

Coronavirus Pandemic Highlights Value Of Data Centers

By **Michael Rechtin and Michael Merar** (April 7, 2020)

With the amount of uncertainty surrounding COVID-19's potential impact on the country and the commercial real estate world, the data center industry stands strong as one of the only essential real estate-focused businesses.



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Data centers, as the backbone of telecommunication, social network, data storage and processing and streaming services, are more critical than ever; so much so that states where stay-in-place orders are in effect have adopted language similar to the Cybersecurity and Infrastructure Security Agency March 19 memorandum to the effect that businesses that maintain the internet are considered essential. Accordingly, as much as possible in these times, it is business as usual for the data center industry.

Current Landscape

Ten years ago, the data center real estate industry was dominated by a small handful of large developers and operators. Large companies (predominantly banks, health care and retailers) thought it imperative to build their own data centers (anticipating the need for increased storage capacity down the line), and the rest of the real estate world watched from the sidelines, scared off by overtly confusing technological jargon, acronyms, enormous HVAC costs and burdensome service level agreements detailing hefty rent credits and lease termination rights.

Today, the landscape of the data center real estate industry looks a bit different. The pool of quality data center developers and operators has increased as top talent continues to splinter off from the traditional operators in favor of spinning off new, lean competitors fueled by private equity technology and infrastructure funds.

The data centers built by the overzealous banks, health care companies and retailers are now partially utilized as storage capacity and processing power of computer servers continues to increase at a pace that is hard to fathom thus simultaneously shrinking the required footprint for the same amount of computing while increasing the need for power.

Cooling and power distribution systems have become more efficient and more affordable, and the number of reliable data center management companies has increased tenfold — whether developing a data center from the ground up or looking to purchase an existing structure, prospective data center owners can now hire well-regarded, efficiently priced data center management companies to control, operate and maintain the critical infrastructure (power distribution units, generators, cooling units, etc.) in accordance with the terms of the lease agreed upon by the data center operator and tenant.

With the amount of operational and technological improvements and efficiencies that have grown in the data center real estate industry over the last 10 years, in combination with the need for data center capacity continuing to mushroom and outpace supply, it is easy to see why more institutional real estate owners and lenders are starting to view data center ownership, development and operation as a solid investment.

Hyperscale Users

The major driver of the need for data centers has been, and will continue to be, the unprecedented growth of the so-called hyperscale user (i.e., major technology companies). As a rule, hyperscale users are always looking ahead, sometimes to secure data center space to meet anticipated needs for increased storage compute and capacity as far as 20 or 30 years down the road.

Developing data center space specifically for a hyperscale user or simply leasing space in an existing data center to a hyperscale user is typically the goal for most data center operators as the deals tend to dwarf so-called enterprise or colocation deals. Hyperscale users look to enter into long-term leases with multiple extension options which are typically exercised to avoid the expenses associated with changing data center locations and operators.

While the amount of rent charged to a hyperscale user is generally under market as compared to an enterprise deal (which may be counterintuitive given the colossal size and value of the typical hyperscale user), any amount lost in agreeing to a below-market rent figure is counterbalanced by the lack of additional services these types of tenants require from their operators.

As a general rule, hyperscale users will take on responsibilities ordinarily left to data center operators (e.g., security, redundancy, maintenance, etc.) which significantly lower the operator's expenses, need for additional management and risk exposure. Developing a data center for a hyperscale user or enticing a hyperscale user to lease space in an existing data center is a key to generating predictable, worry-free revenue.

As one would imagine, the timeframe for developing a new data center and finding an anchor tenant can be lengthy. As the pool of data center developers and operators has increased, competition to land hyperscale user tenants is fierce. The competition has led to instances of bids well below market and slower deal flow (due to hyperscale users testing the waters with each operator in any given market).

While attracting a hyperscale user brings less financial risks as the likelihood is strong these companies will be able to pay next month's rent, with the amount of leverage they have, they can (and will), expect landlords to take on more liability than is typically seen in ordinary commercial lease agreements.

For example, it is not unusual for hyperscale users to demand enhanced self-help and lease termination rights, which may be difficult for certain categories of institutional investors looking to diversify into data center ownership to take on or more traditional lenders to underwrite. In order for a prospective owner to ensure a financially successful investment with appropriate risk allocation, it is important to maintain an experienced team well-equipped to understand all levels of the transaction, including the nuanced technical aspects which inexperienced lawyers often are not equipped to handle.

Partial Leaseback Opportunities

Purchasing a legacy data center from a company that is not fully utilizing its space and leasing back to that same company an appropriate-sized portion of the data center is another entry point into the world of data center ownership for institutional investors. The company selling the data center may end up with a monthly rental payment which is a fraction of its monthly cost to own and operate the entire data center, in addition to the sale proceeds.

From an efficient operator's perspective, the rent from the company may be sufficient to cover the majority of debt and expenses of owning and operating the data center, so any rent received from a new tenant becomes pure profit. The operator also benefits because they have an instant anchor tenant and can create immediate supply in a constrained market.

Hyperscale users, as mentioned above, often need space as soon as they can get it and do not always have the time or patience to wait for new developments — the sale and partial leaseback eliminates much of this delay and puts the operator in a great position to land a hyperscale user tenant, albeit these data centers may be too small for a hyperscale user's needs unless they are strategically located.

If these data centers are located in or near a market that the hyperscale user wants to serve with low latency, but the hyperscale user does not already have a data center in that area, a hyperscale user may lease colocation (multiple-tenant) space to satisfy this need so it can push content to the so-called edge.

In a colocation situation, especially one involving a hyperscale user, engaging a data center management company and having experienced legal counsel can help alleviate the potential stresses inherent with having multiple tenants under one roof as security and the protecting of proprietary technology are major concerns to hyperscale users.

Data Centers as a Resilient Asset Class

The COVID-19 crisis has exposed the fragility of certain types of real estate but has elevated the profile of data centers due to their essential designation and mission critical status. Doing everything from one's residence (work, school, entertainment, socializing, shopping, etc.) while the crisis continues has led to massive increases in the volume of telecommunication, data processing and storage, social network usage and the use of streaming services which is only possible due to the investments made in data center infrastructure.

When the dust settles on COVID-19, the world may be a fundamentally different place that is even more reliant on data centers (sometimes to the detriment of other types of real estate) so much so that they are a real estate asset class that cannot be ignored any longer by traditional real estate investors and lenders.

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