

# Singapore Company Update

## Digital Core REIT

Bloomberg: DCREIT SP | Reuters: DIGT.SI

Refer to important disclosures at the end of this report

DBS Group Research . Equity

3 Nov 2023

### BUY

Last Traded Price (2 Nov 2023): US\$0.550 (STI : 3,082.49)

Price Target 12-mth: US\$0.90 (64% upside)

#### Analysts

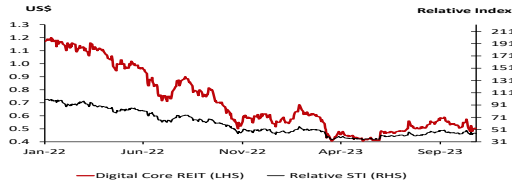
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#### What's New

- Proposed overall solution for portfolio diversification and positioning for growth
- Transactions involving asset recycling and leases amendment a trade-off for more certainty and improved portfolio diversification
- Leveraged on sponsor's pipeline to mitigate further dilution to earnings while building on future growth prospects
- BUY recommendation with TP of US\$0.90; will review once transactions and Cyxtera's Chapter 11 process are solidified

#### Price Relative



#### Forecasts and Valuation

| FY Dec (US\$m)         | 2022A | 2023F | 2024F | 2025F |
|------------------------|-------|-------|-------|-------|
| Gross Revenue          | 108   | 116   | 117   | 118   |
| Net Property Inc       | 69.4  | 73.3  | 74.2  | 74.6  |
| Total Return           | (1.3) | 29.6  | 29.6  | 29.7  |
| Distribution Inc       | 44.8  | 42.0  | 42.4  | 43.0  |
| EPU (US cts.)          | 2.43  | 2.60  | 2.60  | 2.59  |
| EPU Gth (%)            | (25)  | 7     | 0     | 0     |
| DPU (US cts.)          | 3.98  | 3.70  | 3.72  | 3.75  |
| DPU Gth (%)            | (3)   | (7)   | 0     | 1     |
| NAV per shr (US cts.)  | 82.7  | 81.8  | 81.3  | 80.4  |
| PE (X)                 | 22.6  | 21.1  | 21.2  | 21.3  |
| Distribution Yield (%) | 7.2   | 6.7   | 6.8   | 6.8   |
| P/NAV (x)              | 0.7   | 0.7   | 0.7   | 0.7   |
| Aggregate Leverage (%) | 34.8  | 35.0  | 35.3  | 35.6  |
| ROAE (%)               | 2.9   | 3.2   | 3.2   | 3.2   |

Distn. Inc Chng (%):  
Consensus DPU (US  
Other Broker Recs:

-  
-  
-  
5.1  
5.0  
5.1  
B: 6 S: 0 H: 0

Source of all data on this page: Company, DBS Bank, Bloomberg Finance L.P.

## Resolution to a long-standing overhang

#### Investment Thesis:

**Pure-play data centre REIT riding on structural tailwinds.** Demand for data centres in key markets remains robust with the lack of available capacity. DCREIT's presence in some of these key markets throughout the US, Canada, and Europe means it continues to benefit from such robust demand. Moreover, the long WALE for its assets ensures income stability in the foreseeable future. In the event of any vacancy, DCREIT should be able to quickly backfill the space, given the healthy demand dynamics in those markets.

**Recent acquisition of Frankfurt DC to drive earnings.** DCREIT has recently completed the acquisition of a 25% stake in the Frankfurt DC, which is expected to drive an accretion of c.2.0%. DCREIT has the option to increase its stake in the Frankfurt DC, as well as other pipeline assets from its sponsor, which will further drive earnings. The large pipeline of assets from its sponsor will enable DCREIT to continue acquiring accretive data centre assets going forward.

#### Pipeline assets from sponsor valued at more than US\$15bn.

DCREIT has been granted an ROFR by its sponsor for data centre assets in its pipeline valued at up to c.US\$15bn. This allows DCREIT to potentially grow into the largest pure-play data centre S-REIT. Its healthy debt headroom provides it the financial flexibility to embark on further accretive acquisitions. We believe that once markets become more conducive for further acquisitions, DCREIT will be able to grow further.

**Maintain BUY with TP of US\$0.90.** Our TP of US\$0.90 is based on a DCF valuation with a WACC of 6.2% (risk-free rate of 3.5%). This implies a normalised target yield of 4.2% in the next two years.

#### Key Risks

Key risks include a slowdown in demand for data centres or a decline in rents in North America, where the bulk of DCREIT's portfolio is located.

#### At A Glance

|  |           |
|--|-----------|
| Issued Capital (m shrs)  | 1,123     |
| Mkt. Cap (US\$m/US\$m)   | 618 / 618 |
| Major Shareholders (%)   |           |
| DIGITAL CR SINGAPORE   | 33.1      |
| Sumitomo Mitsui Financial Group Inc                                | 7.0       |
| APG Asset Management   | 6.9       |
| Free Float (%)   | 53.0      |
| 3m Avg. Daily Val (US\$m)  | 1.8       |
| GIC Industry : Real Estate / Equity Real Estate Investment (REITs) |           |

## WHAT'S NEW

### Resolution to a long-standing overhang

#### What has happened?

Digital Core REIT (DCREIT) has just made significant announcements regarding its response to the Chapter 11 filing of its second largest tenant, Cyxtera Technologies. In a move aimed at resolving Cyxtera's bankruptcy, Brookfield Investment Partners has inked a deal to acquire a substantial portion of Cyxtera's portfolio (including some of the DCs that are held by DCREIT). Notably, Brookfield is currently engaged in discussions with multiple data centre landlords as part of this transaction.

Below are the strategic actions that reflect DCREIT's proactive approach in navigating the complexities of Cyxtera's Chapter 11 filing, ensuring the stability and growth of its data centre portfolio:

1. **(+) Lease amendment at two Los Angeles data centres.** This involves shortening the lease to Sept 24 (from 2033/2035)
2. **(-) Lease termination at Frankfurt data centre.** The lease at Frankfurt DC, which accounts for approximately 4% of the property, is being terminated where the REIT, together with the sponsor will assume operations at the property.
3. **(-/+ ) Divestment of two data centres in Silicon Valley.** Two facilities in Silicon Valley are set to be divested to Brookfield.
4. **(+) Retention of one lease in Silicon Valley.** DCREIT is affirming the lease for its remaining Silicon Valley asset, with no adjustments to the existing lease terms and rents.
5. **(+) Acquisition of additional stake in Frankfurt.** In a noteworthy move, DCREIT is acquiring an additional 20% stake at Frankfurt DC from its sponsor, Digital Realty.
6. **(+) Expansion into Japan.** DCREIT is also making its maiden entry into Japan by securing a 10% stake in the Osaka Data Centre from Mitsubishi Corporation.

#### Our view

##### Trading off between concentration risk and slight dilution in DPU.

Based on our estimates, these transactions may potentially result in a c.3% dilution to FY24 DPU of c.3.72Scts. However, we view this as a **net positive** for DCREIT, as it is actively addressing investors' concerns over the over-concentration risk in its tenant profile towards selected large tenancies, bringing its exposure to investment grade customers to c.87% (vs. 77% before). Regarding its exposure to Cyxtera, the overall transactions will effectively remove the cloud of uncertainty surrounding the tenant's bankruptcy and represent a strategic trade-off that enhances DCREIT's geographical and tenant diversification.

Furthermore, the entry into the Japanese market through the Osaka DC acquisition offers DCREIT a new growth pipeline, leveraging its

sponsor's 50% stake in the asset, while Mitsubishi Corporation holds the remaining 40%. We understand that the acquisition yield of the Osaka DC was c.4% (after tax leakages) and it is estimated to be c.2.5% accretive to DPU.

Although the lease amendments and terminations may introduce leasing risks in the near to medium term, they also position DCREIT to be able to potentially command higher rents at the affected properties, in our view. This is in line with our understanding that the data centre industry continues to benefit from structural tailwinds driven by technologies such as machine learning and artificial intelligence. However, we understand that these transactions were driven by strategic considerations.

**Los Angeles lease amendments:** In the case of the LA properties, DCREIT has strategic plans to assume direct control of the asset upon the expiration of the current lease. This will enable DCREIT to engage directly with the underlying tenants. Simultaneously, DCREIT intends to invest approximately US\$10m in capex to improve the properties. These improvements will encompass the replacement of ageing equipment and the potential expansion of capacity.

**Frankfurt lease termination:** Regarding the lease termination at the Frankfurt DC, DCREIT is confident in its ability to reposition the vacated space to meet the expansion requirements of an existing tenant. This strategic move is expected to more than offset the early termination fees incurred (US\$2.5m).

These strategic negotiations and amendments, although involving certain risks and costs, are part of DCREIT's deliberate and forward-looking approach to managing and optimising its real estate assets.

In summary, while we acknowledge that these transactions might result in a near-term earnings dilution, it is important to note that DCREIT's access to its sponsor's pipeline has significantly mitigated a potentially larger dilution (-6.5% in DPU without these acquisitions). Moreover, these moves will lead to a more diversified portfolio with reduced tenant concentration, maintaining stable gearing at c.34% and also a **valuation yardstick with the divestment, giving investors comfort that its net asset value (NAV) of US\$0.80 is achievable.**

In the medium term, we see DCREIT increasing its stake in Osaka DC as a promising future acquisition pipeline. On a cautious note, it is worth mentioning that the latest valuation of the Frankfurt DC has decreased by around 6%-7%, pointing to a likely dip in DCREIT's portfolio valuations at the year-end.

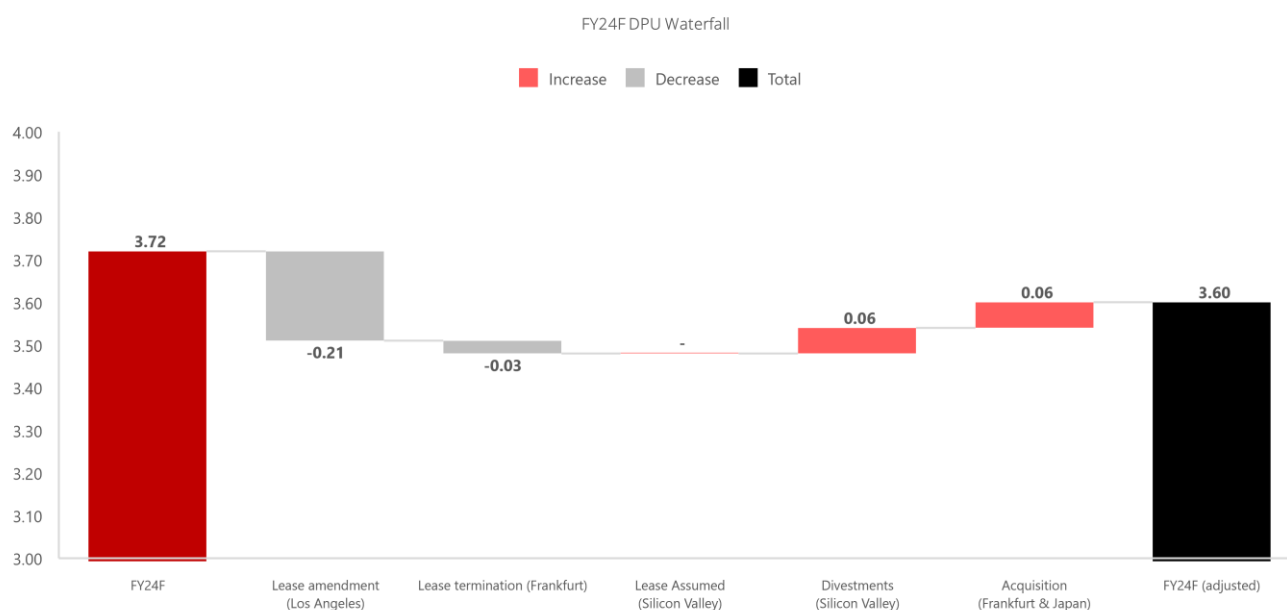
Our current recommendation is a **BUY** with a TP of **US\$0.90**. We will be closely monitoring and updating our projections as these transactions are approved and executed upon.

**Summary of implications and DBS's views of each transaction**

| No.      | Transaction                       | Affected property                                | Details  | Positive implication   | Potential negatives  | DBS's view   | Positive / Negative |
|----------|-----------------------------------|--|--|--|--|--|---------------------|
| 1.       | Lease amendment (Los Angeles)     | 3015 Winona Avenue<br>200 North Nash Street      | Lease expiration will be amended to 30 September 2024; thereafter, DCREIT assumes operation of the property with an underlying occupancy rate of 50% | Immediate lifting of overhang on the Chapter 11 filing.<br><br>Potential to diversify tenant base and rental uplift, which we understand to be up to 5%-10% (vs. current market levels). | Leasing risk in September 2024 when master lease expires<br><br>Drop off in revenue from both properties in September 2024 if unable to backfill vacancies or convert underlying tenant leases | <b>Positive:</b> Overhang lifted, tenant diversification, potential to lift underlying rents   | +                   |
| 2.       | Lease termination (Frankfurt)     | Frankfurt DC                                     | Lease (4% of asset) will be terminated early and DCREIT assumes underlying backfilling of half of the space  | Immediate lifting of overhang on the Chapter 11 filing from Cyxtera  | Leasing risk for vacated space (c.4.3% of property)<br><br>Has to pay an early termination fee of US\$2.5m   | <b>Negative:</b> Immediate leasing risk, early termination fee   | -                   |
| 3.       | Lease assumed (Silicon Valley)    | 1500 Space Park Drive                            | No change to lease terms or rents  | Income stability generated from asset  | Unable to lift rents, as the property is understood to be under-rented   | <b>Positive:</b> Income visibility and stability   | ++                  |
| 4.       | Divestments (Silicon Valley)      | 2401 Walsh Avenue<br>2403 Walsh Avenue           | Both assets sold at book value for a total of US\$150.2m (4.4% cap rate)   | Immediate lifting of overhang on the Chapter 11 filing<br><br>Free up capital for acquisitions to diversify portfolio<br><br>Reduce tenant concentration risk                            | Income void from the two properties divested<br><br>Decline in overall portfolio WALE, as both assets are on long leases   | <b>Neutral:</b> Assets being sold at cap of 4.4% and book value is a positive affirmation of its book value but the REIT is selling their "crown jewels" | +/-                 |
| 5.<br>6. | Acquisition (Frankfurt and Japan) | Frankfurt DC (20% stake)<br>Osaka DC (10% stake) | Frankfurt DC: US\$98.7m<br>Osaka DC: US\$51.5m   | Diversify portfolio and tenant base<br><br>Entirely funded by divestment proceeds<br><br>Additional future pipeline in Japan   | Tax leakage from the structure of the deal (c.4% yield after taxes)<br><br>Valuation of Frankfurt DC suggests that valuations have declined (6%-7%) since last year                            | <b>Neutral:</b> Potential savings in finance cost but yields seem tight, may not be sufficient to offset income void from the string of transactions     | +/-                 |

Source: Digital Core REIT, DBS Bank

**Estimated impact of above transaction to FY24 DPU**



Source: DBS Bank estimates

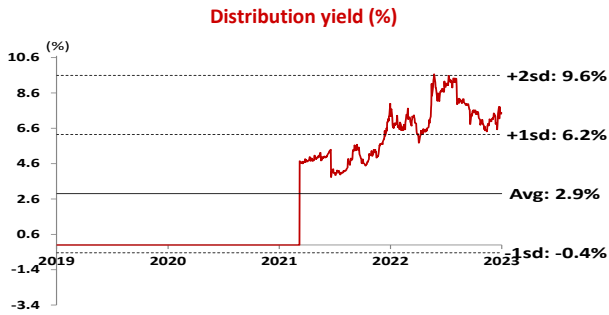
\* It is important to note that the divestments of the two Silicon Valley assets and termination of lease at Frankfurt DC are conditional upon the sale of Cyxtera's assets to Brookfield.

Digital Core REIT

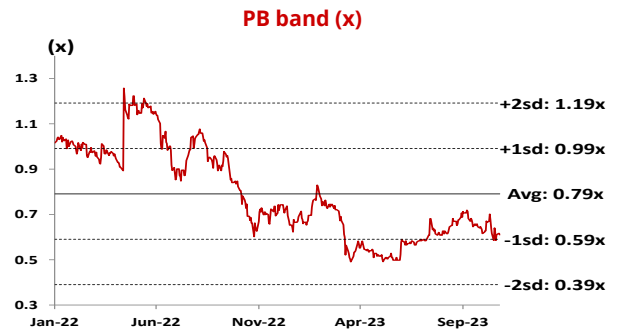
**Company Background**

DCREIT is a real estate investment trust that primarily invests in stable income-producing data centres as well as assets necessary to support the digital economy globally. Its portfolio currently comprises of 13 properties located in major data centre markets throughout the US, Canada, and Germany.

**Historical Yield and PB band**



Source: Bloomberg Finance L.P., DBS Bank estimates



Source: Bloomberg Finance L.P., DBS Bank estimates

**Income Statement (US\$m)**

| FY Dec                      | 2021A       | 2022A       | 2023F       | 2024F       | 2025F       |
|-----------------------------|-------------|-------------|-------------|-------------|-------------|
| Gross revenue               | 105         | 108         | 116         | 117         | 118         |
| Property expenses           | (38.6)      | (38.3)      | (42.4)      | (42.8)      | (43.0)      |
| <b>Net Property Income</b>  | <b>66.1</b> | <b>69.4</b> | <b>73.3</b> | <b>74.2</b> | <b>74.6</b> |
| Other Operating expenses    | (12.0)      | (15.1)      | (10.9)      | (11.0)      | (11.0)      |
| Other Non Opg (Exp)/Inc     | 0.0         | 1.42        | 0.0         | 0.0         | 0.0         |
| Associates & JV Inc         | 0.0         | (0.5)       | (0.5)       | (0.5)       | (0.5)       |
| Net Interest (Exp)/Inc      | (4.4)       | (10.2)      | (20.0)      | (20.7)      | (20.9)      |
| Exceptional Gain/(Loss)     | 0.0         | 0.0         | 0.0         | 0.0         | 0.0         |
| <b>Net Income</b>           | <b>49.6</b> | <b>45.1</b> | <b>41.9</b> | <b>42.1</b> | <b>42.2</b> |
| Tax                         | (7.1)       | (12.7)      | (5.6)       | (5.6)       | (5.6)       |
| Minority Interest           | (5.9)       | (4.9)       | (6.8)       | (6.9)       | (6.9)       |
| Preference Dividend         | 0.0         | 0.0         | 0.0         | 0.0         | 0.0         |
| <b>Net Income After Tax</b> | <b>36.7</b> | <b>27.5</b> | <b>29.6</b> | <b>29.6</b> | <b>29.7</b> |
| Total Return                | 36.7        | (1.3)       | 29.6        | 29.6        | 29.7        |
| Non-tax deductible Items    | 9.51        | 46.1        | 12.4        | 12.8        | 13.3        |
| Net Inc available for Dist. | 46.2        | 44.8        | 42.0        | 42.4        | 43.0        |
| <b>Growth &amp; Ratio</b>   |             |             |             |             |             |
| Revenue Gth (%)             | 300.0       | 3.0         | 7.4         | 1.1         | 0.5         |
| N Property Inc Gth (%)      | 300.0       | 5.0         | 5.7         | 1.2         | 0.5         |
| Net Inc Gth (%)             | 244.5       | (25.0)      | 7.4         | 0.2         | 0.1         |
| Dist. Payout Ratio (%)      | 100.0       | 100.0       | 100.0       | 100.0       | 100.0       |
| Net Prop Inc Margins (%)    | 63.1        | 64.4        | 63.4        | 63.4        | 63.4        |
| Net Income Margins (%)      | 35.0        | 25.5        | 25.6        | 25.3        | 25.2        |
| Dist to revenue (%)         | 44.1        | 41.6        | 36.3        | 36.3        | 36.6        |
| Managers & Trustee's fees   | 11.5        | 14.0        | 9.4         | 9.4         | 9.4         |
| ROAE (%)                    | N/A         | 2.9         | 3.2         | 3.2         | 3.2         |
| ROA (%)                     | N/A         | 1.8         | 1.8         | 1.8         | 1.8         |
| ROCE (%)                    | N/A         | 2.6         | 3.4         | 3.4         | 3.4         |
| Int. Cover (x)              | 12.2        | 5.3         | 3.1         | 3.1         | 3.0         |

Source: Company, DBS Bank

**Balance Sheet (US\$m)**

| FY Dec                               | 2021A        | 2022A        | 2023F        | 2024F        | 2025F        |
|--------------------------------------|--------------|--------------|--------------|--------------|--------------|
| Investment Properties                | 1,441        | 1,424        | 1,430        | 1,435        | 1,441        |
| Other LT Assets                      | 1.14         | 154          | 154          | 154          | 154          |
| Cash & ST Invt                       | 20.1         | 25.2         | 23.8         | 27.8         | 31.3         |
| Inventory                            | 0.0          | 0.0          | 0.0          | 0.0          | 0.0          |
| Debtors                              | 3.49         | 7.14         | 3.86         | 3.90         | 3.92         |
| Other Current Assets                 | 4.09         | 2.16         | 2.16         | 2.16         | 2.16         |
| <b>Total Assets</b>                  | <b>1,469</b> | <b>1,613</b> | <b>1,614</b> | <b>1,624</b> | <b>1,633</b> |
| ST Debt                              | 0.0          | 0.0          | 0.0          | 0.0          | 0.0          |
| Creditor                             | 10.5         | 20.6         | 11.6         | 11.7         | 11.8         |
| Other Current Liab                   | 7.05         | 5.34         | 5.57         | 5.60         | 5.61         |
| LT Debt                              | 341          | 495          | 501          | 507          | 513          |
| Other LT Liabilities                 | 3.40         | 14.6         | 14.6         | 14.6         | 14.6         |
| Unit holders' funds                  | 957          | 935          | 932          | 929          | 926          |
| Minority Interests                   | 150          | 142          | 149          | 156          | 163          |
| <b>Total Funds &amp; Liabilities</b> | <b>1,469</b> | <b>1,613</b> | <b>1,614</b> | <b>1,624</b> | <b>1,633</b> |
| Non-Cash Wkg. Capital                | (9.9)        | (16.6)       | (11.1)       | (11.2)       | (11.3)       |
| Net Cash/(Debt)                      | (321)        | (470)        | (477)        | (479)        | (481)        |
| <b>Ratio</b>                         |              |              |              |              |              |
| Current Ratio (x)                    | 1.6          | 1.3          | 1.7          | 2.0          | 2.1          |
| Quick Ratio (x)                      | 1.3          | 1.2          | 1.6          | 1.8          | 2.0          |
| Aggregate Leverage (%)               | 23.7         | 34.8         | 35.0         | 35.3         | 35.6         |

Source: Company, DBS Bank

## Digital Core REIT

## Cash Flow Statement (US\$m)

| FY Dec                     | 2021A         | 2022A        | 2023F         | 2024F         | 2025F         |
|----------------------------|---------------|--------------|---------------|---------------|---------------|
| Pre-Tax Income             | 49.6          | 45.1         | 41.9          | 42.1          | 42.2          |
| Dep. & Amort.              | 0.0           | 0.0          | 0.0           | 0.0           | 0.0           |
| Tax Paid                   | 0.0           | 0.0          | 0.0           | (5.6)         | (5.6)         |
| Associates & JV Inc/(Loss) | 0.0           | 0.46         | 0.46          | 0.46          | 0.46          |
| Chg in Wkg.Cap.            | 2.10          | 3.64         | (11.1)        | 0.09          | 0.04          |
| Other Operating CF         | 9.51          | (14.4)       | 9.71          | 9.77          | 9.82          |
| <b>Net Operating CF</b>    | <b>61.2</b>   | <b>34.8</b>  | <b>41.0</b>   | <b>46.8</b>   | <b>46.9</b>   |
| Net Invnt in Properties    | 0.0           | 0.0          | (5.8)         | (5.9)         | (5.9)         |
| Other Invnts (net)         | 0.0           | (2.2)        | 0.0           | 0.0           | 0.0           |
| Invnts in Assoc. & JV      | 0.0           | (68.9)       | 0.0           | 0.0           | 0.0           |
| Div from Assoc. & JVs      | 0.0           | 0.0          | (0.5)         | (0.5)         | (0.5)         |
| Other Investing CF         | 0.0           | (86.1)       | 0.0           | 0.0           | 0.0           |
| <b>Net Investing CF</b>    | <b>0.0</b>    | <b>(157)</b> | <b>(6.3)</b>  | <b>(6.3)</b>  | <b>(6.3)</b>  |
| Distribution Paid          | (46.2)        | (26.7)       | (42.0)        | (42.4)        | (43.0)        |
| Chg in Gross Debt          | 0.0           | 148          | 5.78          | 5.85          | 5.88          |
| New units issued           | 0.0           | 1.15         | 0.0           | 0.0           | 0.0           |
| Other Financing CF         | 0.0           | (5.7)        | 0.0           | 0.0           | 0.0           |
| <b>Net Financing CF</b>    | <b>(46.2)</b> | <b>116</b>   | <b>(36.2)</b> | <b>(36.6)</b> | <b>(37.1)</b> |
| Currency Adjustments       | 0.0           | 0.01         | 0.0           | 0.0           | 0.0           |
| Chg in Cash                | 15.1          | (6.1)        | (1.4)         | 3.97          | 3.45          |
| Operating CFPS (US cts.)   | 5.25          | 2.76         | 4.59          | 4.10          | 4.08          |
| Free CFPS (US cts.)        | 5.44          | 3.08         | 3.10          | 3.59          | 3.57          |

Source: Company, DBS Bank

## Target Price &amp; Ratings 12-mth History



Note: Share price and Target price are adjusted for corporate actions.

| S.No. | Date of Report | Closing Price | 12-mth Target Price | Rating |
|-------|----------------|---------------|---------------------|--------|
| 1:    | 21 Nov 22      | 0.58          | 0.90                | BUY    |
| 2:    | 03 Feb 23      | 0.68          | 0.90                | BUY    |
| 3:    | 28 Jul 23      | 0.51          | 0.90                | BUY    |

Source: DBS Bank

Analysts: Dale LAI

Derek TAN

DBS Bank recommendations are based on an Absolute Total Return\* Rating system, defined as follows:

**STRONG BUY** (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

**BUY** (>15% total return over the next 12 months for small caps, >10% for large caps)

**HOLD** (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

**FULLY VALUED** (negative total return, i.e., > -10% over the next 12 months)

**SELL** (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

\*Share price appreciation + dividends

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Dissemination Date: 3 Nov 2023 06:40:24 (SGT)

Sources for all charts and tables are DBS Bank unless otherwise specified.

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