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Structured Finance Is Playing a Key Role as the Capital Demands of Data Center and Power Build-Outs Balloon

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Key Points

– The enormous sums of capital needed to build the data center and power infrastructure for AI have led developers to employ a variety of structured financing tools to appeal to lenders and investors while minimizing capital costs.

– Capital sources range from private capital funds that seek equity positions to banks that make project finance-style loans, as well as various hybrid structures and asset-backed securities.

– The structures cater to different types of investors, from insurers who will buy very long-term debt to sponsors, who may seek equity engineered to put a floor under their returns while allowing them to capture potential upside.

As the global data center and related power infrastructure build-out continues at an unprecedented pace, the magnitude of the required capital is measured not in millions or billions but in trillions of dollars. J.P. Morgan recently estimated that at least $5 trillion will be required to fund the scale of the data center, artificial intelligence (AI) and related power infrastructure now contemplated.

With such vast capital needs, no one product or market is deep enough to finance all that growth. Participants in this process face balance sheet considerations and must choose the right type of capital for their circumstances.

As a result, developers are increasingly tapping multiple pockets of liquidity across different layers of the capital stack in order to fund their investments. In addition to the traditional — and still very liquid — bank project finance market, developers are increasingly turning to structured equity products, institutional debt and the asset-backed securities (ABS) market.

Structured Capital Solutions

Equity Investments

For developers seeking to limit the debt on their balance sheets, structured equity capital is a growing source of financing for data center projects. These products typically take the form of a joint venture between one or more financial investors and the developer (which in the data center space may be the hyperscaler tenants themselves).

Economic terms can range from common equity to preferred equity, or a hybrid, with most transactions providing some degree of protected return to the financial investor.

A key feature of most of these transactions is that the financial investor raises back leverage debt capital. The availability and pricing of such debt is driven by the extent to which the financial investor's equity return is protected under the joint venture governance documents (and associated project-related agreements).

The back leverage capital is typically a combination of bank and bond products, with longer tenor bond products becoming the "permanent" back leverage for these investments.

Benefits of this structure include:

- Collaboration on a project among multiple well-known players, which can help with project credibility.
- The creation of access to deep pools of capital for a project.
- Desirable pricing and returns for participants.

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- For financial investors, multiple exit options across different investment levels.
- For the developer, significantly less debt on its balance sheet.

For financial investors, the key risks of these transactions are counterparty and project risk. For developers, it is adverse accounting or ratings outcomes. With appropriate structuring, these risks can be mitigated or quantified.

Once a project is stabilized (*i.e.*, operating), another option for recycling capital is a yieldco structure involving one or more equity investors seeking exposure to high-quality cash flows. While there are recent examples in the data center space, the volume of yieldco deals has been limited due to a valuation gap arising from many existing leases having been signed during a period of historically low interest rates. As newer leases come online and that bid-ask spread narrows, we may see more of these yieldco structures.

Debt Finance

Bank project financing remains the go-to source of capital for new build data centers and energy generation projects. Within the bank finance space, developers are increasingly turning to borrowing base facilities as a source of flexible capital, allowing stabilized data centers to be pooled with those under construction in order to provide a ring-fenced borrowing base that increases the capital available as the portfolio grows.

This is typically not long-term capital, though, so a key question in the market today is what will finance billions (or trillions) of dollars in long-life assets for their useful lives. Structured equity capital transactions like those described above are one answer, but even that capital is typically funded with debt of its own.

We see three types of debt products being utilized as permanent capital: institutional notes, securitized notes and private capital.

Institutional notes, typically issued via a private placement to institutional investors such as insurance companies, are an attractive source of capital, and a source that has long been heavily invested in similar energy infrastructure assets. These notes typically have long tenors, fixed interest and a relatively flexible covenant package. While they need not be rated, they typically are (and a rating is typically required to be maintained, though not at a particular level). A key to accessing this market is for an asset to be operating and substantially derisked, which makes stabilized data centers an ideal asset class.

The ABS and commercial mortgage-backed securities (CMBS) markets have been another frequent source of capital to refinance stabilized data centers in the U.S. Following two recent successful data center ABS transactions in Europe, we expect to see more of these transactions in Europe going forward.

Private capital is already widely available, and we see that continuing to be the case. Typically structured as preferred equity or mezzanine debt, this form of capital is less risk-averse than the note and ABS and CMBS markets described above. As a tradeoff though, tenors, advance rates and pricing are not as favorable.

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