield on offer from the data-center real estate investment trusts and a substantial pickup from today's average 4.3% junk-bond yield.

To compare bonds and preferreds, of course, is to liken cantaloupes to watermelons. The preferreds have no maturity date, and therefore no contractual destiny with par. And they command no such privileged place in the corporate capital structure as senior securities do.

AGNC, as the name (and ticker) implies, is an agency REIT, meaning a holder of mortgage-backed securities issued by the government-sponsored enterprises Fannie Mae and Freddie Mac. As of March 31, AGNC used 7.7 turns of debt for every dollar of equity to fund its $90.3 billion portfolio. Excluding the preferreds, $9.9 billion of common equity stands between the Series F and a hypothetical first loss.

On now to data centers, the facilities that house computer servers. They date from the 1945 construction of the Electronic Numerical Integrator and Computer at the University of Pennsylvania. In those days, ENIAC tabulated firing tables for the U.S. Army's field artillery and performed calculations that figured in the construction of the world's first hydrogen bomb.

Peaceful applications followed. The microprocessor boom in the 1980s made computers ubiquitous in corporate America. By the 1990s, the proliferation of complex systems spurred growth in the business of operating and maintaining servers. Equinix, Inc. (an agglomeration of the words "equality," "neutrality" and "internet exchange"), the largest, and arguably best, data center REIT by market cap and revenues, came along in 1998 to capitalize on the trend in computational outsourcing.

Modern data centers come in two varieties, hyperscale and colocation. In the former, a single, large customer, typically a cloud provider like Microsoft Corp.'s Azure unit or Amazon.com, Inc.'s AWS, takes over a whole building. In the latter, multiple smaller customers rent portions of the same structure. The REITs that own such facilities typically provide the power, cooling equipment and connections to the worldwide web; the customers bring their own servers, storage and networking gear. Data-center providers charge fees based on the space rented, electricity consumed, costs of installation and interconnection to other customers (about which, more later). Colocation tenants pay higher rents than hyperscale customers do.

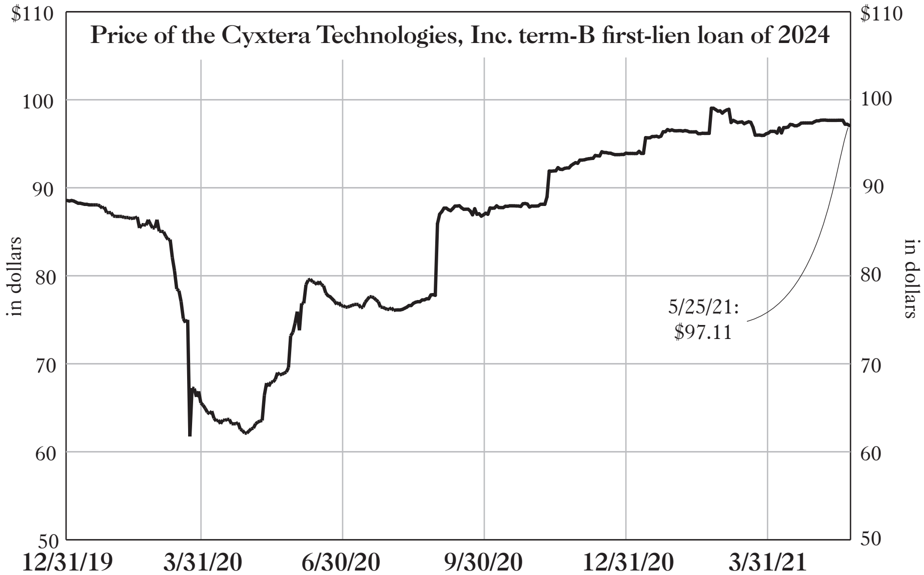
Though no spring chicken, the industry is still growing. "You will never find someone who can quantify demand because the reality is we keep creating new uses for data and new datasets that we can store and analyze," David Guarino, who leads data-center research at Green Street Advisors, LLC, tells me. "The demand has been exponential. We are finding new ways to store and process data and use it in interactive ways."

The pandemic only helped. As white-collar workers traded office life for homebound Zooming, demand for well-connected servers jumped. "You saw an acceleration in digital transformation," says John Stewart, senior vice president of investor relations at Digital Realty Trust, Inc. AWS, the largest of the supersized cloud businesses, reported a 29.5% leap in revenue, to $45.4 billion, in 2020.

"At the same time, as you can imagine, it has been a relatively challenging time to bring on new supply," Stewart goes on. "The combination of growing demand and curtailed supply has tilted the scales a little bit towards a slight demand/supply imbalance." This is especially acute in places such as Singapore, which halted all construction during the pandemic.

In consequence, data-center stocks rung up an 8.8% gain in last year's first quarter as the S&P 500 sold off by 20%. The other 15 subsegments of the REIT industry tracked by the National Association of Real Estate Investment Trusts

**Mr. Market breathes easier**




source: The Bloomberg

posted losses in the first three months of 2020, leading to an overall 27.8% decline in the MSCI U.S. REIT Index.

Yet, oddly enough, the data centers are posting rather humdrum results. Adjusting for the impact of acquisitions, Equinix eked out a 6% year-over-year revenue growth rate and Digital Realty, the No. 2 player by sales, showed a flat top line last year—both noticeably lower than the respective 10.7% and 4.1% rates of revenue growth, excluding mergers and acquisitions, reached in 2015.

What *is* growing are the balance sheets. Equinix's asset base expanded by 13% in the plague year and has compounded by 21% over the past five years. Digital Realty, which paid $7 billion to buy Interxion Holding N.V. in 2020, reported a 56% jump in assets last year, and at a 26% clip since 2015.

Combine slowing revenues with growing asset intensity, and you get exactly what you'd expect. Thus, between 2015 and 2020, Equinix's return on assets fell to 1.45% from 2.07%, Digital Realty's ROA, to 1.21% from 2.83%.

The explanation for this is multifold. For one, data centers, like personal computers, don't improve with age: "[I]ncreases in server density are beginning to strain the current power and cooling capacity of traditional colocation data centers," d.c. owner Switch, Inc. notes in its latest 10-K. "As IT hardware advances, servers increase in power but decrease in size, generating more heat and requiring more cooling per cabinet."

For another, it appears that some colocation customers are shifting work to the cloud. Capital One Financial Corp., the ninth-largest bank by market cap, went all in on AWS last November, ditching eight data centers. "Capital One can provision infrastructure almost instantly at a virtually unlimited scale, using as much or as little computing and storage as its applications need—and paying only for what it uses," an Amazon.com case study relates. Among other benefits cited by Bezos's brainchild: Capital One no longer updates its software monthly or quarterly, but daily, and the time needed to create a product (or build a "development environment") has collapsed to minutes from months.

A chief technology officer who is familiar with that change tells me that speed to market is the key selling point for businesses migrating to the cloud. Over time, as younger executives get promoted at major banks, my source says, you can expect more workloads to be shifted to the cloud from on-premise servers and enterprise colocation.

"Retail colocation, as a sub-segment, is currently shrinking and, in the future, will continue to shrink," Dgtl Infra, a research boutique that focuses on the sector, concurred in a March 22 post. "In aggregate, data center customers are not disappearing. Instead, these hyperscale cloud providers are winning customers from retail colocation."

Size does matter. Over time, one or two buildings in a given data-center market tend to become hubs for high levels of interconnection between business, cloud and network providers. The likes of AWS, Microsoft and Verizon Communications, Inc. pay up for these digital amenities, although the biggest of the big—hyperscale customers—can build their own data centers if they choose not to rent. Such mega-users drive most of the leasing volumes and are well aware of their negotiating leverage. Microsoft and ByteDance Ltd. (the parent company of TikTok), for example, accounted for half of all leasing volumes in North America last year. As for the lesser corporate beings, Katie Morgan, an investor-relations spokesperson at Equinix, tells me that most other data centers are "becoming highly commoditized."

The upshot is falling data-center profitability. In the three years ended March 31, Digital Realty's occupancy rate slipped to 85.3% from 89.2%. As rents rolled lower and clients chose to renew (or not), same-store net operating income in the first quarter decreased by 3.3%, the third straight year of declining same-store NOI.

Pricing pressure may soon intensify. Combing data from Digital Realty, CyrusOne, Inc., CoreSite Realty Corp. and QTS Realty Trust, Inc., Green Street finds that 28% of customer leases renew in 2021, 17% in 2022. (Equinix is silent on this key matter.) Many of the expiring leases are at "above-market rates, and, in some cases, have known move-outs."

Nor is there any guarantee that even modern facilities, designed for hyperscale customers, will turn out to be future-proof. Un-green diesel generators were the key source of backup power that kept the data centers functioning during the surprise Texas snowstorm last winter. Microsoft told the REITs in 2020 that it wants a green solution in all the space it rents by 2030, but no commercially viable, ESG-compliant power backup is currently available.

From 2011 through early 2020, Gary Wojtaszek was the CEO of CyrusOne. Upon joining the board of Quantum Loophole, Inc., a d.c. upstart, he said: "The data-center industry is growing quickly; however, it is under tremendous pricing pressure. Most data-center designs being deployed today

## Data centers at a glance

| | market cap | % of rev. from interconnect | dividend yield | Px/2021 AFFO |
|---|---|---|---|---|
| Equinix, Inc. (EQIX) | $65,865 | 19% | 1.6% | 36.6 |
| Digital Realty Trust, Inc. (DLR) | 44,105 | 8 | 3.0 | 30.0 |
| CoreSite Realty Corp. (COR) | 5,885 | 14 | 4.2 | 28.3 |
| CyrusOne, Inc. (CONE) | 9,088 | 5 | 2.8 | 26.2 |
| QTS Realty Trust, Inc. (QTS) | 4,344 | 9 | 3.2 | 36.2 |

sources: The Bloomberg, Green Street

are too costly and inefficient and will be challenged to meet the computing-power needs required to support the shift towards AI-focused data centers."

The low cost of capital naturally plays its part in the drama. "In these hyper-competitive markets like northern Virginia," Adam Simmons, founder and CEO of Dgtl Infra, tells me, "you have so many new players, mainly on the private side," and talented executives besides. "So you have billions of dollars supporting these private hyperscale players."

As to Equinix (EQIX on the Nasdaq), owner of the highest proportion of differentiated data centers, with a valuation to match its sterling reputation—36.6 times estimated 2021 adjusted funds from operations (AFFO) per share and a 1.6% dividend yield—we are neither bullish nor bearish. Nicholas Del Dio, who rates EQIX a buy for MoffettNathanson, LLC, condenses the bullish case, thus: "Everyone goes to Equinix, because everyone is at Equinix."

Cyxtera Technologies, Inc. is another story. Arguably the worst-positioned of the group, Cyxtera debuted in 2017 when BC Partners, Medina Capital Advisors and Longview Asset Management joined to purchase 57 data centers from CenturyLink, Inc. for $2.3 billion. The p.e. shops are in the process of listing Cyxtera through a merger with blank-check company Starboard Value Acquisition Corp. (SVAC on the Nasdaq). The transaction is tagged for an early closing.

Given the high valuation of d.c. REITs, you might wonder why Cyxtera chose the blind-pool method of public listing. Apart from its overexposure to the troubled colocation market, the company emerged from its buyout staggering under net debt equivalent to 10.4 times Ebitda. So it was that, during the March 2020 market crash, the d.c. group rallied while Cyxtera's term-B first-lien loan of 2024 (Libor plus 300 basis points) sold off to $61.75 from $88.56 at year-end 2019.

The B3/triple-C-plus-rated Cyxtera says it plans to earmark proceeds from the SPAC and PIPE investors for debt reduction (to a still-elevated height of 7.6 times Ebitda), but that won't fix its dwindling occupancy rate, move revenue growth off the dime or revitalize the sagging colocation market. Based on deal terms, Cyxtera is trading at a fancy 13.7 times enterprise value to Ebitda.

CoreSite Realty Corp. (COR on the New York Stock Exchange), our second pick not to click, is a special case. Note, in the accompanying table, that no less than 14% of its sales stems from interconnect fees, ranking behind only Equinix in that desirable category. So far, so good, but there's more to the analysis. As the American market is the world's most mature, the domestic data-center industry has moved to diversify outside the 50 states—all except CoreSite, that is.

And while the other d.c. REITs have lowered their hurdle rates for new developments, CoreSite is sticking to the assumptions it was using as long ago as 2014. Provoked by subpar first-quarter leasing volume, analysts on the April 29 earnings call questioned how long it will take to fill up new developments. "It's probably a three-to-six-year time frame," CFO Jeff Finnin replied. In an industry where rents fall every year, that's an eternity.

"CoreSite has kind of drawn a line in the sand and said, 'We are going to be a U.S.-only company'," Guarino, who rates the stock a sell, tells me. "'We're not going to go global. And we're not going to cave in to pricing for what these cloud companies want. We're going to stick to the targets that we think we can achieve on building our data centers.' And while that sounds like a really good idea and a good strategy, it's not, and it hasn't played out well. So, as the U.S. market matures and growth slows and tenants leave CoreSite data centers to go to the public cloud, it starts to show up in their results."

CoreSite changes hands at 28.3 times AFFO per share and boasts a 4.2% dividend yield. As of March 31, net debt summed to 5.1 times trailing Ebitda. The Street is neither here nor there, with eight analyst buys, eight holds and five sells. While the short interest sums to a modest 2.4% of the shares outstanding, insiders this year have sold 55,129 shares worth $6.3 million. Not one officer or director has bought a share.

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