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New Recommendation: Digital Realty Trust Inc. (DLR)

Position: Buy **Date: October 14, 2013**

Recent P/E: 10.3 (ftm consensus) **Recent Price: $53.00** **Dividend Yield: 5.9%**

Summary:

Digital Realty Trust Inc. is a REIT that builds buildings specifically designed to house large scale data centers. DLR typically leases these buildings on a long term basis to clients who subsequently install their own set of computer servers. The buildings required to house data centers have certain specific requirements that are quite different from other commercial space, such as office, warehouse or retail. These special requirements include large amounts of very high reliability electrical power, proximity to fiber optic data transmission corridors, low vehicle traffic, good shipping facilities but virtually no parking, etc. DLR was the first major player in this market, which has since attracted two other dedicated competitors.

The data center market is experiencing very good growth with the continued increase in computing services being required by virtually every corner of modern society. DLR offers an attractive asset proposition for many large scale private clients, who would rather deploy their capital on strategic assets rather than on ancillary buildings.

Since 2011, Internet Protocol (IP) traffic has increased at a rate of over 29% annually. Most of IP traffic is handled at a large data center, like those housed in DLR buildings. With the continually increasing use of mobile devices and cloud computing, there does not seem to be any sign that growth in IP traffic will subside.

This past July, DLR announced what appears to be a very minor change in their accounting practices, whereby they capitalized certain costs that were previously expensed. These accounting changes boosted current quarter earnings by less than $2 million. The change, however, seemed to spook investors. The stock is now down 30% from the July highs while the overall S&P 500 is up about 5%. To be fair, part of the downward pressure could also be ascribed to Fed tapering rumors, which are assumed to portending higher capital costs for DLR.

We believe the negative impact on the stock price to be unfounded and look to adding DLR to income oriented portfolios to take advantage of a 6% yield along with the possibility of good capital protection and some potential capital gain.

There are a number of positive factors which support the conclusion above.

1) Insider Purchases: Recently, the Chief Financial Officer completed the purchase of 10,000 shares of common stock for a total price of $550,000. There have been no recent insider sales. If anyone knows the impact of changes to financial reporting practices, it would be the company CFO. Clearly, he believes that the share price decline due to the changed accounting practice is oversized.

2) Balance Sheet Strength: Digital Realty has increased its stockholder equity from $1.962 billion on December 31, 2010 to $3.468 billion on December 31, 2012. Stockholder equity has edged up to $3.547 billion in the most current quarter ended June 30, 2013. In August of this year, they have completed a $3 billion revolving credit financing. The most recent refinancing reduced the overall cost by just over 20 basis points. In October, 2013, Digital Realty completed a $369 million joint venture with Prudential Real Estate Investors whereby Digital Realty contributed nine data centers with just over 1 million ft sq of property. The joint venture will be owned 80% by Prudential and 20% by Digital Realty, with Digital Realty retaining operating responsibility for the properties. The joint venture arranged a $185 million unsecured bank loan and Digital Realty realized $328.6 million of net proceeds.

3) Dividend Growth: The company has consistently increased its dividend from $1.47 in 2009, to $2.02 in 2010, to $2.72 in 2011, to $2.92 in 2012. They are on track for a dividend in 2013 between $3.12 and $3.25. Income and operating fund flows have grown similarly over the period.

4) Business Operations

    a. Market Growth: Since 2011 traffic over the internet has grown by 29% annually. All of this traffic is processed through data centers, similar to those which are housed in Digital Realty properties. Overall revenue of Digital Realty's largest customer, CenturyLink, tripled in 2009 vs 2008. Their revenues doubled again in 2011 compared to 2010 and have shown an increase of 12% since 2011. CenturyLink is the third largest telephone company in the US and a substantial portion of its revenue is derived from digital internet traffic. Increases in cloud computing and further penetration of smart phones point to continued growth, albeit at a slower pace going forward compared to that in the past. Growth in IP traffic alone does not guarantee growth for Digital Realty, but a company serving a growing market is in a lot better shape than one that is serving a declining one.

    b. Market Trends: DLR is expanding its data center portfolio in two directions beyond their historic business model. These directions are increased space for co-located facilities and the production of Type III certified data center modules, both of which address important market trends. The two trends are discussed below.

       Co-location: Data servers continue to become more capable and more compact, but not commensurately energy efficient. These trends support smaller data centers with more complex engineering needs. The smaller physical sized centers can meet the needs of many smaller and medium customers and a number of these smaller centers can economically be housed, or co-located, within a single facility. DLR offers these co-located facilities in numerous global locations. Development of facilities offering co-location potential is more expensive than DLR's historic model, but the increased costs should be offset by higher revenues.

Modules: DLR has recently designed and began manufacture of a data center module. This module has a Tier III classification by the Uptime Institute, the recognized authority on data center uptime in the industry. Tier III is a hard to achieve and expensive to achieve certification. DLR has spread the cost of the certification between a number of modules that they have produced and are in the process of deploying. The DLR module is unique in the industry and fits a real customer need for extremely reliable data center facility that can be quickly deployed. We suspect that a fair chunk of DLR's more recent capital expenditures were made in support of their module program.

c. Leases: Digital Realty's real estate portfolio consists of 19.5 million square feet of rentable space. Of that space, 94.4% is leased with an average rent of $93.07 per square foot. The rentable space is dispersed geographically with 133 properties located throughout the world. The largest single location is in Chicago with just over 1 million ft. sq.

   The unleased space amounts to just over 1 million ft. sq., or about 5% of their existing portfolio. The unleased space amounts to about a one year supply based on their leasing performance in 2012. In addition, the company holds about 2.5 million ft. sq of shell building space which would require significant investment to be commercially useable.

   They lease space from very small installations of 1,000 ft sq. to large facilities greater than 100,000 ft sq. There are just over 2,000 leased properties with the largest 100 property leases constituting 50% of the company revenues.

   Leases expire every year from 2013 through 2032. Through 2022, leases expire fairly regularly with no one year seeing any large lease expirations. The company's ability to execute lease renewals appears to be quite good. The annual report for 2011 shows a total of 377 leases to expire in 2012 totaling 510,232 ft sq. The most recent 10Q curiously shows that a total of 833,000 ft sq of leased space was renewed. The amount of unleased space increased only modestly from 2012 to the present (834,522 ft sq to 1,094,000 ft sq) in spite of aggressive new building during the year and an increase of total leased space from 16 million to 19.5 million ft sq from Q4 2011 to Q2 2013.

d. Lessees in good shape: All told, the leases appear to be in good shape, with good renewal rates. For the most part, Digital Realty is able to realize increased revenue on a lease renewal, but the revenue increase has mitigated from 20%+ of a few years ago to small single digit increases today. The lower rent increases signify that the overall market is not as "hot" as it was a few years ago.

5) Dividend in Good Shape: The quarterly dividends appear to be well covered. At present, the quarterly dividend is $0.78 per share. REIT's must pay out at least 90% of earnings, but most pay out higher dividends based on their cash flow – typically the Funds Flow

from Operations (FFO). These flows are then adjusted with non GAAP entries to produce an Adjusted Funds Flow from Operations (AFFO). DLR's major adjustments are for straight-line rent and recurring capital expenditures. Both adjustments have been relatively constant quarter to quarter and result in the AFFO being approximately $30 million less than the FFO.

Dividends can then be compared to AFFO to determine the "payout ratio". For DLR, the payout ratio was 95% in 2006. The ratio dropped to 65% in 2009 then bounced up a bit to 80% in 2011 and 83.8% in 2012. Through two quarters in 2013, the payout ratio is 83.6%, down just barely from 2012.

The dividend coverage looks reasonable given the long term nature of the leases, the market growth and the modest inventory.

6) Stock Price Decline: The price per share peaked in April at 74. It declined to 64 in July and down again to 51 in September 2013. It is presently trading at forward P/AFFO of 11.2x. Comparable ratios for its two principle REIT competitors are 15.7 for CoreSite Realty (COR) and 23x for DuPont Fabros Technology (DFT).

   It is interesting to look at the share prices for DLR's competitors since last April. DLR has a number of competitors, both within the REIT space as well as from construction companies with data center expertise. Every one of the competitors with publicly traded shares has seen a continuous rise in value over the past six months in contrast to DLR which has declined 30%. So what gives and why the disparity? The basic strong fundamentals of the industry have buoyed the stock prices of DLR's competitors during the past six months. Within that timed period, on May 9th, to be exact, a noted manager at a large hedge fund (Jon Jacobson from Highfields Capital) made a presentation which recommended a short of DLR. Some years ago, Mr. Jacobson warned of accounting issues at Enron and he based his short recommendation of DLR also on accounting issues. His thesis was that a large portion of DLR's capital expenditures are for maintenance capex and that these expenditures should be deducted from current earnings. Fuel for Mr. Jacobson's fire was added in DLR's Q2 earnings review where they noted a change in accounting practice which resulted in a small charge of about $2million.

   Digital Realty does indeed have higher capex than its other REIT competitors. From what we can tell, the capex is going to property improvements and additions to manufacturing capacity and that the company is realizing a reasonable return on its capital. Conversations with professionals in the data center universe confirm the finding that DLR's capex is properly accounted for.

7) Large Short Interest: Finally, there is a very large short interest for DLR. Open short sales now total 24.4% of all shares outstanding. These shares have already been sold, so their impact is already reflected in the stock decline. At some point in the next few months, these short sales will need to be repurchased, - creating a large buying influence in the stock.