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The Best-Kept Secret in Asset Classes

ATLANTA—Data-center sale/leasebacks make sense for investors who are seeking limited tenant turnover, high cap rates and TIs that keep the property current and are often paid for by the tenants, Colliers' Tim Huffman tells GlobeSt.com EXCLUSIVELY.

By Carrie Rossenfeld

ATLANTA—**Data-center sale/leasebacks** make sense for investors who are seeking limited tenant turnover, high cap rates and TIs that keep the property current, **Colliers International** EVP **Tim Huffman** tells GlobeSt.com. Those TIs are also often paid for by the tenants. While not one of the most talked about property types in **commercial real estate**, data centers are highly sought after as sale/leasebacks by a number of **REITs** attracted to their low maintenance and strong yields.

The core drivers creating interest from investors in data-center sale/leasebacks start with the tenant profile: a company with a mission-critical operation—describing hardware or software that's vital to the functioning of an organization—in a building. "It's a very sticky kind of tenant," Huffman explains. "It's very disruptive for tenants to move their IT equipment. When an **investor** owns a building like this and has 15 to 20 years on a lease, it's a pretty good bet that the tenant—and it's usually a credit tenant—will not leave and will invest a lot of money in the building."

Huffman gave the example of a data-center building he is selling for a client where the tenant spent $20 million in the last five years simply improving the building. "Now the lease is up, and the TIs belong to the landlord. It creates a good opportunity for the next tenant moving in."

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What's the motivation for a tenant to invest so much in improvements only to leave shortly thereafter?

"An exit shortly after a big investment by a data center tenant is not common. But, IT strategies change, business environments change. It's a very fluid world that the data center environment must react to. Sometimes the data center can be a very wasteful bucket of mis-placed cap-ex spend," says Huffman. "And for investors, it's a beautiful thing: the building is enriched, the tenant is probably not going to leave, but if they do exit, they will leave behind some valuable tenant improvements."

If regular, tenant-sponsored improvements weren't enough to attract investors to this asset class, the high **cap rates** due to rising prices per square foot make it even more enticing. Prices range from the low $200s to $400 per square foot, and cap rates can run from the mid-6s up to low 8s, depending on the credit of the tenant, says Huffman. "What will drive the big spread in prices is the age of improvements—when was it last updated and on what level is it being done? And what drives the changes in data center infrastructure is that IT gear keeps changing, requiring more power and less space. The A/C systems, chillers, etc., that make a data center work are reactive to the latest IT trends, and the price per square foot goes up."

The other thing that can rise in data-center sale/leasebacks in conjunction with sale price is rental rates. When an owner is selling and then leasing back a property, their tolerance in rent per square foot can affect the sale price, along with how current the TIs are, says Huffman.

Strong data-center-industry markets geographically tend to be near NFL cities: Silicon Valley, New York/New Jersey, Northern Virginia, Atlanta, Dallas, Chicago and Phoenix. "Those are the leading data-center markets, but the sale/leaseback investor is less focused on market and more so on the income and quality of the asset," says Huffman. "Either the tenant wants to **lease** the whole thing back, or it's a partial sale/leaseback, which allows the new owner to engage a data center operator to lease up the balance of the building. Data center sale/ leasebacks don't have to be in a top market—Cincinnati, Cleveland and Charlotte would compete just as well against the major city markets. Some of the leading investors in the data-center sale/leaseback space include REITs like **Carter Validus Mission Critical REIT**, a premier investor focused on data centers and **healthcare** facilities with an infrastructure that's mission critical; **GI Partners**; and **H5 Data Centers**. "In some cases, we'll even see a data-center operator that's a publicly traded REIT doing a sale/leaseback—**QTS Data Centers, CyrusOne** and **Digital Realty Trust** are more data-center operators and opportunists when it comes to a sale/leaseback," says Huffman.

Some companies consider a data-center sale/leaseback because they just don't want to be in the data-center business anymore, so they're trying to monetize their asset and bring some cash back into the business. "They're willing to submit to a long-term lease arrangement in exchange for cash, or they're in need of an upgrade and can use this as an opportunity to put their hand out for TI dollars," Huffman explains. "It's a way to get **cap-ex** for the improvements and monetize the asset at the same time."

"And the investor isn't the only beneficiary of these types of transactions. The seller in a sale/leaseback gets the best of both worlds—rather than move, they get their improvements, monetize their assets and and they can even outsource facilities maintenance."

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