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Digital Realty Trust (DLR)

While researching this particular realty trust, I wondered why REITS are segmented for particular tenants, such as tech based, or health related business. Do these particular REITS provide both a real estate and sector exposure? I found it interesting that these REITS invest in sectors rather than a mixed bag of quality tenants.

101 buildings, including data gateway centers, in 31 metro areas, primarily in the US. 18.3mm rentable sq. feet, 2.4mm for redevelopment. CenturyLink, Equinix (which we wrote a piece on in November 2012) and Facebook are the main tenants. $2.9BB in debt and $1.2BB in revolving credit available.

Cashflow is tremendous. $1BB in revenue, EBITDA is $600MM and interest expense is $150MM. Operating cash flow is running around $400 MM. EBITDA/Interest, or interest coverage is 4x. The co. could choose to generate a similar level of cashflow, but they have been acquiring new buildings and the co. could finance the new acquisitions through debt financing. Should the co. continue to pursue new acquisitions at the current pace, or a larger scale, we are concerned about solvency issues. In particular, between 2012 and 2015, a sizable number of leases are expiring and we wonder if the co. could sign new tenants at a similar lease rate, or may have to cut rates to attract tenants, which will reduce cash flow. With equity or fixed income portfolio management, a main concern is reinvestment risk. For RE portfolio management, the main concern is finding new tenants when leases expire. The leases don't seem like it is for a long period –maybe 5 years, so it's like operating a bond portfolio with 5 year maturities.

When calculating the operational spread, or the return from assets purchased through debt financing compared to the cost of debt financing, we must use comparable figures. Let's assume, the co. borrowed $1BB at an annual cost of 5%, or $50MM, in interest. If the assets purchased using the $1BB generates EBITDA, or cashflow before accounting for the next expense line, which is interest cost, greater than the interest, then we can anticipate a higher book value in years to come. We believe DLR is realizing positive net interest margin spreads and will continue to acquire new buildings, since financing costs are very low on a historical basis, and the yields, or cap rates are higher than the financing cost, with potential to realize capital gains as the commercial real estate market strengthens. Also, the Trust issues new common shares, which dilutes the ownership, but with regards to the cost burden on operations, it is mitigated, so financing through equity participation is also reducing the cost of financing.

Building book value is $5.25BB and EBITDA in 2011 was $600MM, or an EBITDA/Building return of 11.4%. $150MM interest on $2.8BB debt is 5.4%. So, the trust is realizing a 6% NIM spread, which may narrow should 1) the cost of debt rise and 2) new tenant lease rates fall when signing new contracts during the current down market.