Securitized Products Special Topics

Data Centers: Performance Wrinkles to Test Operators' Role

Check Your Data Center Operator as Underwriting Focus Shifts to the Property

The growing focus on property underwriting in data center deals, and brewing headwinds for leasing demand, will test the impact data center operators have on deal performance. Data center ABS deals now regularly include wholesale data centers which put less emphasis on the identity of the operator compared to retail colocation properties, in our view. In turn, the rating methodology changes Standard & Poor's recently proposed for the sector appear to shift much more attention to property attributes and analysis. This should bring the agency's data center ABS rating approach much closer to the property-driven approach it uses for CMBS. S&P's proposal rattled investors. If adopted as is, the agency could downgrade about 40% of its outstanding ratings by two notches, on average.

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Recent anecdotal evidence suggests large data center tenants are looking to own their properties, rather than lease capacity. Examples include Meta/Facebook announcement it is building a new 700K sf data center campus in Jeffersonville, IN, and Google's 290K sf data center development in Wasco County, OR (Figure 1). While the data center sector fundamentals remain stable, tenants' shift to ownership, and any subsequent softening in their leasing demand, could position the strongest operators to outperform.

Figure 1. Data Center Tenant Recent Development Announcements

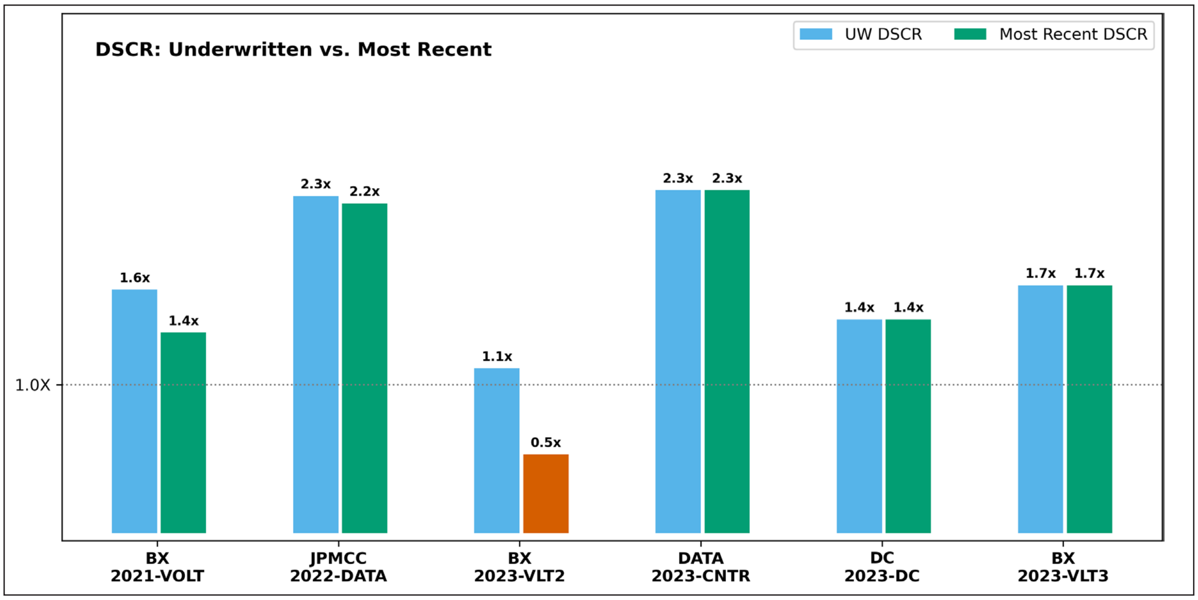
User	Announcement Date	Location	Announced Investment ($MM)	Facility Size (SF)
Meta Platforms	January 2024	Jeffersonville, IN	$800	700K
Google	January 2024	Wasco County, OR	$600	290K
Amazon	January 2024	Madison County, MS	$10,000	NA
Meta Platforms	October 2023	Temple, TX	$800	900K
Amazon	September 2023	Hilliard, OH	$515	NA

Source: Press reports and Academy Securities

Data Center SASB Sees Sharp Occupancy Drop, but Is It Real?

The role of the data center operator can also come to the fore as investors observe collateral performance deterioration, real or not, on outstanding deals. Interestingly, the $800 million BX 2023-VLT2 SASB deal reported a sharp drop in the overall occupancy on the underlying four-property data center portfolio, to 53% from 99.5% underwritten level. The deal's reported DSCR plummeted to 0.53x, from 1.11x at issuance. No other data center SASB showed such a large swing from underwritten to reported levels (Figure 2).

Figure 2. Data Center SASB Parameters



Source: Morningstar Credit and Academy Securities

Data center underwriting nuances may explain the eye-popping occupancy drop in VLT2. Most of the leases in the portfolio's largest property, Ashburn 3DC2 in Sterling, VA, are so-called booked but not billed (BBnB) leases. Such data center lease type is akin to a commercial lease that has been fully executed before the loan's origination, but where the landlord/tenant is building out the space and has not taken occupancy. The VLT2 underwritten levels took the BBnB leases into account while calculating occupancy. However, deal servicers report actual income, and excluded the BBnB leases from the reported occupancy levels. All told, while the VLT2 properties are not necessarily seeing leasing issues, the large component of a build-out space may still require the involvement and guidance of a strong operator.

Operator Replacement on Troubled Data Centers

The operator's strength and their commitment to their portfolio should play an even bigger role as properties do experience distress. To be sure, most data center properties across the outstanding universe are not seeing serious performance issues (Figure 3). But a few loans, such as 32 Avenue of the Americas ($425 million, across five 2015- and 2016-vintage conduit deals) and TEK Park ($56.8 million, MSBAM 2016-C31, SGCMS 2016-C5, and CFCRE 2016-C6), are reporting deteriorating occupancy levels and some challenges in leasing out capacity. More broadly, investors should reasonably expect performance issues, especially as tenants become more discerning about their leasing needs. Not only hyper-scalers such as Meta, Google, and Amazon increasingly prefer to own properties, but also such tenants and others may have a clear preference for newer, more powerful data centers. Operators may be forced to lower leasing prices on legacy assets with vacancies, as commercial brokers noted in recent sector outlook reports.

Figure 3. Conduit Data Center Properties

Loan	Deal(s)	Balance $(MM)	Location (MSA)	Most Recent Occ%	Reported LTV	Most Recent DSCR	Maturity
One Wilshire	CGCMT 2022-GC48; BMARK 2022-B32; B33; B34; B35	$389.3	Los Angeles, CA	87%	42.6%	3.29	Jan-2032
32 Avenue of the Americas	JPMBB 2015-C33; JPMCC 2015-JP1; JPMBB 2016-C1	$297.5	New York, NY	61%	55.2%	1.04	Nov-2025
Powered Shell Portfolio - Ashburn	CGCMT 2019-GC41; GSMS 2019-GC42	$87.0	Washington, DC	100%	58.2%	2.59	Jul-2029
Powered Shell Portfolio - Manassas	CGCMT 2019-GC41; GSMS 2019-GC42	$83.8	Washington, DC	100%	55.9%	2.61	Jul-2029
State Farm Data Center	BBCMS 2017-C1; CD 2017-CD3	$80.0	Kansas City, MO	100%	62.5%	3.09	Feb-2027
KOMO Plaza	BBCMS 2017-C1; WFCM 2017-RB1	$69.5	Seattle, WA	100%	50.0%	2.65	Jan-2027
TEK Park	CFCRE 2016-C6; MSBAM 2016-C31; SGCMS 2016-C5	$56.8	Allentown, PA	61%	55.7%	1.09	Jul-2026
Kings Mountain Center	BBCMS 2019-C3; CSAIL 2019-C16	$42.0	Shelby, NC	100%	56.0%	2.58	Apr-2029
The 511 Building	MSC 2016-UB11	$39.7	Minneapolis, MN	75%	35.6%	3.11	Aug-2026
NTT - Quincy	MSC 2019-L2	$31.0	Moses Lake, WA	100%	51.2%	2.48	Jan-2029

Source: Bloomberg and Academy Securities

Servicers have shown clear inclination to collaborate with sponsors/landlords on troubled situations. But when the servicers view the landlord as part of the problem rather than the solution, the servicer will look to replace them. It is an open question whether such an approach can apply to data centers in the same way it had worked in other property segments. Data center operators have argued (admittedly in a self-serving way) that their unique know-how and management prowess is integral to the properties ongoing operations. Rating agency criteria also underscore the critical role operators play (despite the growing emphasis on the properties themselves.) We will be watching to see if, or how, the forced replacement of an existing manager of a troubled data center property impacts future performance.

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