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Why Data Centers Challenge the Core Real Estate Fund Playbook

At first glance, data centers appear to be an ideal real estate investment for today's market, a concrete cornerstone of the "digital gold mine" narrative surrounding artificial intelligence. Exploding demand for AI, cloud computing services, and streaming media seem to have created the perfect storm for data centers to be positioned as the hottest emerging segment of commercial real estate. But for core fund investors, the story beneath the headlines is a bit more complex.

One of the most immediate challenges is asset size. Unlike your typical apartment building or logistics warehouse, which are sized to fit comfortably in a diversified real estate portfolio, many of today's emerging data centers are multibillion-dollar assets and packaged with purpose-built campuses designed for specific power, cooling, and fiber needs. Such magnitude of scale and niche specialization make them difficult to incorporate into diversified core portfolios, where stability, liquidity, and predictable cash flows are paramount for successful returns.

Data centers also face a degree of technological risk unprecedented in traditional core assets. Advances in server architecture and cooling systems can quickly render facilities or the expensive equipment inside them obsolete, potentially requiring costly retrofits or leaving owners with properties that are hard if not impossible to repurpose indefinitely. The question of future residual value at the end of a lease looms large. Will these assets retain their worth, or will they become abandoned as technology evolves?

Multiple industry cost indices also indicate elevated construction and equipment expenditures heading into 2026. For funds looking to invest in the development of these assets, that heavily front-loaded CapEx amplifies the potential downside and any stall in demand or a drop in lease rates can leave owners with a stranded, hard-to-repurpose property.

While the market's current momentum is driven by massive capital expenditures and aggressive expansion, it lacks a deep, liquid secondary market. Much of the capital being invested is in the production phase where investors are expecting opportunistic returns, sometimes north of 20% per year. But those attractive returns are predicated on an investor with a core real estate cost of capital acquiring these new data centers upon construction completion. Who will step up to buy these very large and specialized assets? The groups with the deepest pockets are the hyperscalers and they seem to want these assets *off* their

balance sheet, instead preferring an asset-light, high return on equity model. The pool of potential buyers is limited and the risk of illiquidity is real, especially if capital markets tighten or the in-place tenant struggles or needs to be replaced.

Environmental considerations further complicate the picture. Data centers are among the most energy- and water-intensive real estate assets, raising operational and reputational risks. For core funds with net-zero commitments or ESG mandates, these factors can weigh on relative performance as compared to competitors. At the project level, increased scrutiny around permitting, community buy-in, and resource usage can also affect timelines and long-term operating costs. Increasingly, local communities are questioning the burden of potential increased power costs on consumers relative to long term job growth with respect to data center projects.

Diversification across property types, tenants, and locations remains a key advantage of core funds. Concentrating too much value in a few individual assets can distort portfolio balance and increase volatility. For instance, a fund with 200 properties located in varied markets, each worth an average of \$50-100M, holds assets that are easy to manage and sell, giving the overall portfolio flexibility and liquidity. Folding in even one or two data centers into the fund, valued at \$5B each, could significantly alter fund composition, affect performance, weaken diversification, and limit options during periods when assets need to be sold to manage liquidity.

None of this is to say that data centers can't deliver strong returns for the right owners. But for core real estate fund investors seeking stable income, liquidity, and long-term risk management, the combination of asset size, uncertain residual value, and environmental challenges warrants caution. The digital gold rush may be real, but not every mine belongs in a core real estate portfolio.

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