LM CAPITAL GROUP
GLOBAL FIXED INCOME MANAGEMENT



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The Data Center Dilemma:

What makes a Data Center financing a good bond investment?

Investing in a data center financing involves numerous risks that can be summarized by the question of who bears the risks: the tenant or the bondholder. These risks include: who pays the operating costs; the mismatch, if any, between the lease horizon and the financing term; who bears the costs of construction delays; and who is responsible for declines in the value of the underlying asset. The tenant's name is the starting point, not the answer.

In considering a number of financings (we count approximately 15 thus far), we derive the following four lessons:

- **A famous tenant is not an investable lease.** What matters is whether a creditworthy counterparty is unconditionally liable for the rent, and whether bondholders can enforce this obligation.
- **The cost of leaving matters more than the length of the lease.** A four-year lease can support a longer-term bond if the exit costs for the tenant are equal to the outstanding debt.
- **Looming refinancing risks.** Many of the financings we have evaluated leave 70-100% of the principal to be refinanced.
- **Completion and power now set the price.** Until a building is delivered and energized, investors demand compensation for assuming these risks.

The Actual Dilemma

Hyperscalers such as Alphabet and Meta need gigawatts of capacity faster than they want to own it. Leasing from a special-purpose landlord limits nominal debt and preserves flexibility by allowing hyperscaler tenants short initial terms, the right to walk away, and the ability to terminate under certain conditions. Data center developers, on the other hand, borrow 70-95% of the project's cost, meaning that bondholders fund almost the entire project against one tenant's promise. That, in short, is the dilemma: the tenant wants the option to leave and the bondholder needs the tenant to stay. Guarantees, termination payments, residual value guarantees, actual amortization and debt service reserves are all attempts to resolve this tension. We believe a data center is investable to the extent this tension is resolved.

Six tests of investability

We have developed six tests of investability to assess these risks. A deal is investible when a party to the transaction can capably bear this risk or the bondholder is adequately compensated for bearing it.

Investment Criteria / Tests

Core institutional credit and underwriting criteria to determine asset investability

Test	Investable when	Not investable when
Who really pays?	Investment-grade tenant, or a full guarantee from an investment-grade parent that bondholders can enforce	Weak or unrated tenant; partial, springing or releasable guarantee
Can the tenant walk away?	Exit costs: the tenant pays the debt at aminimum (termination payment or residual value guarantee)	Exit for less than the debt; unpaid walk-away from a late building
Who carries running costs?	Triple net, power passed through	Gross or modified gross lease
Will it be built and powered?	Complete; or energized power, fixed-price contract, completion guarantee, fixed rent start	Construction not begun or power undetermined
What is it worth without the tenant?	Hub site, existing power, flexible design, or residual value guarantee	Remote, single-purpose site, no residual support
How is the debt repaid?	Amortizes within the committed term	Large balloon before an operating record exists

These tests are not equally weighted. An enforceable guarantee from an investment-grade counterparty and/or the existence of an adequate termination payment are critical considerations. The next two concerns focus on operations. The last two considerations focus on the so-called “ways out” analysis.

Market Structures

We have seen a wide spectrum of data center financing structures. Below, we review some of these structures and relay some of the observations we have made.

Investment Tiers / Ratings Framework

Comparative underwriting spectrum, ratings benchmarks, and credit spread profiles

Metric / Category	Best	Middle ground	Weakest
Typical form	Hyperscaler joint venture, or completed campus leased to a AAA/AA tenant	Strong tenant, campus still being built; or weak tenant with structural support	Weak tenant with no guarantee; or strong tenant with partial guarantee and cheap exit
Cost of leaving	At least the debt	Debt-sized during operation; unpaid exit if late	Below the debt, or none
Debt repayment	Fully amortizing, or bullet well inside the lease	Five-year notes, 70-100% balloon	Five-year notes, little amortization
Ratings	A+ to Baa2	Baa3 to BB	BB to BB-
Spread (OAS, Oct 2026)	295–305 bp	275–590 bp	490–870 bp
Over tenant's own bonds	65–215 bp	250–425 bp	220–555 bp

The best structures ensure that exit costs are at least equal to any outstanding debt, so a short initial lease is not necessarily a weakness. The middle ground may prove investable but requires further analysis/investigation. We would claim that financings composing the third category are either not investable or must be priced in such a way as to provide above-market compensation.

Three additional risks that often arise in these financings bear special mention and must be considered:

- **Refinancing risk.** Recent bond issues have had five- to six-year terms. Limited amortization underscores the refinancing risk.
- **Construction risks.** Some of these data centers are unbuilt. State moratoria could place financing arrangement for certain data centers at risk.
- **Tenant concentration risk.** Many of the tenants (e.g. META, Oracle) are the same.
- **Political and permitting risk.** The November 2026 midterm elections explicitly introduced a complication tied to political and permitting risk. While this concern is, in part, addressed by some of the criteria we have already suggested above, we would like to underscore potential issues, namely, the need to ensure that all construction and operating approvals, including cooling water sourcing, are in hand and that any required interconnection and/or generation permits have been granted.

Conclusion

What we consider to be data center financing dilemma resolves itself when the risks the tenant declines to assume is assumed by another creditworthy party or explicitly priced. We suggest that before investing in a data center bond that investors need to consider each of the following questions:

1. Is an investment-grade party unconditionally liable for the rent and can bondholders enforce the guarantee directly?
2. Does early termination, non-renewal, or default require the tenant to make good on the debt obligation?
3. Have all legal requirements required for operation been received?
4. Is the lease triple net, with power passed through to the tenant?
5. Is the construction complete or is the construction underway with experienced, creditworthy contractors that are responsible for any cost over-runs and delays. On a related issue, is the rent start fixed regardless of delays?
6. Could the facility be re-leased or sold for enough to repay the debt, or is the residual value guaranteed.
7. Is the debt repaid by the rent within the committed term?

A deal that answers yes to all seven questions is clearly investible. A deal that answers no to the first three is arguably not investible on structure alone. Everything else is a question of deal pricing, that is, whether the spread is sufficient for the construction, refinancing, and residual-value risks a bondholder is being asked to assume.

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