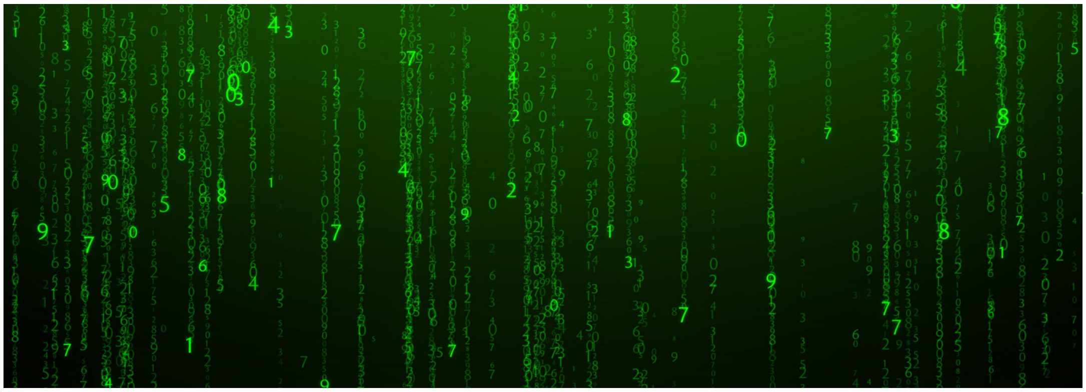
Securitizing the Digital Present & Future

Investing in Data Center Asset-Backed Securities (ABS)

Stephan Diaz Ellinghaus & Phil Gioia, CFA | October 2024



Summary

- **Industry Update:** Data centers are crucial for everyday activities. Demand seems insatiable, and supply faces challenges. Vacancy rates are low, and rents are high.

- **Data Center Asset-Backed Securities (ABS):** Data center securitizations are on track to hit record issuance in 2024, with more than $8 billion expected. The total data center ABS market outstanding could reach $50 billion by 2027, up from $25 billion in 2024.

- **Investment Opportunities:** DoubleLine sees a compelling case to invest in data center ABS. We see the present environment as a good opportunity to access high-yielding investment opportunities with modest risk.

- **DoubleLine's Capabilities:** As an early adopter in Infrastructure ABS in general and data center ABS in particular, DoubleLine possesses expertise and experience in identifying, valuing and managing investment opportunities in this space.

Booming Demand for Data Centers

Data centers play a crucial role for all members of the digital economy by providing the infrastructure necessary to support the technologies that are now critical to people's everyday lives. This holds true for both established applications (e.g., email, messenger, streaming, social media) as well as emerging ones (e.g., machine learning (ML), virtual reality (VR), augmented reality (AR), artificial intelligence (AI)).

As a result, the need for data center infrastructure is growing rapidly. Data center capacity doubled between 2020 and 2024 and is expected to at least double again by 2030.[1] The primary driver for this rapid expansion is the rise in demand for digital applications. For example, ChatGPT, a chatbot that employs both ML and AI, needs between 10 to 25 times as much computing power and electricity per search than a regular Google search.

However, expansion of data center supply is constrained by availability of reliable power generation and transmission bottlenecks. And supply constraints are not expected to abate any time soon since it can take a decade to site, permit and build power plants and transmission lines. Not surprisingly, although colocation data center capacity has doubled since 2020, vacancy rates still dropped to record lows from 10% to 3% in primary markets and rents increased by more than 40% during that same span. *(Figure 1)*

Data center tenants are sticky customers to begin with, and with demand growing and few relocation options available, that stickiness is growing even more pronounced. We see tenants re-leasing the same space at higher rates rather than signing up with new facilities.

Investments in digital infrastructure, including data centers and energy resources, is shifting from venture capital and retained earnings to credit markets, including securitized financing such as asset-backed securitizations. The data center ABS market is currently at $25.2 billion outstanding. As data center capacity is expected to double from 40 gigawatts (GW) to 79GW by 2027, it is reasonable to expect the size of data center ABS also to double to $50 billion outstanding by 2027 (equivalent to a 20% compound annual growth rate). *(Figure 2)*

Colocation Data Center Rent & Vacancy | As of Aug. 19, 2024

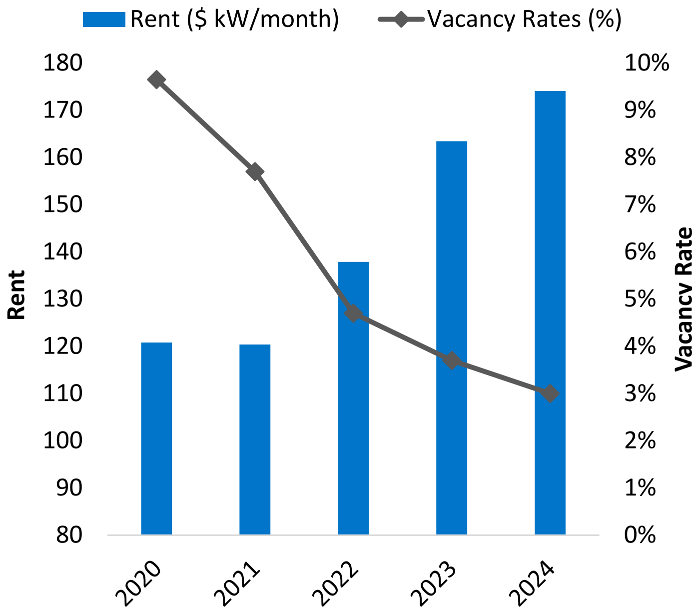


Figure 1
Source: DoubleLine, CBRE

Data Center ABS Potential Market Size | As of Aug. 31, 2024

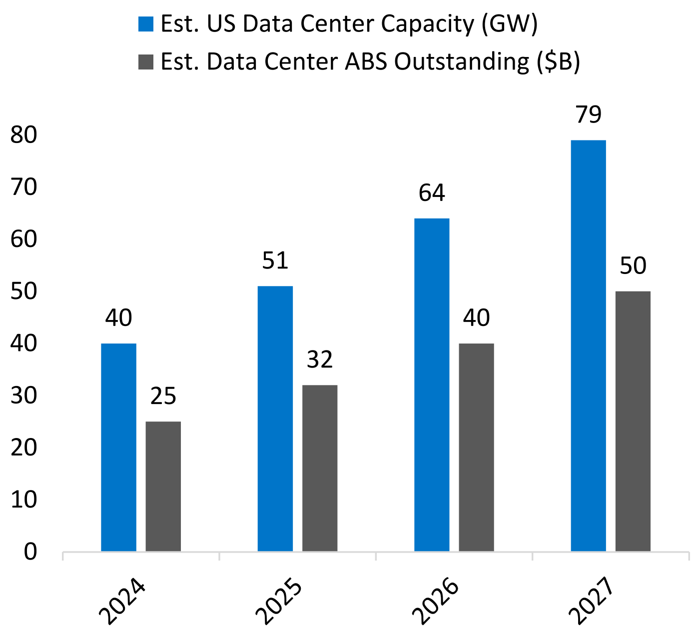


Figure 2
Source: DoubleLine, Morgan Stanley, Intext

The Case for High-Yielding Data Center ABS

Considering the industry's dynamics (high demand, constrained supply, historically low vacancy rates and high rents), DoubleLine sees a compelling investment case for data center ABS across the capital stack. The collateral consists of data centers with medium- and long-term leases and high-quality tenants.

The senior-most tranche in the payment waterfall (or Class A) is higher rated, generally provides the most resilient and stable cash-flow profile and (as of the time of this writing) carries a spread in the mid-high range of 100 basis points (bps). *(Figure 3)*

Data Center ABS, Illustrative Capital Structure
As of Oct. 11, 2024

	Spread (bps)	Yield (%)	LTV	Rating	WAL (Years)
Class A	Mid-High 100s	Mh5%	50-65%	A	~5
Class B	Mid-High 200s	Mh6%	60-70%	BBB	~5
Class C	Mid-High 500s	10%	65-75%	BB	~5

Figure 3
Source: DoubleLine
Weighted average life (WAL)

In our view, however, the subordinate and mezzanine tranches (Class B and C) currently offer the most attractive risk-adjusted return profiles. Like the senior tranches, the subordinate tranches are generally resilient to stress cases and benefit from the same industry dynamics and sticky client base and have more attractive spread and yield.

Subordinate tranches can generally withstand a 20-30% permanent drop in Net Operating Income on day one without disrupting bond cash flows. We view stress of that magnitude as highly unlikely given the industry dynamics. Moreover, 80% of the data centers under construction are already pre-leased, even though some will not be operational for another four years.[2]

While the tailwinds for data center demand are likely to remain strong, risks are associated with the space. Perhaps most obvious, the industry could be overbuilding capacity. However, given the power and transmission infrastructure bottlenecks and the booming demand from all sectors, we do not see a plausible path for overcapacity in the near- to mid-term future.

Another risk would be a mass exodus to the public cloud. This would particularly impact colocation business models. That said, data center cloud capacity is a zero-sum game. Whether companies deploy workloads in private, public or hybrid clouds, all require data center infrastructure.

Finally, demand from the AI boom and other compute-intensive applications could be overstated, resulting in lower-than-expected future demand. While this risk bears watching, we believe the world is in the early innings of the development of data center infrastructure and adoption of applications will continue to grow.

DoubleLine in Infrastructure ABS

In our view, the biggest risk to data center investing is idiosyncratic risk, i.e., the risk that a given data center or pool of data centers is unfit to meet the demands of its tenants. This is where DoubleLine's industry expertise and experience are critical in identifying compelling opportunities, especially when early in their investable trajectories. As an early adopter in the digital infrastructure space, DoubleLine has developed substantial know-how and skill sets to assess the market and individual opportunities. We track performance and data of all data center ABS issuers to stay well informed and ready to identify accretive investment opportunities.

DoubleLine's ABS team members have an average of 18 years' experience managing ABS and infrastructure debt. The DoubleLine ABS team invests across the credit spectrum and capital structure; participates in direct originations; and maintains deep working relationships with the industry's top lenders, owners and operators. ■

About the DoubleLine Asset-Backed Investment Team

The Asset-Backed Securities Investment team manages $5.2 billion in ABS investments as of the close of the third quarter 2024. Its seven members have worked together since 2013 and, among other professionals, call upon the additional support of 60 corporate and structured-products analysts and 21 risk analysts at DoubleLine. DoubleLine enjoys captive sourcing channels including securitizations of financings of data centers and other telecommunications infrastructure. The team has extensive experience in public and private ABS markets across the risk spectrum.

About the Authors

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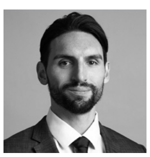
Mr. Diaz joined DoubleLine in 2021 as a Specialist on the Global Infrastructure Investments/Asset-Backed Securities team. He is also part of DoubleLine's ESG Investment Task Force, responsible for the ESG integration framework for the Global Infrastructure Investments/Asset-Backed Securities group. Prior to DoubleLine, Mr. Diaz was with Nomura Securities International as an Executive Director. Previous to that, he was with Norddeutsche Landesbanak Girozentrale as a Director. Mr. Diaz holds a B.A. in Economics from Instituto Tecnologico Autonomo De Mexico and an MBA in Business Administration from New York University.



Phil Gioia, CFA
Client Portfolio Manager

Mr. Gioia joined DoubleLine in 2018 and serves as a Client Portfolio Manager. In this capacity, he is responsible for communicating DoubleLine's macroeconomic views and portfolio positioning via client engagement, published market commentary and dedicated strategy content, with a focus on DoubleLine's Securitized Product strategies. Prior to DoubleLine, Mr. Gioia was an Investment Product Manager for Fidelity Investments. He holds a B.S. in Financial Management and Business Administration with a minor in Accounting from Salve Regina University, and he earned a certification for the Applied Data Science Program from the Massachusetts Institute of Technology. Mr. Gioia is a CFA® charterholder and holds the FINRA Series 7 and 63 licenses.

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DoubleLine ETFs are distributed by Foreside Fund Services, LLC.

Endnotes

[1] "The AI Angle of ABS: Data Center ABS to Double by 2027," Morgan Stanley, Sept. 23, 2024

[2] Carol Ryan, "Everyone Needs Space at the Data Center," Wall Street Journal, Aug. 23, 2024

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