



Affinius Capital

Data centers

Investing to power the digital economy

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Carrington Brown**, senior managing director, development and portfolio management, with Affinius Capital. Following is an excerpt of that conversation.

How long has Affinius Capital been investing in data centers, and how did you decide to enter this market?

My colleague and co-portfolio manager in the data center space and I have been talking about investing in data centers for the past seven or eight years. We made our first investment in December 2020 – a 130-acre tract of land in Northern Virginia. I wish we had bought more! Modern computing is not so much our ubiquitous phones nor the laptops. Rather, it's servers that exist within data centers that are enabling almost everything we touch societally, because technology has become such a big part of our daily lives.

The rapid growth of data center demand, accelerated by artificial intelligence, has left a massive undersupply of facilities to power the digital economy. How do we best meet the demand, as an industry and as investors?

We've seen significant demand in the data center sector, much of which was driven by cloud business during the past four or five years. We have a new accelerant in AI. The largest hyperscalers, Microsoft/Microsoft Azure and Amazon Web Services, each produce more than \$100 billion a year in revenue. The data center sector is still in a nascent stage of its adoption cycle. Today, roughly only 15 percent of all data is stored in the cloud. That means there is still a very large opportunity for growth just in cloud adoption. The addition of AI throws fuel on the flame of the data center infrastructure needed.

When the major hyperscalers last reported earnings, a pretty consistent message was the increasing spend to support AI development. We witnessed a similar phenomenon in the ecommerce space. For example, in the course of the past 10 to 15 years, we saw companies invest heavily in developing infrastructure for their delivery network. Ultimately, the significant investment in infrastructure helped position certain companies for dominance in their sector. We're seeing the same pattern now in the data center sector. It's an arms race.

How has the transition from infrastructure-based support for data centers to a real estate investment trend affected those in the market?

It has enabled experienced developers to deliver new product more rapidly and at a lower cost. We believe we will have a lot of success in the data center space, but there is an important distinction between experienced developers and experienced data center developers. In order to develop and operate a data center for some of the most admired companies in the

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world, there is a rigorous onboarding process required for a developer to prove its aptitude to develop and operate these mission-critical facilities 24/7, 365 days a year. When we were entering the space, we thought it would be important to align ourselves with a qualified developer/operator. We ultimately helped create a platform in Corscale, a data center development company focused on delivering infrastructure at scale for hyperscale customers.

We talk about the changing environment and the changing model. In the past four or five years, a number of investors looked at the digital transformation we're going through societally and agreed that, to access this opportunity, it would be important to align with a qualified development group. From 2018 to 2021, there was significant consolidation in the sector, and a number of the former public companies went private. Only two pure-play public companies remain. The investors that acquired these public companies are some of the largest, most sophisticated investors in the world. The weight of the institutional capital coming to the sector will

ultimately create more liquidity for the sector and lower the cost of occupancy for the users.

As demand for office wanes, it appears some of that capital is being reallocated to data centers. Is that true, and if so, why?

Data centers have high-credit tenants, long leases and a mission-critical purpose, which has contributed to a shift in institutional investor interest. I wouldn't go as far as to say investors are asking: Are we allocating towards office or data centers? Five or six years ago, here in the United States, we saw roughly \$500 billion a year in transaction activity in the commercial real estate sector. And 25 percent to 30 percent of that went to office, with the rest going to industrial, multifamily and other product types. But the amount to the data centers was a small part of the equation. What we are seeing today from an investment perspective is long lease terms – great credit, attractive development yields and a more institutionalized lease structure. A good deal of capital is being allocated to the data center sector, but there is not as much capital being allocated to the office sector. A big reason for that is the fundamentals for data centers are positive – historically, low vacancy rates and favorable demand and supply characteristics.

A data center can cost more than \$1 billion to develop. What is your view of the potential for new public market capital sources to capitalize these assets post-stabilization?

We've been in the construction financing market several times in the past year. The trajectory from last year to this year has been positive. We've found significantly more lenders in the market looking to finance these deals. And these lenders include traditional banks, debt funds, infrastructure funds, life insurance companies, and the list goes on. Additionally, in the past few months, the securitization markets have started to open up – single-asset securitizations, asset-backed securities financings. The spreads are beginning to tighten with increasing subscription for this type of product. It's probably too early to speculate on what the public market acceptance would be for data centers, but historically, the public markets have been a huge source of liquidity. If the financing activity in the asset-backed securities markets is any indication of interest in the space, during the next couple of years as the development projects in process now are delivered and their investors start looking for liquidity, the public market will likely be one of many options for an exit.

What are some solutions you're discussing at Affinius to navigate what some are calling the power supply crisis, as society and businesses become increasingly reliant on data?

Power is a challenge. Depending on whose report you read, the U.S. data center market is approaching 20 gigawatts, and it could double during the next five to six years. The only thing that's keeping it from growing even further is power. Some markets have power-generation issues. Other markets have power delivery or transmission capacity issues. Infrastructure will continue to need to be developed not only for transmission, but for generation. Coal-fired plants comprise much of the infrastructure today, but the users ultimately want green power. Some utilities are far more progressive and are developing cleaner sources of renewable power, whether wind, hydro or nuclear. Long term, new power sources for generation will need to be developed. And it's hard to imagine a world 10-plus years from now in which nuclear power is not at the top of the list of clean, scalable power sources to power these data centers. Nuclear power is challenging, though, in that it is expensive, and building a nuclear power plant requires a very long permitting process. The government will have to play a role in the approval and permitting process for some of these power-generation sources.

What are the geographical targets for hyperscale tenants? Where are you looking to find affordable, sustainable power?

Northern Virginia is still the most in-demand data center market in the world, but every new data center cannot exist there. Five years ago, Santa Clara, Calif., would have been one of the top three data center markets in the world, but right now, there is limited development occurring there because of the need for significant infrastructure improvements not only for power generation, but power transmission. Much of that demand has shifted to Phoenix; Atlanta; Reno, Nev.; Dallas; and Columbus, Ohio.



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ABOUT AFFINIUS CAPITAL

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