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Opportunity knocks for build-to-suit data centers

Hyperscalers' growth is outpacing in-house delivery capabilities, with third-party providers set to capitalize on bespoke data center demand.

Alicia Villegas - 5 hours ago

The AI boom – along with the growing need for cloud services – is driving massive demand for hyperscale data centers, catching the eye of private real estate investors eager to support this unprecedented expansion. Build-to-suit data centers will proliferate.

The growth of the data center sector is extraordinary. Bloomberg Intelligence projects the generative AI market will grow to \$1.3 trillion over the next 10 years, from a market size of just \$40 billion in 2022. This, along with significant increases in the use of cloud services, 5G technology and the Internet of Things, is likely to have a profound impact on the global data center landscape.

The market for hyperscale data centers worldwide is predicted to reach \$593 billion by 2030, representing a 28.42 percent CAGR, according to Precedence Research. Meanwhile, 120-130 hyperscale data centers will come online each year over the next decade, according to Synergy Research Group.

While hyperscale providers have in the past focused on building and maintaining their own data centers to meet most of their needs, the surge in data center demand has outpaced their self-build capacity, driving a rise in build-to-suit deals with data center providers. These arrangements have also proliferated given the supply-demand imbalance created by little existing speculative data center vacancy around the globe.

“We have the cloud [driving data center demand] and now, since about 18 months ago, there is a new wave of demand coming from the world’s largest technology companies, who are investing hundreds of billions of dollars in AI. So, over the last year, we started getting all these calls to build the next wave of capacity [facilities],” says Jordan Sadler, senior vice-president, public and private investor relations, at Digital Realty. “This is where the opportunity is right now for those who can seize it.”

× Eyes on the prize

According to CBRE's *2024 Global Data Center Investor Intentions Survey*, looking 12-24 months ahead, 31 percent of respondents believe the best opportunity in the data center sector lies in hyperscale build-to-suits. This represents almost no change from last year's survey but is a significant increase from 22 percent in 2022 and 17 percent in 2021.

"Given the sheer size of [build-to-suit] deals and the investment tenant credit of the hyperscale customers, these are highly financeable assets and are understandably attracting significant investor interest, which is likely to lead to some cap rate compression, particularly if and when interest rates fall," says Paul Mortlock, head of European data center capital markets at CBRE.

Additionally, the shortage of available stock for sale or investment is driving the increase in build-to-suit deals. Chris Curtis, global head of data centers at Prologis, explains that most existing stabilized data centers are customer-owned and developed, or developed and owned by platform data center companies.

These platform companies, often funded by private equity, are focused on aggregating and creating a portfolio of data centers with the intent to eventually sell the portfolio, while publicly traded companies plan to hold their assets long-term. "Therefore, there are not a lot of individual data center projects available for sale or investment," he says.

Data center developers and operators that want to capitalize on this market opportunity recognize that building hyperscale data centers is a capital-intensive process. However, a build-to-suit transaction is considered a lower-risk investment.

"With a build-to-suit, the tenant typically commits to a minimum 10-year lease term, often 12-15 years with multiple renewal options, prior to the developer investing in vertical construction," says Jim Footh, managing director, data center investments and portfolio management, at PGIM Real Estate.

"With a pre-commitment by a tenant, developers/operators are typically able to secure more attractive construction financing terms than speculative construction, due to not having leasing risk."

In addition, build-to-suit arrangements also offer resilience during economic downturns.

"Hyperscalers require bespoke customized facilities with sizable capacity, which implies long-term leases providing predictable, stable cashflow," says Craig Duffy, global head of fund management at GLP Capital Partners. "The demand for digital infrastructure tends to remain stable or even increase during economic downturns, as businesses and consumers rely more heavily on digital services. This resilience makes hyperscale data centers an attractive investment across various economic cycles."

With lower risk, however, build-to-suit lease rates and returns on investment are typically lower than in pre-built data center deals because the rental rate for build-to-suits is based on development costs, which are usually below market rates at the time the project is completed. Thus, in a build-to-suit transaction,

the rent is typically calculated using a “yield-on-cost” model, where the monthly rent is a pre-agreed markup on the developer’s total development costs.

Footh notes: “With market rents rising on average 10 percent per year, a build-to-suit generally results in a lower net rental rate for the tenant.”

Data center landlords are still getting higher rental rates when it comes to leasing pre-built space in a shared facility to several tenants – although rents for scale data centers and hyperscale build-to-suits are catching up because of scarcity of this type of product, Digital Realty’s Sadler says. “In Northern Virginia, for instance, scale data center rents have more than doubled since the end of 2021,” he notes.

Build-to-suits vs co-location

For tenants, the most obvious advantage of build-to-suit facilities is their customization, since these data centers are tailored to meet their specific needs and requirements.

“Build-to-suit data centers allow for the incorporation of specific technological requirements that are unique to a hyperscaler’s operations, such as advanced cooling techniques for high-performance computing or dedicated spaces for special hardware like GPUs for AI processes,” GLP’s Duffy says. “This level of customization is crucial for companies whose operations depend on cutting-edge technology and cannot be efficiently accommodated in a shared facility.”

Hyperscalers are also subject to stringent regulatory requirements that vary by region, including data sovereignty laws. “Build-to-suit data centers can be designed to meet these specific legal and compliance requirements, offering a tailored solution that shared facilities cannot match,” Duffy adds.

PGIM’s Footh notes that build-to-suit arrangements make sense when the tenant has a capacity need in a given location where they don’t have the ability to meet their own customer demand by building themselves – assuming they have internal development capabilities – and they can spare the roughly 24-plus months required for ground-up development and related power procurement. “However, when the hyperscale tenant’s capacity needs are sooner than 24-months, then a build-to-suit will not deliver the capacity in time,” he says.

When time is of the essence, leasing pre-built data center space from data center operators – known as co-location – makes more sense for hyperscalers needing to procure data center space. A key benefit that co-location facilities offer developers and operators is that they can house multiple tenants, which enhances market competitiveness and diversifies the owner’s revenue sources, reducing dependency on a single client.

While partnerships with hyperscalers are crucial when it comes to build-to-suit deals, their sheer size could give them significant leverage. “If we lease a billion-dollar building to a single tenant for seven years and they no longer need it, finding a new tenant could be challenging. We mitigate this by building in locations with multiple potential customers and depth of demand,” Digital Realty’s Sadler says.

For CBRE’s Mortlock, leasing risk in build-to-suits is minimal. “The churn rate in the sector is really low: less than 2 percent. Almost all the tenants renew their

leases at the end of the term because these buildings become critical to them and their work,” he says.

The case for speculative data centers

Some investors are comfortable commencing construction without a pre-let, with the expectation of contracting higher market lease rates than available through a build-to-suit

PGIM is one company in the process of commencing vertical construction without a pre-let to a tenant or tenants. Jim Footh, managing director, data center investments and portfolio management, at PGIM Real Estate, explains that, within Tier 1 data center markets globally, there is a severe supply-demand imbalance where demand is outstripping the ability of both the hyperscale tenants to build themselves to meet their customer demand, or the ability of developers/operators to build capacity fast enough to meet the hyperscale tenant demand from a leasing standpoint.

“Thus, for data center developments in the right location and with power availability within roughly 24-30 months, developments that are under vertical construction are often experiencing competition among tenants to lease this data center capacity. Under this scenario, these developments are being leased at generally the higher market rental rates at that time, versus a lower rental rate calculated on yield-on-cost basis with a build-to-suit,” he says.

According to Paul Mortlock, head of European data center capital markets at CBRE, an investor buying land and speculatively building a data center with the expectation to lease it to a data center tenant could expect a return in excess of 20 percent. Meanwhile, a data center leased to a hyperscale tenant on a long-term lease would be a less risky investment, corresponding to high single-digits returns.

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