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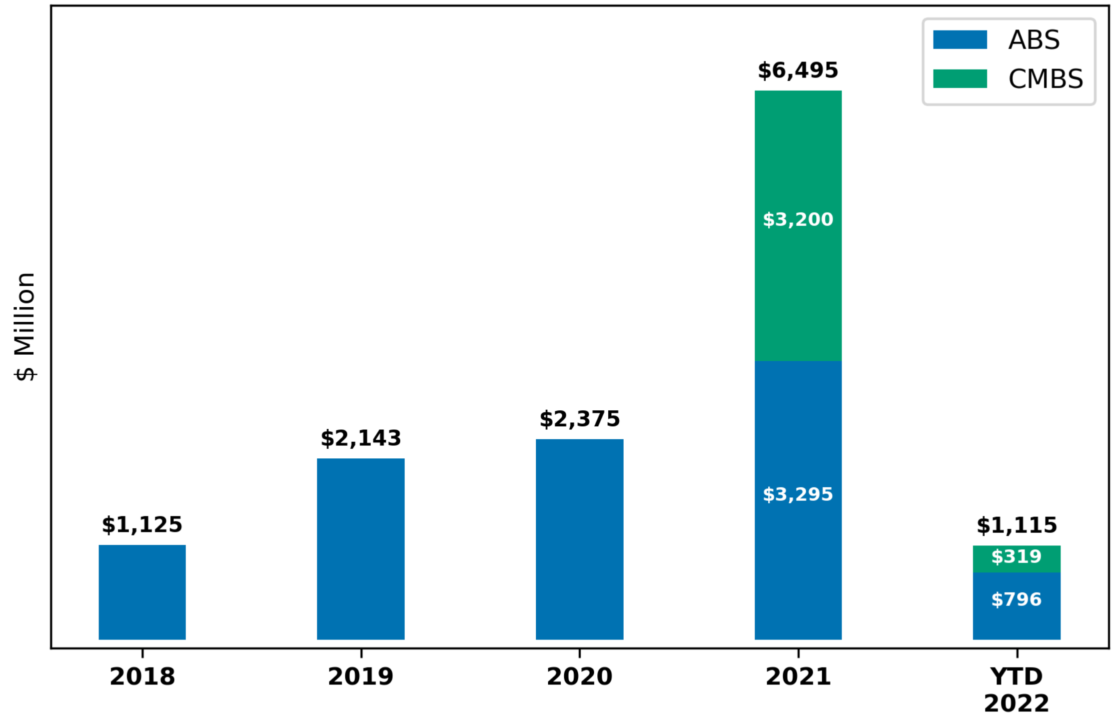
Data Centers Drift to ABS, Potentially Piquing CMBS Investors Interest

We expect to see growing exposure to data centers in the ABS market, potentially siphoning properties that could have landed in CMBS deals. Data centers is a relatively strong commercial real estate segment, which should be well-positioned for a recessionary environment. CMBS investors looking for exposure to the sector may take a closer look at the master trust ABS vehicles that now finance many data center operators. Data center ABS issuance reached $3.3 billion last year, across eight issuers (Figure 1). Issuance was much more subdued in 2022 amid market volatility and broader securitized issuance pullback. Still, given data centers' strong growth, we expect operators return to the market for their financing needs.

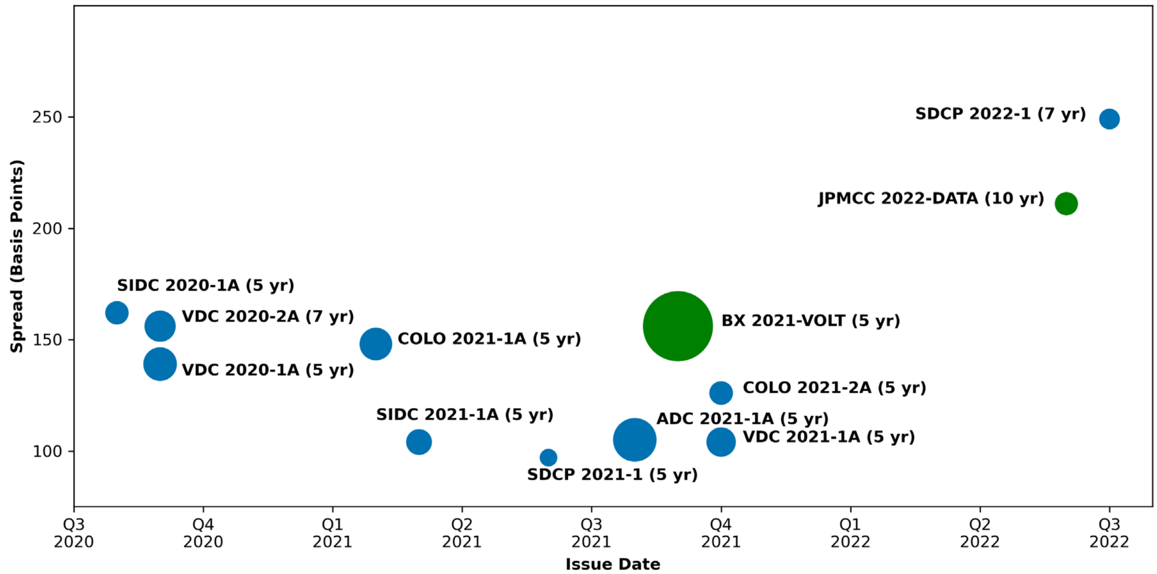
Figure 1. Data Center ABS Issuance, 2018-2022 ($ millions)



Source: Bloomberg and Academy Securities

Data center borrowers currently are likely to find ABS a more attractive financing execution versus tapping the CMBS market. The recent data center ABS deal, SDCP 2022-1 (Sabey Data Centers), priced its seven-year, 70% LTV benchmark bond at 249bp over Treasury benchmark in July (Figure 2). The $175 million SDCP deal was backed by a six-property data center portfolio, with 92 tenants. In contrast, JPMCC 2022-DATA priced its 10-year, 45% LTV deal in early June to the tune of T+211bp (on a weighted average basis across all classes). The $319 million CMBS SASB deal was backed by Nexus Data Center, a "hyperscale" data center in Loudon County, VA, with a long-term lease to Google. Overall, the recent ABS and CMBS deals show that the ABS market currently offers a higher advance rate at a lower marginal cost than CMBS.

Figure 2. Data Center ABS and CMBS Spread Levels



Note: the dots sizing represents the relative issuance balance of each deal
Source: Bloomberg and Academy Securities

ABS Collateral Includes All Data Center Segments, Not Just Retail Colocations

Comparing the property characteristics of the data centers backing different ABS and CMBS deals defies some of our expectations. Data center ABS securitizations aim to put emphasis on the strength and experience of the operators, rather than mostly on the buildings economics, according to rating agencies. The ABS cashflow analysis also considers a wide scope of services the operators may provide tenants, especially small or mid-size ones. Data center tenants may sign service-level agreements, instead of purely capacity- or space-driven leases.

As such, we would expect to see mostly retail colocation properties in ABS deals. Retail colocation data centers typically involve an elevated service level, especially for tenants that need the operator's technical expertise. The lease terms are also usually shorter, one to four years, putting greater importance on the operator's ability to renew or release expiring contracts.

Yet ABS deals appear to include a wide spectrum of data center types, including wholesale colocations (larger tenants and longer leases) and powered shell properties (Figure 3)**.** The latter entails very little operator involvement once the tenant gets the basic "shell". In these buildings the tenants build and install their own equipment, and the rent payments are based off of square footage rather than power use.

Figure 3. Data Center Deals Pool Characteristics

Deal	JPMCC 2022-DATA	SDCP 2022-1	BX 2021-VOLT	ADC 2021-1	SIDC 2021-1	VDC 2021-1	SDCP 2021-1
Deal Balance ($MM)	319.1	175.0	3,200.0	1,350.0	400.0	530.0	175.0
Sponsor	CalPERS, GI Partners and Sentinel Data	Sabey Data Centers	Blackstone	Aligned Data Centers	Stack Infrastructure	Vantage Data Centers	Sabey Data Centers
# of Properties	1	6	10	4	8	13	6
# of Tenants	1	92	850	23	26	14	85
Rem. Lease Term (Yrs, WA)	6.5	6.3	2.6	NA	7	9	6.6
Turnkey %	100.0	79.6	89.9	100.0	94.9	100.0	74.2
Powered Shell %	0.0	20.4	10.1	0.0	5.1	0.0	25.8
Triple-net Leases %	100.0	20.4	100.0	0.0	55.0	0.0	25.8
Modified Gross Leases %	0.0	79.6	0.0	100.0	45.0	100.0	74.2

Source: Rating Agencies, MCIA, Bloomberg, and Academy Securities

The data centers contract types we find in the ABS deals feature both triple-net leases and modified gross leases, as Figure 3 also shows. In triple-net leases the tenant is responsible for operating expenses and electricity expenses, in addition to the base rent, as well as accompanying taxes and insurance to use the facility. In modified gross leases, the data center operator pays the operating expenses as well as the taxes and insurance. The presence of different types of leases in ABS deals again suggests data center portfolios can fit both ABS and CMBS structures. It appears there isn't necessarily a rigidly defined data center sub-segment that finds its way to one deal type or the other.

More Than Meets the Eye on Some Data Center Conduit Loans

CMBS investors most likely embraced data center exposure in recent conduit deals. To be sure, the sector does face a few headwinds, such as potential over-supply in some markets or the shift of hyper-scalers to own rather than lease capacity. Yet data centers are widely considered a robust CRE segment. Enterprise demand for cloud should grow exponentially, according to JLL's latest data center outlook. New supply will be impeded by land and power availability in many major markets. The sector is also seeing robust investment activity. Notable deals in recent months include KKR/GIP $15 billion acquisition of CyrusOne, and Blackstone's ~$10 billion purchase of QTS Realty Trust. Anecdotally, data centers is also one of the several property types that foreign investors indicated they plan to significantly increase exposure to in the coming years, according to the 2022 AFIRE International Investor Survey.

However, we find that some large data center conduit loans feature characteristics that may distinguish the loans, or the underlying properties, from plain-vanilla exposure to the growing data center market. For example, the $80 million State Farm Data Center (CD 2017-CD3 and BBCMS 2017-C1) is backed by State Farm's enterprise data center in Olathe, KS, that the insurer constructed in 2016 and then sold to the borrower in a sale-leaseback transaction the following year. The borrower is ultimately owned by a collection of family trusts and multiple other investors (Figure 4). It is not a data center operator. In turn, the $100 million Equinix Data Center (WFCM 2019-C53 and BBCMS 2019-C5), is actually backed by the ground lease on the land. Equinix, one of the largest data center operators, is the lessee on the 663K sf land in Secaucus, NJ, and owns the improvements.

Figure 4. Large CMBS Data Center Loans

Loan	Deal	Balance ($MM)	Maturity	Location	Sponsor	Comment
BX Commercial Mtg Trust	BX 2021-VOLT	3,200.0	Sep 2026 (w/ all ext)	Various	Blackstone	Collateral part of the sponsor's take-private acquisition of QTS Data Centers
Nexus Data Center	JPMCC 2022-DATA	319.1	Jun 2032	Sterling, VA	CalPERS, GI Partners	Sponsors bought the property from Sentinel Data Centers, the original developer
60 Hudson Street	COMM 2013-CR13 COMM 2014-CR14	280.0	Nov 2023 (ARD)	New York, NY	Cordiant (acquired early 2022)	"Carrier Hotel" collateral (combine traditional telecommunications facilities characteristics and data
Equinix Data Center	WFCM 2019-C53 BBCMS 2019-C5	100.0	Oct 2029	Secaucus, NJ	Hartz Mountain Industries	Ground lease collateral
State Farm Data Center	CD 2017-CD3 BBCMS 2017-C1	80.0	Nov 2031	Olathe, KS	JDM Partners Opportunity Fund	Multi-investor sponsorship, mostly family trusts

Source: MCIA and Academy Securities

To be sure, we do not necessarily identify potential credit issues with any of these loans, or other data center-related ones we found. But the loan features we see do confirm that not all data center exposure is created equal, even beyond views investors may have across the various data center types (e.g. colocation vs. hyperscale properties).

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