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Towers of Babel

Evan Lorenz writes:

Artificial intelligence can cut emissions from dirty industries like steel and cement, according to the Innovation for Cool Earth Forum. Governments are beginning to invest in "sovereign AI infrastructure" to boost GDP growth, Nvidia Corp. CFO Colette Kress informed on the latest earnings call. And—lo and behold—AI is even starting to generate revenue, JPMorgan Chase & Co. divulged last week.

In fact, the only thing that AI can't seem to do is boost the per share earnings of data-center operator Digital Realty Trust, Inc. (DLR on the New York Stock Exchange). In preview, *Grant's* remains bearish on the new-age real estate investment trust. While you may not sell short a stock that appears on trend for the latest investment mania, Digital Realty is also a case study in how a company that borrowed too well during the low-rates era is attempting to deleverage at the expense of its equity holders.

Whatever promises it might ultimately redeem, AI isn't cheap. *The Wall Street Journal* recently reported that, while Microsoft Corp. receives $10 a month per user for its AI assistant, it loses more than $20 a month per user. Artificial intelligence is computationally intensive, both in training the large language models that make it possible and in utilizing those models to parse requests from consumers and businesses. This means more demand for space at data centers, which are sprawling, industrial-type buildings that house massive arrays of computer servers and provide their tenants with power and air conditioning.

Demand for data centers was strong even before AI exploded on the scene. "A recent Gartner poll found 55% of organizations are in pilot or production mode with generative AI," Charles Meyers, the CEO of Equinix, Inc., told his Oct. 25 earnings-call audience. "We are seeing this manifest in accelerated interest from both enterprise customers and from emerging service providers looking to service this demand. We see strong similarities between the evolving AI demand and the multi-tiered architectures that have characterized the cloud build-out for the past eight years." So, more good news for data centers.

Worldwide, leases for more than 1.4 gigawatts (GW) of capacity—a record—were signed for existing centers and buildings still under construction in the third quarter, Green Street points out. America has dominated this activity, with slightly more than 1.0 GW of leases signed last quarter, up from around 0.8 GW in the second quarter and about 0.3 GW in the third quarter of last year.

"If you want to move into a data center and you sign a lease today, you're probably waiting two-plus years before you can actually move in because of all the preleasing that happened," David Guarino, who rates DLR a buy for Green Street, tells me. "I'll be honest: I'm struggling, and have been for the past year, to poke holes in the sector's growth outlook for the next several years."

Most real estate booms go boom because of speculative overbuilding ahead of exaggerated projections for growth. "You really don't see that in data centers, just because the build costs are so high," Guarino adds. "You're talking about three- to four-times higher development costs per square foot than in other commercial property types."

This surge in demand is further exacerbated by a restriction in new supply in key geographies. Data centers are power-hungry, and some utilities can't keep up with the raging demand. Last year, Dominion Energy, Inc. warned that it's running out of spare generating capacity in Northern Virginia, the world's largest market for data centers. Other markets facing power constraints include Singapore, Frankfurt and Tokyo.

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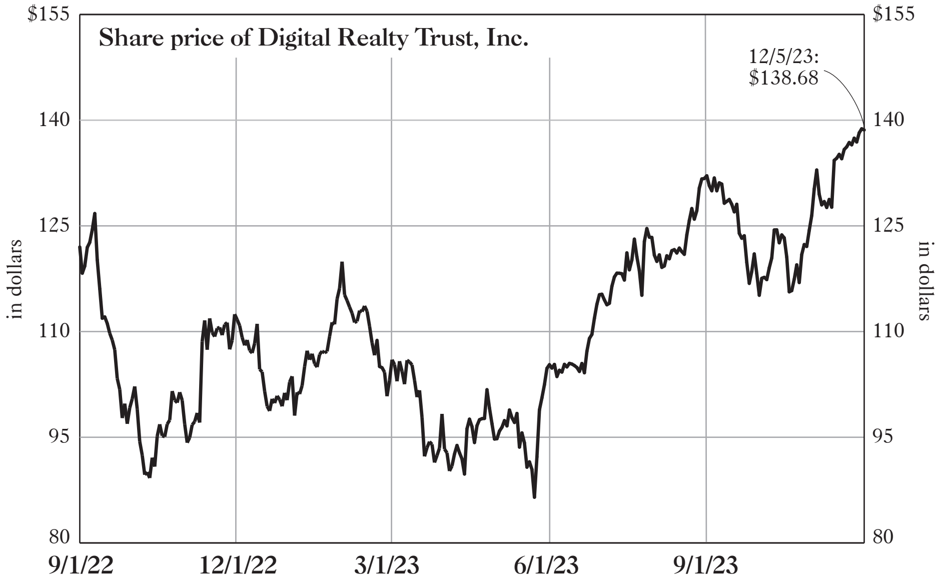
Since we had our bearish say on data centers in the issue of *Grant's* dated Sept. 2, 2022, pick-not-to-click Cyxtera Technologies, Inc. filed for bankruptcy protection, zeroing out its equity value. However, Digital Realty, after an initial decline, has generated a 23.8% return, outpacing the S&P 500's 18.8% return over the same period (figures include reinvested dividends).

Digital Realty is the second-largest owner and operator of data centers after Equinix. It controls 312 centers that span 39.5 million square feet. Northern Virginia (which, in the third quarter, contributed 17.5% of revenues), Chicago (8.1%), Frankfurt (6.3%) and New York (5.2%) make the list of its top markets; 51.9% of the top line is booked in America.

Much has changed over the past

Doesn't cover the dividend



source: The Bloomberg

year, including the DLR's C-suite. On Dec. 13, 2022, Andrew Power was promoted to CEO, from president and chief financial officer, succeeding A. William Stein, who was swept off the management team and the board of directors.

Power made debt reduction his top priority in his inaugural earnings call on Feb. 14. Current plans anticipate a reduction in the ratio of debt to Ebitda to 5.5 times by 2024 from 6.9 times at year-end 2022. Inasmuch as a REIT is required to pay out 90% of income to maintain its tax status, deleveraging Digital Realty was never going to be easy. Nevertheless, there's been impressive progress in raising cash: In the first nine months of 2023, the company sold $2.5 billion's worth of buildings and joint venture stakes and issued $1.1 billion of equity. On his Oct. 26 earnings call, Power identified sales of joint venture stakes in the development pipeline as the next source of funds with which to push his debt-reduction agenda.

As of Sept. 30, the balance sheet showed $15.8 billion in net debt, a figure equal to 6.3 times trailing Ebitda. DLR, rated Baa2/triple-B, would look highly leveraged against an average of investment-grade companies. It certainly appears so in comparison to peer Equinix, which, in the third quarter, showed a leverage ratio of just 3.5:1. Despite that tower of debt, Digital comfortably covered interest expense with Ebitda 4.3 times in the third quarter. Low borrowing costs—the weighted average coupon is just 2.9%—no doubt helped.

Mr. Market seems approving of the actions to date. Thus, the 3.6% senior unsecured notes of 2029 change hands at $90.84 for a yield to worst of 5.5% and a spread of 137 basis points over Treasurys, in line with the typical triple-B-rated bond.

"The trend has been our friend on multiple fronts," Power crowed on the Oct. 26 earnings call. In the third quarter, Digital's "same capital" net operating income increased by 9.4% year over year, the biggest rise in more than a decade. "We saw the pricing environment firming and continue that momentum, whether it is asking rates, [returns on investment] on our development pipeline and cash mark-to-market in both products sets," the CEO added. "And I would say that this environment is continuing."

Of course, an appealing self-help story in a booming corner of the market never comes cheap. Digital, which is priced to a 3.5% dividend yield compared with a 4.2% yield for the MSCI U.S. REIT Index, trades at 22.4 times enterprise value to Ebitda, a premium to cloud giant Alphabet, Inc., which commands a 15.2 times multiple.

The Street is broadly friendly towards Digital Realty, with 12 of the 26 analysts on the case rating shares a buy and only two calling it a sell. Despite the 38% year-to-date levitation in the share price, short interest sums to 4.9% of the equity float. Over the past 12 months, insiders have sold 16,572 shares for proceeds of $1.9 million.

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While it's boom times for the digital REIT industry at large, DLR's shareholders are seeing little operating benefit. Third-quarter funds from operations (FFO, a measure that adds depreciation and amortization to net income and strips out gains or losses from property sales) was flat from a year ago at $1.55 per share.

Digital Realty Trust, Inc. at a glance

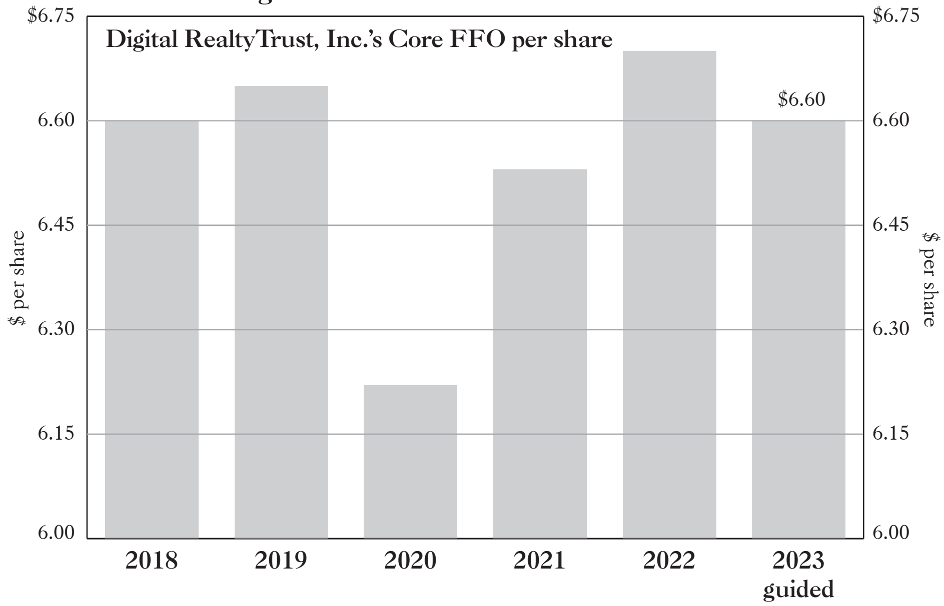
all figures in $ mns except per share data

	TTM*	2022	2021	2020	2019
revenue	$6,340.5	$4,691.8	$4,427.9	$3,903.6	$3,209.2
operating income	511.4	590.0	694.0	557.5	594.2
funds from operations	1,872.0	1,819.6	1,843.0	1,382.0	1,453.8
FFO/share	6.10	6.03	6.36	5.16	6.69
shares outstanding	306.9	303.7	289.9	270.5	218.4
cash	1,062.1	141.8	142.7	108.5	89.8
debt	16,869.8	16,596.8	13,448.2	13,304.7	10,122.4
leases	1,404.5	1,471.0	1,512.2	1,468.7	693.5
total assets	41,932.5	41,485.0	36,369.6	36,076.3	23,068.1

*12 months ended Sept. 30, 2023.

source: company reports

Where's the growth?



source: company reports

The explanation for this seeming disconnect is straightforward. Issuing equity is dilutive (the share count is up 5% year over year), as are Digital's asset sales. The market has capitalized DLR's stock at a 4.6% cap rate, i.e., net operating income divided by the sum of market capitalization and net debt. Yet Digital has sold assets this year at cap rates ranging from 6%, for a good property in Northern Virginia, to 9.8%, for a marginal one in Watford, England. Incidentally, if DLR itself were valued at a 6% cap rate, the share price would be lower by one-third.

The math gets even more difficult if Power follows through with plans to sell stakes in the development properties. Digital is at work on 43 new centers at a total cost of $6.9 billion, of which $3.8 billion remains to be funded. While selling down the ownership in the pipeline would liberate cash, it would also remove the highest-yielding opportunity in Digital's portfolio; the development yield (net operating income divided by total cost) on new centers can reach into the low double digits.

"The bull case used to be that the company was raising all this money and all this capex was going to high growth opportunities," Eliav Assouline, the founder of Circle Road Advisors, L.P. and who is short DLR, tells me. "Now they're thinking about JVing their pipeline. You know from Liberty [John Malone's stable of media properties] that when you start JVing your core assets, you can end up with a multiple discount."

And, despite the strong backdrop, operating metrics in DLR's portfolio continue to slip. Yes, renewals in the September-end quarter came in at 4.5% above in-place rents, but occupancy at "same-capital" properties slipped to 82.7% from 83.1% in the third quarter of 2022 and from 86.9% at year-end 2019.

This gets to the core problem that we earlier identified with Digital Realty: Data centers, much like the computer servers they house, are subject to obsolescence. Older centers are typically smaller and lack the power and cooling requirements that today's customers demand. Recall that data centers come in two flavors: colocation, in which multiple tenants share the same building, and hyperscale, in which large cloud companies such as Microsoft Corp., Alphabet and Amazon.com, Inc. lease an entire building. Not all older centers are suited for the needs of modern hyperscalers.

Who, then, is supplying the surge in AI-enhanced demand? In late 2021 and early 2022, private equity went on a data-center buying binge, with Blackstone, Inc. acquiring QTS Realty Trust, Inc. and a consortium that included KKR & Co., Inc. purchasing CyrusOne, Inc., both at multiples of more than 20 times Ebitda. To lower their effective purchase price, p.e. buyers are focused on ramping up the development of new data centers.

"There has been a tremendous amount of leasing in the U.S. this year, but that's largely been absorbed by the private hyperscale developers," Adam Simmons, founder and CEO of research boutique Dgtl Infra, tells me. "You haven't seen record blowout results from Digital Realty or Equinix on the leasing side."

Besides, DLR does not earn its cost of capital, current low borrowing costs notwithstanding. In the third quarter, Digital's returns on invested capital were a meager 1.1%, continuing the long decline in ROIC from 2.7% in 2019 and 4.7% in 2016.

It's to management's credit that Digital's debt is mostly fixed-rate (86% of the total) and well-laddered, with an average maturity of 4.6 years. Refinancing needs are minimal next year, at $0.9 billion, but pick up to $1.6 billion in 2025, $2.5 billion in 2026 and $3.5 billion in 2027. Each 1% increase in average borrowing rates costs shareholders $0.54 per share in foregone earnings.

Cutting debt doesn't fix the essential problem that free cash flow fails to cover the dividend. Since 2011, cash flow from operations has topped capital expenditures in only four years, and in no year has free cash flow covered payments to shareholders. In other words, to generate its 3.5% dividend yield, DLR must continue to borrow or sell assets.

The front office explains this deficit by saying that most capital expenditures are in the service of growth. Thus, in the first nine months of the year, capital outlays, at $2.5 billion, were nearly twice as large as depreciation and amortization expense, at $1.3 billion. By management's reckoning, just $184.2 million of that spending was earmarked for the maintenance of existing properties; the balance financed growth.

Between 2018 and 2022, DLR spent $9 billion on so-called growth capex and $10 billion in total capex. Granted, few investments begin producing income on the day they're completed. However, based on the midpoint in the latest guidance, DLR will produce $6.60 per share in core FFO in 2023, which is flat to the penny with the core FFO per share reported in

2018. "How do you spend $2 billion every single year," Assouline marvels, "in the middle of the greatest boom in history and you can't grow?"

"I don't think that they're going to grow earnings meaningfully for a long time," Simmons sums up. "I think they are going to sort out their balance-sheet issues. We're going to probably see in the forthcoming quarter more development JVs that rid them of trapped land and such. They're going to take cash and pay down debt, perhaps do an equity issuance, which will also dilute earnings. So, I don't see them growing on a per share basis meaningfully in 2024–2025."

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