

Staying ahead of change

How supply, demand and technological advancements driven by AI are affecting data center infrastructure and investment

Geoffrey Dohrmann, founder and CEO of Institutional Real Estate, Inc., recently spoke with **Jeffrey Kanne**, president and CEO of National Real Estate Advisors. Following is an excerpt of that conversation.

Tell me about National Real Estate Advisors. Who are you, and what do you think makes you different from other advisers?

We're an SEC-registered real estate investment manager that represents institutions in the investment of their capital in various parts of the real estate industry. What makes us fundamentally different from many investment advisers is that we don't just buy existing real estate; we invest in new developments. Almost everything in our portfolio is something we caused to be built in one way or another.

Where are you focusing today? Where do you see the greatest opportunity for your investor clients?

The world is changing at an extremely fast – and accelerating – rate. What was good yesterday in almost any sector is likely to change, and to change dramatically, in shorter and shorter periods of time. We're always looking for opportunities that play into where we see change going, and we also focus on properties and markets we think will be timeless, even though there is change happening all around them. We think communities that have high intellectual capital, for instance, are going to survive and thrive in the future. There is resilience in those cities based on cultural factors and educational institutions we believe make urban centers extremely resilient despite the changes that will continue to occur.

This philosophy has directed our current focus to five areas. One of the property types we believe in, have believed in, and continue to believe in is high-rise urban luxury apartments. We're also focused on data centers, which we became interested in 20 years ago because we saw them as a critical part of the infrastructure enabling the digitization around us. A variety of forces are pushing more and more of our economy into medical services, and changes are going on in medical building structures caused by technological changes. That's an area we are in, and we intend to increase our exposure. We are also exploring modular workforce housing. We see that as the future, enabled in many respects by artificial intelligence and robotics that are rapidly becoming truly useful. Finally, we are also interested in mezzanine and preferred equity financing to get higher returns when we have cash, which we aren't deploying in permanently owned hard assets.

How do you identify emerging property opportunities?

We keep our eyes wide open, and we read. We read a lot. And we don't just read industry publications. I personally spend a lot of time reading about technological developments, both in process and predicted. We keep abreast of cultural developments, demographic developments and demographic projections. I encourage everyone in the firm to read as much as they can about almost any subject to try to understand what's going on around us and how the new technologies and shifting

demographics are going to affect the kinds of products we want to invest in. We are currently undergoing a period where, for the first time, replacement rates of many populations are not being met, and that has a big impact on almost everything we do.

In short, we assume we aren't going to be doing in 12 months what we did 12 months ago. That message causes a fair amount of anxiety until people get used to it. We won't see everything, but we are open to changes that can happen, and we are always evaluating ways to capitalize on those changes on behalf of our clients.

What are key risks associated with investing in emerging property types and in different kinds of markets, and how can they be mitigated?

In any emerging property type, the pool of reliable professionals – architects, engineers, contractors, property managers and consultants – is pretty shallow. The office market is doing poorly today, but for every question you might have about office buildings, there are hundreds of professionals you could approach to get an answer. That is not the case for modular housing or data centers. That absence is a key risk. Investors will have to be more self-reliant. Along the same lines, emerging property types do not have a long history of construction and operations that would help you analyze an asset's constructability and operational characteristics. Your database will be much thinner than if you were investing in one of the established property types.

You've been investing in data centers since 2010, and when you first started, data centers were niche. Today, they seem like a got-to-have-it product. When did this sector shift from niche to mainstream in the portfolio?

We started looking into data centers in 2005. I was convinced they were going to be a critical part of our business and cultural infrastructure. And I've always wanted to own the railroad, so to speak, but not the goods on it. To me, then, data centers were becoming a critical part of the "railroad." You can develop software – and all kinds of technologies that rely on software – that require a data center to function, but that is not what we are investing in. Back then, it was the Wild West. Few people knew what the data center business was or what services a data center owner would provide. After a long search, we finally found a partner with a culture like our own. They also had something else we were looking for, which was sustainable power. It's been clear to us for a long time that sustainable power is going to become very valuable. We started building data centers on the Columbia River, where the power source is hydropower. At the time, some people thought data centers were not an appropriate asset for an institutional investor to invest in. I couldn't have disagreed more then, and I couldn't disagree more now. The result of this attitude was that data centers remained a niche property type until 2021. In 2015, it was almost uninvestable for many institutional investors.

I was with a major bank one night in 2010, trying to get a data center financed. The banker was very polite – we had borrowed

a lot of money from his institution and still do. I basically begged him to do some construction financing on a data center. His response to me was, "I don't really understand them. I really don't believe in them. Don't you have a good retail center? I really understand retail, and I'd love to do some retail financing for you." I think of that story because he was going in exactly the wrong direction, and I couldn't even get him to start asking questions, such as, What is a data center? Why does it work? Why do you believe it's going to be essential?

People didn't really want to learn what it takes to understand data centers until the spring of 2021, when COVID-19 was raging, and people were doing work by video. All of a sudden, they realized that all these communication technologies run through data centers. Then, they started to want to learn and invest, and within the past 18 months, the sector went from being perceived as niche to a must-have. The pandemic caused people to realize data centers are critical infrastructure – they are assets that live at the junction of technology and real estate.

In addition to lack of understanding, what other barriers to entry are there for this property type?

Capital – data centers are extremely expensive. Instead of \$500 per square foot all in, you are \$1,500 per square foot all in before your tenant starts putting in their \$3,000 per square foot. The need for capital is huge. Each building can cost \$200 million to \$500 million. Second, the ability to develop with a contractor who knows how to construct a data center is a significant barrier to entry. It's not just another apartment or office building. You need to understand electrical distribution and HVAC issues. Another barrier is reputation. In most property types, residential, for example, if you get a bad property manager, you go find another one, and the tenants might not even notice. In the data center business, you don't get tenants unless you have an incredibly good reputation. It takes years and years to build an excellent reputation. Finally, the current biggest barrier to entry is energy. Today, there is an intense clash between the cultures of users and suppliers. We have high-tech industries needing more space now, and we have utilities that take years to deliver new supply. Presently, there is no easy or quick solution to this problem, making existing operating assets more valuable and driving steady rent increases.

What should investors be looking out for? Where are the risks embedded in this type of investment opportunity?

Most investors should never invest in a data center that is not entitled and doesn't have power. If it is entitled and has power, the next set of risks involves: Who is the operator, and who is the builder? I get calls almost every day from developers of offices and apartments who now want to get into the data center market. They are trying to put land under contract and promising people they're going to bring power to it and get it entitled, but they don't have a clue what they're doing. All investors should be extremely wary of that. They should only deal with established operators and developers. If you are in the right market, with the right connectivity, with power, with the right partner, the amount of leasing you can do is almost unlimited at the moment.

How is the rise in artificial intelligence impacting not only the data center industry, but other possible emerging sectors?

The use cases for AI are almost infinite. For example, education. AI is going to enable children to each have an individualized tutor in every subject. That's happening already. This is the biggest change in education since we went from having tutors only for the wealthy to mass education with 30 kids in a classroom being taught by a single teacher. With AI, we will have the essence of an individual to tutor for every student in every subject. The AI tutor will be far better than a human tutor at assessing a student's strengths and weaknesses and adjusting instruction to meet the needs of the child, and then transmitting that information to human teachers and parents. This is only a simple – but revolutionary – AI use case that will drive demand for decades.

When you translate AI into demand for data centers, it will be enormous and strain resources. For example, a single traditional Google search takes one-tenth of the power it takes to do one ChatGPT search. That means our in-place platforms, our land we have ready for development, our relationships with utilities have become much more valuable and are going to stay that way for the foreseeable future. I believe AI is going to change almost everything in our lives, over time.

How do you plan to build a future-proof portfolio? Given these tremendous technological changes, how do you make decisions today that will survive those changes?

You don't future-proof a portfolio with the idea you're going to keep the same property types in it forever, which seems to have been the prevailing view for decades and which worked out in many ways until the dawn of the millennium that saw the internet and data centers reaching a useful robustness. In 2006, about the same time we decided to get into the data center business, I was on the board of a super-regional shopping mall REIT. We had about 14 large and some of the most prominent shopping centers in the country. I was studying Amazon. I remember a discussion by the board of directors at that time concluding that people would always want to go to the store – that online shopping was fine for a few things like books, but it would not affect most retail. I disagreed. We sold all of our super-regional malls. We didn't try to future-proof those investments. Two of those malls have done extremely well. Most of them don't exist anymore. If they do exist, they're mostly pickleball courts. Future-proofing your portfolio requires making sure you're adapting your product types and what's in your portfolio to the changing world.



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COMPANY PROFILE

An investment manager developing, operating and managing commercial real estate projects across the United States, **National Real Estate Advisors** manages separate accounts and multiple commingled investment vehicles, including a data center fund.

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