SDC Quincy; Quincy, Wash.

Data centers

The sector is growing in prominence at an accelerated pace

by Jeffrey Kanne

Over the past 25 years, data centers have grown in prominence at an accelerated pace, moving from the fringes of the built environment to their current place as an important component in constructing a diversified real asset portfolio. Throughout 2020 and the first half of 2021, COVID-19 has tested all asset classes. The data center industry has flourished and emerged as a strong and stable investment option. Today, the data center sector's upward trajectory continues, rising to meet the seemingly insatiable demand from all segments of both society and business to store, analyze and stream data. Satisfying this demand are credit tenants committed to long-term leases. This combination creates an attractive investment that exposes investors to both tech-sector growth and real estate fundamentals.

Inside the center

A data center is a centralized location containing servers used for any number of computing processes and data storage. A data center may look like a typical warehouse or industrial building from the outside, but inside is a meticulously engineered technological environment with seemingly endless rows of server racks being cooled by powerful HVAC systems critical for dispersing the generated heat. Server uptime and computing speed are everything to a data center tenant. Therefore, any successful facility must have direct access to ample reliable electricity and fiber-optic telecommunication networks. Protected locations with extremely low risk of natural weather disaster, political unrest or security breach are optimal. Regardless of location, however, a state-of-the-art data center must have advanced power and communications network

Public data center REIT returns								
	NAREIT All Equity Index	NCREIF Property Index (NPI)	S&P 500	QTS (QTS)	Digital Realty (DLR)	CoreSite (COR)	CyrusOne (CONE)	Equinix (EQIX)
1-Year Return	32.8%	7.4%	40.8%	23.6%	9.1%	15.3%	1.1%	15.9%
3-Year Return	12.0%	5.5%	18.7%	28.0%	13.6%	10.3%	9.9%	24.7%
5-Year Return	8.1%	6.1%	17.7%	8.9%	9.4%	11.9%	7.7%	17.0%
10-Year Return	10.3%	8.8%	14.8%	N/A	11.7%	25.8%	N/A	24.1%

As of 6/30/21; all returns are gross of fees. Sources: NAREIT, NCREIF, S&P Indices, Morningstar

redundancy capabilities. Providing tenants and their customers uninterrupted electronic access to their servers is the most important mission of a data center operator.

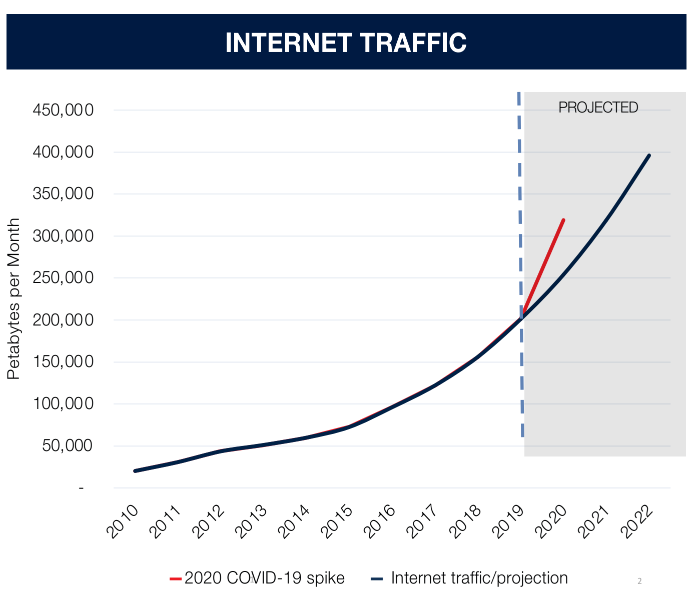
The operator

A key component to a data center's success is its operator. Due to the importance of a data center operator's industry expertise and reputation, a single, stand-alone data center is not as likely to be successful because robust operations require an organizational infrastructure that only a scaled portfolio can support. Also, a robust operator can offer tenants quick expansion guarantees and access to large networks, providing one-stop shopping for tenants looking for multiple locations. The need for these characteristics suggests that the use of entity-level investments may be a viable approach to investing in data centers. Entity-level investments can be made by investing in public REITs or in private entities, although the latter option is limited.

Data centers as an asset class

Investors review many attributes of an asset class before including a particular asset in their real asset portfolio. Some of the attributes investors gravitate toward in a real asset portfolio may include stable cash flows, low correlation with traditional assets, growth potential, high barriers to entry and appealing risk-adjusted returns. The data center category carries the allure of real estate income from high-credit tenants leasing space in stabilized assets. But the true differentiator is that it is uniquely positioned to capture the outsized growth associated with both the expanding tech sector and the increasing reliance on technology for business, healthcare and the exchange of social information. In addition to the prospect of tech sector growth, investors can take advantage of significant barriers to entry. Beyond the relatively limited pool of seasoned, capable operators with whom investors can align, data centers have barriers to entry more typical of real estate investments. Data centers tend to cluster around network hubs where global telecom carriers coincide with reliable and inexpensive power. Data center tenants like to be at the center of major hubs, leading to supply scarcity and outsized rents in these gateway locations.

COVID-19's impact on the data center industry

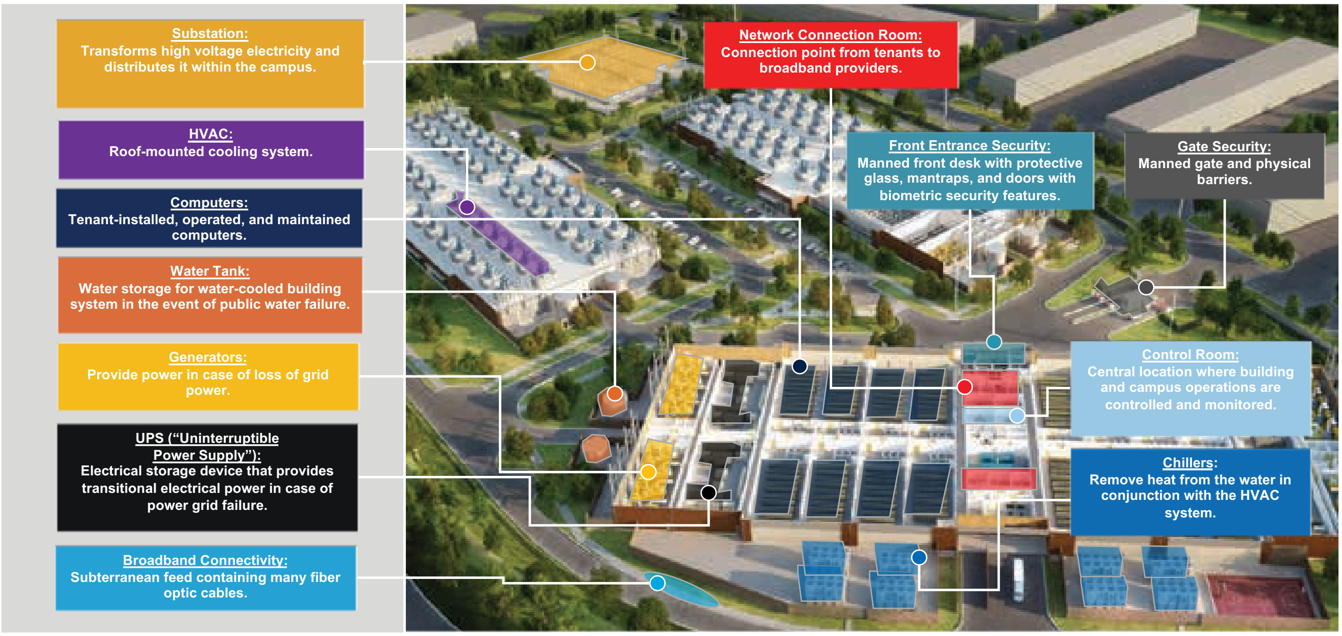


Note: COVID-19 spike based on press reports of up to 30% spike in March 2020. Source: "Cisco Annual Internet Report (2018–2023) White Paper." Cisco, March 10, 2020; www.cisco.com/c/en/us/solutions/collateral/executive-perspectives/annual-internet-report/white-paper-c11-741490.html

Historical performance

Based on the metrics included in the chart above, the data center sector has a return profile we believe would fit well into a real asset portfolio. Analyzing publicly traded REIT returns can provide a current source of quantitative information for assessing data center performance. The five major publicly traded data center REITs comprise a combined total market capitalization of $139 billion, an increase of 102 percent since June 2018. Industry players feature a wide variety of business models with different approaches to leasing, as well as both regional and global operations. Given these characteristics, REITs provide a limited

Inside and outside a data center and campus



Source: Sabey Data Centers

data set from which to draw conclusions; however, their historic performance is informative.

Investors should view an entity-level data center company investment as a core-plus investment containing a stable core of leased space with significant growth potential. Therefore, such an investment can offer higher return potential than a strictly core investment.

Conclusion

Given tech sector income growth, appreciation potential, and relatively low correlation to the S&P 500, data centers can offer a compelling complement to other real assets. Investors, however, must be comfortable with the sector's uniquely capital-intensive development component, as well as its volatility. The category fits well into a core-plus strategy with the objective of allowing investors to take advantage of income-oriented returns from existing assets while also realizing value gains from developing new space. ❖

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Top 10 U.S. data center metros	
1.	Northern Virginia/Washington, D.C.
2.	Silicon Valley/San Francisco Bay Area
3.	Dallas/Fort Worth
4.	Chicago
5.	Phoenix
6.	Greater New York/Northern New Jersey
7.	Austin/San Antonio Region
8.	Seattle/Portland Northwest U.S. Corridor
9.	Atlanta
10.	Los Angeles/Southern California

Source: Site Selection Group

SDC Ashburn facility; Virginia

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WITH WELLS FARGO REAL ESTATE CAPITAL INVESTMENTS, LLC

as part of $320 million raised in partnership with Sabey Data Centers in 2021

Sabey Data Center Properties LLC is one of the largest and greenest privately held data center owner/developer/operators in the United States, as well as the sole data center ABS master trust platform with an S&P A+ credit rating. Funds from this closing will be used to capitalize on robust tenant demand for data center space by growing Sabey's portfolio.

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