DuPont Fabros Technology, Inc. (NYSE:DFT): Short

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Important Company Financial Data

Share Price: 25.39
Market Cap: 1.61B
52-week Range: 25.21-25.49
EPS: 0.41
Beta: 0.95
EBITDA Margin: 60%
FFO: 142 M
FFO per share: 2.23

DuPont Fabros Technology

Company Description

DuPont Fabros Technology, Inc. (DFT) is a real estate investment trust (REIT). The Company is an integrated, self-administered and self-managed company that owns, acquires, develops and operates wholesale data centers.

Thesis / Key Points

- **Undiversified business and unsustainable development will hurt DFT**

  • Since data center companies are targeting at companies that depend heavily on Internet and Cloud computing and those companies are normally associated with high risks, so a diversified client base is necessary to reduce risks. DFT's top three clients generated 48.5% of the company's profit. This is really dangerous. DFT's major competitor—Digital Realty Trust Inc. (DLR)—has no client claimed over 5% of its revenue other than Century Link's 9%. DFT, with 12 facilities, only has 82 leases with 33 tenants in total, which can create a lot of uncertainties; but DLR, with 121 facilities, has over 2000 leases with over 550 tenants. CoreSite, another competitor that has 13 centers, has 750 customers with over 1500 leases.

  • DFT is only covering 4 markets in U.S. with 2M square feet of land in total; but DLR is covering 32 markets across 10 countries over North America, Asian and Europe with 22.7 M square feet of land in total.

  • I calculated electricity generated per square feet to show the efficiency. DFT has 205 W/sf, which is less than DLR's 303 W/sf.

  • DFT charges rent on power-used basis ($x per MW used) and the company treats it as a selling point, but my VAR shows that not all the data center user like this. If clients have strong data flow, they want to be charged on square feet basis ($x per sf). DLR, on the other hand, has four options for clients. Clients can choose to be charged on power basis, sf basis, or more flexible way.

  • DFT's growth is majorly driven by rents collected. This growth potential will be limited since all the data centers are running over 90% capacity. However, DLR only got 55% of its NOI growth from leasing and the rest 45% from acquisition. Although DFT and DLR have similar debt/EV, DLR has more favorable debt structure. DFT doesn't have enough cash to do acquisition.

  • DFT's facilities are really old, which already incurred a lot of costs for power cut. Out of the 9 stabilized centers, none was built last year and only one was built in 2011. However, DLR started to build a lot of its Turn-Key Flex (new generation of data center) since June 2012. Out of 2.4M sf constructions in DLR, 1.4M sf is new Turn-Key Flex.

- **The promising market for wholesale data center industry is the biggest misperception people have for DFT**

  • Firstly, it's true that whole data center industry will grow at 15% YOY for the next 5 years because of the emerging and developments of cloud computing, online gaming, Internet of things and etc. However, DFT is not able to tap that growth market because it's not the best option of small growing companies. Messrs. du Pont used his personal connections to get big clients like Google, Yahoo and Facebook thinking that the company will be fine for the future. However, the major driving forces for cloud computing are small companies. From my VAR, small companies like to be charged on sf used over power used.

  • While DFT is not able to satisfy small growing companies' flexible needs, it also had a hard time retaining old big clients for their growing needs. DFT only has 5 facilities that can accommodate a tenet who need 6MW. The maximum capacity for DFT's biggest center is 36.5MW. However, DLR's facilities have average capacity of 50MW with maximum capacity over 200MW.

  • Investor Relations people emphasized that high switching cost and long-term leases will protect company's client base. That's not true because if clients don't like DFT's service, they will just place their new servers into competitors' data centers. A company as big as Facebook (VAR) will need 2MW more data center services every year. Unable to convince clients to place new servers in its new facilities, DFT will suffer huge loss because empty place can't get reimbursements for taxes and insurances.

- **Fierce competitions from companies like DLR already had negative effects on DFT**

  Data center in North America is highly fragmented with more than 200 companies providing different forms of Internet data center services. Without abroad exposure, DFT has to face this competition.

  • DLR launched the new generation of data center—Turn-Key Flex— that utilizes the idea of just-in-time data power, which share the same idea as cloud computing. This data center is considered to be in the middle of space-based and power-based data center with incredible flexibility. Even with 7% rent premium, this new generation of data center already generated 50% of the total rent revenue in DLR. This new data center placed huge threats on DFT. DLR also has 54 times of intangible assets as DFT.

  • I wasn't able to get pricing info for DFT. However, with 27.5 times of capacity (6000MW VS. 218MW), DLR generates 3 times revenue (1B VS. 327M) as DFT. Since both of them are running at nearly full capacity, DFT must charges higher price than DLR.

  • DLR apparently tried to kill DFT. DLR's first couple of locations to launch its Turn-Key Flex were Santa Clara, Ashburn, and NJ, all of which are DFT's markets. We can see DFT's revenue increased much slower since Q2 2012 than before. The CQGR before Q2 2012 was 3.5%, which decrease to 1.6% for the last 3 quarters in 2012. (Exhibit 2)

- **DFT's relative bad financial performance and unfavorable debt structure implies huge cash problem in the near future**

  • As we can see in exhibits, FFO per share, which is a very important indicator for REIT, and EBITDA Margin are not only much less than DLR's financials but also decreasing in 2012. The EBITDA growth rate slowed down rapidly during 2012 from 17% CAGR to 9%. All these signs show that DFT is unable to generate profits in data center industry any more majorly due to DLR's innovations and fierce competition.

• DFT will have debt problems. Although DFT and DLR have the same Debt/EV (31%), but DFT has a more unfavorable debt term structure, which will put huge pressures on DFT's cash flow and ability to get new debts. Exhibit 6 shows DFT and DLR's total debt need to pay in the future 5 years and the percentage of those debts compared to total debt. As we can see DFT's need to pay a lot more percentage of total debt than DLR does. DFT will have to pay off all its debt in 5 years. This fact will hugely affect DFT's credits to get new loans. Investor relations' people also mentioned the possibility of defaults. As long as one default happens, the maturities of all DFT's debts will be accelerated.

• DFT's PPE is accumulating at 7.7% CAGR since 2009, and DLR's PPE is growing at 34%. Even though DLR spent much more money accumulating PPE than DFT, it still has more cash/share than DFT (0.45 VS. 0.37). My VAR also indicates that DFT will have trouble paying off capital expenditure during 2014.

- **Poor cost management and distracted management team will harm the company not only financially but also legally**.

• DFT and DLR seem to have controlled costs to the same level because of similar SG&A/Revenue (about 6%), but DFT had 192M of other operating cost in the past two years, but DLR only has 1.35M. DFT did not explain specifically about 192M of other costs in 10K and investor relations' people did not want to talk about them neither.

• Maintaining REIT status is the most important task of DFT because if company is disqualified as a REIT, it will lose the favorable tax benefits. The amount of tax DFT need to pay will let DFT lose half of its collateral because of short of cash from my calculation. There are 5 basic requirements to maintain REIT status; one of them is tangible net worth being not less than 1.3B. DFT's tangible net worth is 1.35B now, which is really dangerous. Since DLR really wants to kill DFT, it will report to IRS as soon as DFT fails to satisfy those requirements. DFT also received a letter from IRS regarding their usage of properties. A REIT cannot use its property for a non- REIT purpose.

• Co-founder and Chairman Messrs. Du Pont gave up his executive power last year and has been getting money out of company for personal use. Co-founder and CEO Mr. Fateh owns another non-data center company and asked DFT to buy a private jet for him for business in his other company. Mr. Fateh also executed 6 insider sales for the past 2 months. Company's founders and leaders are not interested in DFT anymore.

- **Overvalued stock price make DFT a good short**. (Exhibit 7)

Misperception

- The biggest misperception people have for DFT is that it will get benefits because of the promising data center market. However, DFT's poor services and undiversified clients base prevent company from gaining profits in this promising market.
- DFT has mean rating 2.5/5 and mean target price of 26. Some funds raised their target price for DFT thinking that it will do a great job like DLR. However, my analysis points out that DLR is better than DFT in many fundamental aspects. The recent price rise gives us more room for short.
- Another big concern for shorting DFT is potential acquisition possibility. However, Maryland General Corporate Law basically inhibits a third party to acquire DFT. Change of control can only be done under many extreme limits.

VAR

- Chris Warnke (Senior Development Associate at DFT): The high switching cost is DFT's moat that ensures high revenue. Other operating costs mean other unexpected costs. Debt is not a problem for DFT; the company can get enough new debt.
- John Muncan (Network Engineer at Canon)(small user): Canon uses 0.2MW of data center in CA. Power-bases fee is not favorable for them because they only have 6 servers but all of them are dealing with huge piles of data.
- Scott Morris (Network Service Technician at Windstream): Windstream just leased 2MW from DFT, which is already the maximum that they can get from DFT. They are working on next generation of Internet Conference, which need more space in data center. DFT can't meet Windstream's future needs.
- Jason Verge (Editor at Data Center Knowledge): With development of cloud computing, companies need more and more data center supports. Facebook, for example, averagely needs 2MW every year. DLR is the innovator and leader in the market, but DFT is just copying the basic services from DLR. DLR has much favorable debt situation than DFT.

How It Plays Out

- Tons of emerging new small companies will choose DLR over DFT because of low price high efficiency, and more flexibility. Revenue will stop to grow.
- DFT cannot lease out room in new facilities, and land taxes and other fees cannot be reimbursed, which will drive up the costs. Outdated equipment will incur more losses and costs.
- DFT won't have enough money to pay for debts, so it has to get more debt and make more facilities as collaterals.
- DFT will finally default and lose both collaterals and REIT status.
- Leaders lose confidents in company and leave. Because of limitation of acquisition, DFT can only choose to bankrupt.

Risks / What Signs Would Indicate We Are Wrong?

- Q1 earning is coming in May 7th; if DFT's performance, price will continue to go up.
- If DFT decide to lower leasing price and spend more money on local marketing, they can attract some small clients. With only 4 markets, it's fairly easy for DFT to do marketing.
- If DFT negotiates some agreement with DLR, the competition DFT is facing will be less.
- Since neither of Chairman nor CEO are interested in this company, there is a high possibility that new management team will take place soon, which may bring new energy.

Signposts / Follow-Up

- Q1 of DFT; analysts' rating change.
- DFT's number of new leases.
- Debts and cash situation.
- Any news about changing leaders.
- DLR's further actions on DFT.
- R&D of DFT.

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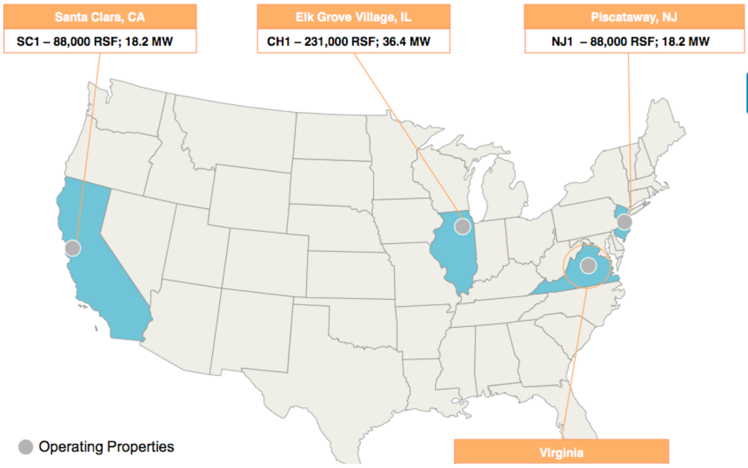
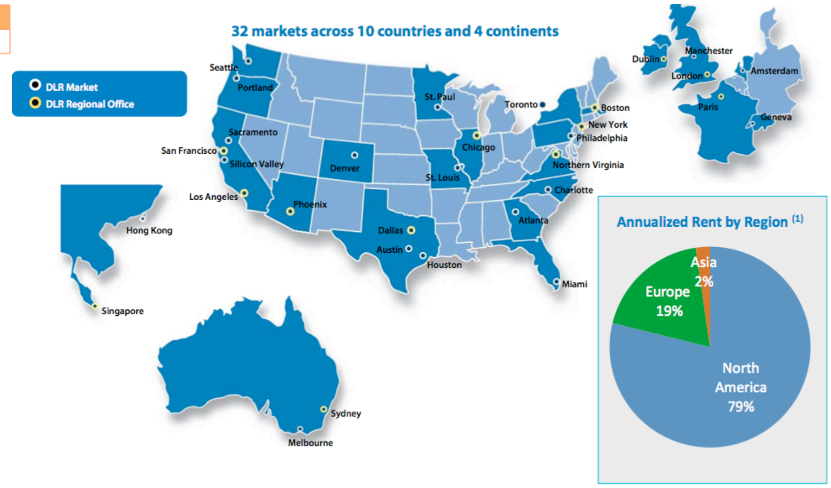
(Page of Exhibit/s)

Exhibit 1: DFT has less market exposure than DLR



DFT only covers 4 markets in U.S.



DLR covers 32 markets in 10 countries

Exhibit 2: DFT's revenue growth rate decreases a lot in second half of 2012 as a results of DLR's fierce competition

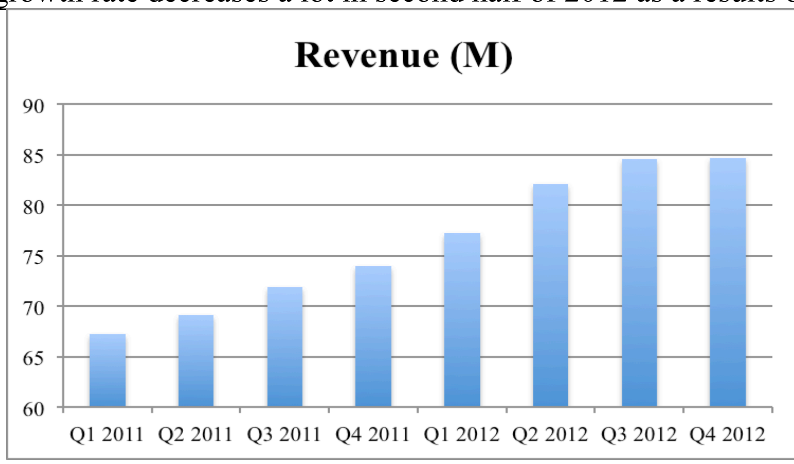


Exhibit 3: FFO per share of DFT is decreasing

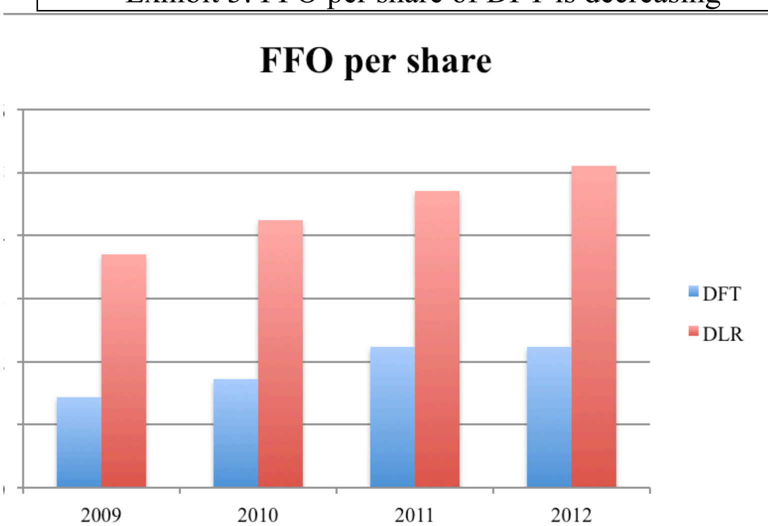


Exhibit 4: DFT's EBITDA Margin is decreasing

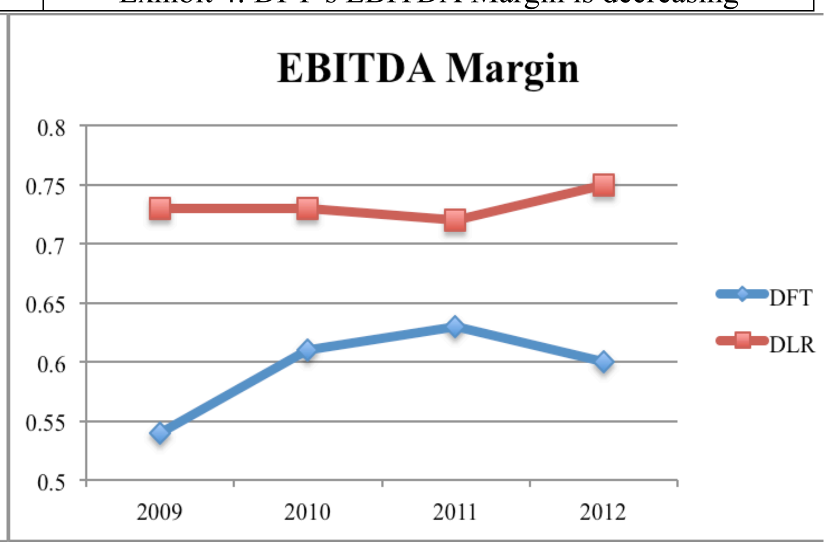


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Exhibit 5: DFT's EBITDA growth rate decrease a lot more than DLR in 2012

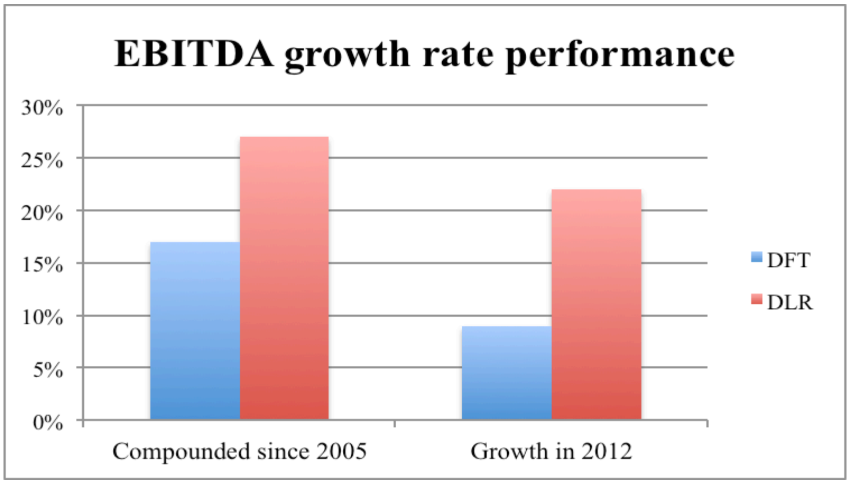


Exhibit 6: DFT has more unfavorable debt term structure than DLR

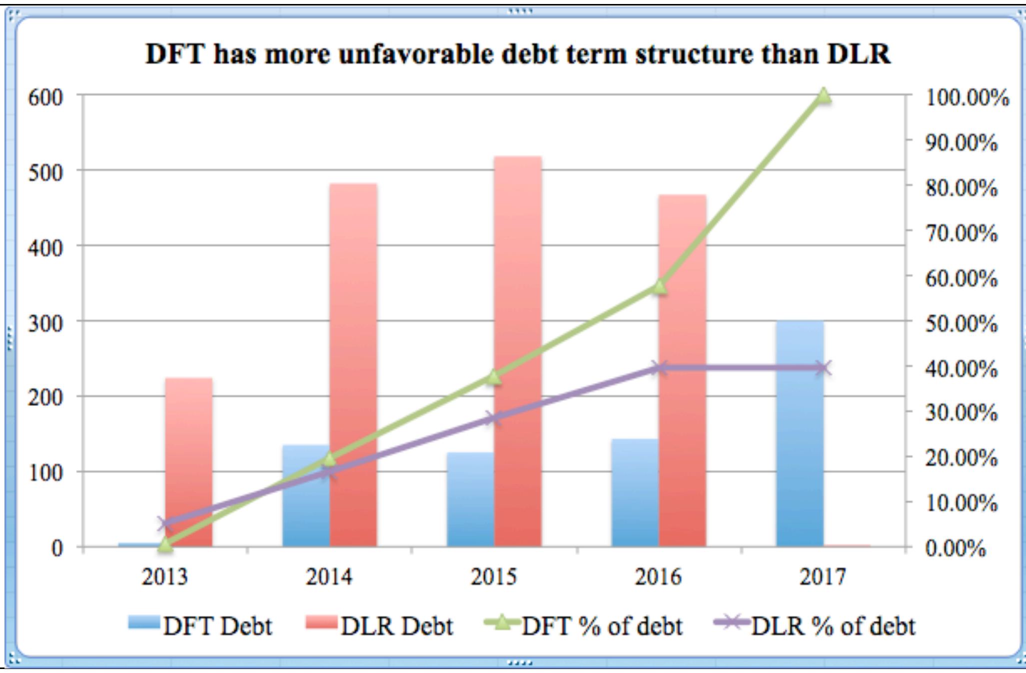
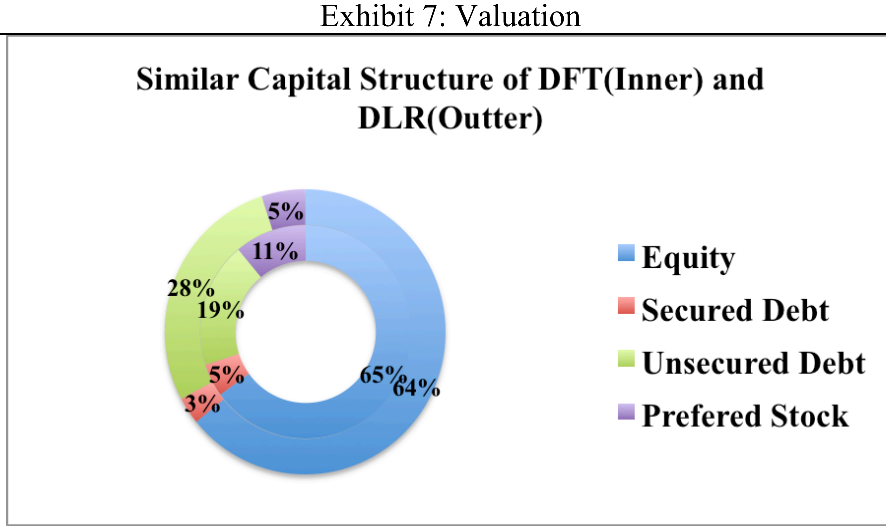


Exhibit 7: Valuation



We can compare DFT with DLR because they have similar capital structure and they are in exactly the same market.

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Comp Valuation

	P/E	Forward P/E	Cash/Share	FFO/share	Average
Target Price	19.82	15	20.55	29	21.09

DCF Valuation

	2012	2013E	2014E	2015E	2016E	2017E
Income After Tax	60.83	64.5	27.7	42.11	31.5	20.4
Depreciation/Amortization	89.24	103.8	120.74	135.45	150.38	155.76
Changes in Working Capital	-6.63	6	-15	-6.9	-1.8	-3
Capital Expenditures	3.89	4	9.8	5.4	10	5
FCF	152.81	158.3	153.64	179.06	173.68	174.16

Cash Flow Growth Rate	
7.19%	
	Terminal Value
20% Discount rate	1332
Target Price	21.15

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Suggestion to the Club

1. Some words up front:

It has been a great semester working with you guys! I learned a lot from every single person on the manager team. I know I still need to learn more and contribute more to the weekly discussion. I always did some research before the manager meeting but just could not say it out either because other people covered my points or the topics moved so rapidly. I believe ICE will help me to speak up more confidently.

I also need to apologies for my three absences. One of them was because of a conference in NYC, and two of them were because of MSN's annual election. I know it's my fault not able to work around the schedule and attend the manager meeting. I will make sure that I won't have any conflicts between manager meeting and other meetings/elections if I am reelected. I was really burned out this semester because I was involved in 7 organizations. It's terrible. I learned my lesson and I will reduce that number to 2 next semester and focus more on MII.

Finally, I want to say I really love MII. It's the first student organization I joined in my first semester here. I learned everything about stock in MII and from MII people. I put a lot of effort in MII and experienced every single position: member, analyst, associate and manager. I also encouraged all my friends to join MII, at least for the weekly meeting. MII teaches me all I know about stocks, so I want to continue my story with MII and give back to MII.

2. Mini Pitch Competition:

Many of my friends think the whole research and pitch process need too much time and they do not want to try it. So we can hold Mini Pitch Competition at the end of training program. Basically we give them part the research and let them finish the rest by doing their own work. For example we can provide them with company's info and the financial data's research outcome and let them do some company's valuation by doing research about company's service and products, company's competitors and VAR. We can even leave the long or short choice for our members.

3. MII Alumni:

Every year, we have many former or current MII managers or associates go to prestigious banks on the Street. These connections are very precious and we can use various ways to keep the connections. For example we can organize a MII Alumni Reception in a weekend to invite as much as possible former MII Alumni back to UVa and share their experiences with current MII members. This reception is also a good chance for MII members to networking.

We can also invite MII Alumni come back to UVa and do the presentation about their companies to MII members. Actually everybody can be benefit from this event. The members get chances to know their potential employers and network with people; MII Alumni can get more appreciation from their bosses; and MII can get more awareness in Wall Street, which will be crucial for our future development.

Since foxfield is coming, some social event with MII Alumni will also be really great.