SECTOR UPDATE

REITs – Singapore

Data Centre REITs – Cloud Service Providers Are A Source Of Demand

Cloud service providers have been portrayed by Jim Chanos as aggressive competitors who prefer to build their own hyperscale data centres. The evidence gathered from CBRE suggests otherwise. Cloud service providers are a key source of demand for data centres. A multi-cloud strategy would reduce concentration and tame the power wielded by cloud service providers. Data centre REITs also benefit from limited future supply. BUY DCREIT (Target: S$0.98) and MINT (Target: S$3.36).

WHAT'S NEW

- **Hearsay from hedge fund?** An article carried by the *Financial Times* dated 29 Jun 22 highlighted hedge fund manager Jim Chanos' big short idea to sell providers of legacy data centres, such as Digital Realty, Equinix and Iron Mountain. Mr Chanos is raising several hundred of million dollars for a new fund that takes short positions on REITs listed in the US.
- **Customers turning into competitors?** According to Mr Chanos, cloud service providers, such as Amazon Web Services, Google Cloud Platform and Microsoft Azure, prefer to build their own hyperscale data centres based on their own design. In Mr Chanos' opinion, the three cloud service providers, which are Digital Realty, Equinix and Iron Mountain's largest customers, will become their biggest competitor.
- **Investors in the US did not overreact.** Share prices of Digital Realty, Equinix and Iron Mountain were relatively unchanged on 29 and 30 June, although trading volume was exceptionally high during these two days. Investors in the US did not fall prey to Mr Chanos' marketing ploy to raise funds for his new fund.

a) **Cloud service providers are a source of growth.** Many companies are shutting down their standalone data centres, which are costly and inefficient to operate, and switching to cloud service providers instead. Some companies adopt a hybrid approach by tapping on cloud service providers for parts of their enterprise IT system while keeping some functions, especially those involving sensitive financial and healthcare information, at data centres they rent and control themselves.

Cloud service providers and social media companies are key drivers of demand for co-location data centre capacity. They are likely to sign leases for purpose-built hyperscale data centres of more than 100MW on a single-tenant basis.

b) **Asset-light business model based on outsourcing provides higher ROE.** Cloud service providers utilise a mix of in-house data centres and outsourced data centres. They adopt an asset-light business model by leveraging on outsourced data centres provided by Digital Realty, Equinix and Iron Mountain so as to generate higher ROE. They also sign long-term leases with their data centre landlords to ensure their outsourced data centre capacity is locked in.

c) **Cloud service providers focus on software and services.** Cloud service providers have developed tools to help companies run their enterprise IT systems across the public and private clouds and their own data centres. Microsoft has developed Azure Arc, which allows companies to run cloud-based database applications in their own data centres. Amazon has a similar software named AWS Outposts. They would also want to cross-sell their higher value-added services, such as data analytics and AI. Cloud service providers have to focus on their core competency so as to sharpen their competitive advantage.

OVERWEIGHT

(Maintained)

SECTOR PICKS

Company	Rec	Share Price	Target Price
DCREIT	BUY	0.725	0.98
MINT	BUY	2.64	3.36

Source: UOB Kay Hian

AVERAGE ASKING RENTS (US$ KW/MONTH)

Northern Virginia	Minimum	Maximum
5-10MW	70	90
1-4MW	75	95
250-500kW	85	120
Silicon Valley	**Minimum**	**Maximum**
5-10MW	100	110
1-4MW	125	135
250-500kW	135	150

Source: CBRE

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PEER COMPARISON - DATA CENTRE REITS

Name	Bloomberg Code	Rec	Curr	Price 6 Jul 22	Target Price	Mkt Cap (US$m)	Yield (%) HIST	Yield (%) CURR	Yield (%) FWD 1Y	Yield (%) FWD 2Y	Debt to Equity (%)	Debt to Assets (%)	P/NAV (x)
Digi Core REIT USD	DCREIT SP	BUY	US$	0.725	0.98	817	n.a.	5.6	5.5	5.6	35.4	26.0	0.83
Keppel DC Reit	KDCREIT SP	NR	S$	2.00	n.a.	2,451	4.9	5.1	5.3	5.4	56.3	36.1	1.50
Mapletree Ind	MINT SP	BUY	S$	2.64	3.36	5,063	5.2	5.1	5.2	5.3	58.3	38.4	1.42

Source: Bloomberg, UOB Kay Hian

d) **Multi-cloud strategy levels the playing field.** Companies are adopting a multi-cloud strategy by tapping several public and private clouds provided by cloud service providers for different workloads, sometimes in addition to their in-house data centres. Several software companies, such as Snowflake, have developed new tools to manage applications across various public and private clouds, which facilitate the migration to multi-cloud strategy. Companies prefer to use multiple cloud service providers to avoid being locked into one external vendor. This multi-cloud strategy would reduce concentration in the cloud services industry.

ACTION

- **Fundamentals for data centres remain positive.** Data centres have diversified sources of demand with future growth driven by emerging technologies, such as 5G, AI and social media, including virtual reality communities and metaverse. Compression of capitalisation rates continued in 2H21. Many private equity firms have taken listed data centre REITs private through M&A activities, such as Blackstone's acquisition of QTS Realty Trust and KKR's acquisition of CyrusOne.

- **Primary markets: Growth from hyperscale data centres.** According to CBRE, the average asking rent across primary markets was US$120 kW/month. Land and power constraints affect supply from Northern Virginia and Silicon Valley where vacancy rates are low at 5.1% and 1.6% respectively. There is limited developable land within the two markets. The timeline to secure supply of electricity is delayed by deployment of a sub-station.

- Inventory bottlenecks are expected to result in higher rental rates in primary markets. Rental rates at Northern Virginia increased for the first time in 10 years during 2H21, supported by a substantial increase in demand for hyperscale data centres. Within Silicon Valley, Santa Clara plans to increase load development fees, which creates barrier to entry. Pre-leasing activities are dominated by cloud service providers.

- **Secondary markets: Benefitting from positive spillover.** According to CBRE, the average asking rent across secondary markets was US$130 kW/month, a premium of US$10 compared to primary markets. Secondary markets have a higher pre-leasing percentage of 76.3% compared with 44.2% for primary markets. Demand for data centres is likely to spill over from low-vacancy and expensive primary markets to more affordable secondary markets. The migration to secondary markets is expected to accelerate. Large tenants are signing leases for hyperscale data centres in secondary markets due to more affordable pricing for land and electricity.

- **Digital Core REIT (DCREIT SP/BUY/S$0.77/Target: S$0.98)**

- **Portfolio remains resilient.** Occupancy rate for all 10 data centres remains at 100%. DCREIT has long WALE of 5.5 years. All its leases contain cash rental escalation of 1-3% (weighted average: 2%).

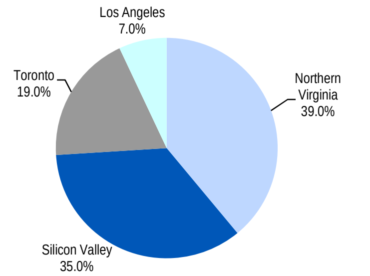
- **Insulated from variation in price of electricity.** All lease contracts are structured with energy costs 100% reimbursed by customers. 63% of its leases by net rentable sf (NRSF) are on a triple net structure, whereby real estate taxes and property expenses are absorbed by tenants.

- **Hit by higher interest rates.** DCREIT has maintained the proportion of borrowings hedged to fixed rates at 50%. We expect its cost of debts to increase from the current 2.1% to 3.6% in 2023, assuming the US Fed Funds Rate hits 3.25% by end-22. Fortunately, aggregate leverage remains low at 26%.

- **Mapletree Industrial Trust (MINT SP/BUY/S$2.63/Target: S$3.36):**

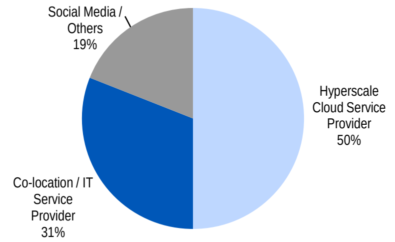
- **Sticking to diversification strategy by expanding into new arenas.** MINT is committed to its goal of allocating two-thirds of AUM to data centres. Data centres have expanded by 12.9ppt to account for 54.1% of AUM in FY22. Having reached a sizeable scale of 57 data centres in the US, MINT will look at opportunities to unlock value through: a) asset enhancement to upgrade the data centres, b) redevelopment to cater for new usage such as life science and c) divestment and asset recycling.

RENTAL INCOME BY CORE MARKET (MAR 22)



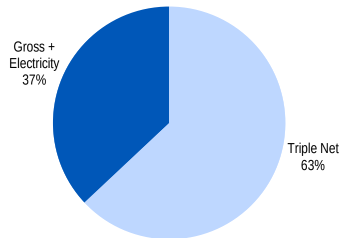
Source: DCREIT

TRADE SCTOR BY ANNUALISED RENTS (MAR 22)



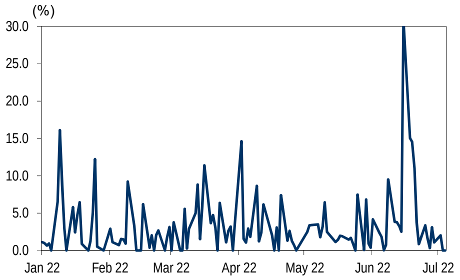
Source: DCREIT

RENTAL INCOME BY CONTRACT TYPE (MAR 22)



Source: DCREIT

SHORT SELL VOLUME AS % TOTAL TURNOVER VOLUME – DCREIT



Source: Bloomberg, UOB Kay Hian

- **Striving for sustainable growth in FY23.** MINT benefits from full-year contribution from its acquisition of 29 US data centres (completed on 22 Jul 21) in FY23. It plans to release tax-exempt income of S$6.6m withheld in 4QFY20 to unitholders during FY23.
- **Portfolio remains resilient.** Occupancy for its data centres in North America was 94.2% as of Mar 22. MINT has long WALE of 6.1 years. The portfolio provides average rental escalation of 2.0-2.5%.
- **Minimal impact from higher cost of electricity.** Triple net leases accounted for all leases for data centres in Singapore and 90.2% of leases for data centres in North America (the increase in cost of electricity is less dramatic due to diversified sources of energy). Thus, a higher cost of electricity does not have material impact on MINT's portfolio of data centres.

SECTOR CATALYSTS

- Continued growth from cloud service providers and social media companies.
- Land and power constraints reduce future supply of data centres.

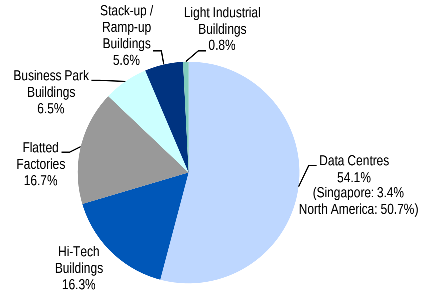
ASSUMPTION CHANGES

- We maintain our existing earnings forecasts.

RISKS

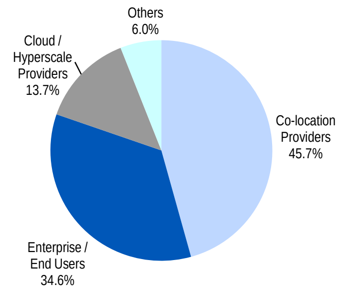
- Continued capitalisation rates reduce opportunities for yield-accretive acquisitions.

PORTFOLIO BREAKDOWN BY AUM (MAR 22)



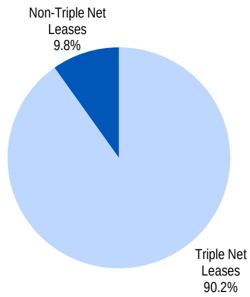
Source: MINT

TENANT TYPE BY GROSS RENTAL INCOME (MAR 22)



Source: MINT

LEASE TYPE BY GROSS RENTAL INCOME (MAR 22)



Source: MINT

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