The network of data centres providing critical infrastructure for European economies presents a unique opportunity for real estate investors. With growth and defensive attributes, the data centre industry has proven resilient in both economic downturns and periods of economic expansion. Low correlations to other assets, a strong risk/return profile, and new liquidity from institutional capital make data centres an indispensable portfolio component.

While industrial real estate certainly remains an important traditional investment, we believe the data centre industry will continue to attract attention. Investors are drawn to its combination of strong demand and relatively low supply (a scenario sparked by a structural transformation of the economy), and the rapidly increasing demand for data and processing capacity. Even as the pandemic has accelerated this demand trend, the essential role of data in our lives is a secular shift that will continue, making data centres an increasingly significant consideration when building a diversified real estate portfolio.

Evaluating data centres as real estate

Investors are taking various approaches to how they view these investments. Some consider an allocation to data centres in the same light as an infrastructure or operating company investment. However, our perspective is that these properties are better considered from a real estate perspective. A data centre’s individual components are similar to a modern office building or manufacturing facility, with backup generators and massive heating and cooling equipment, such as chillers and air handling units. Additionally, triple net leases (leases that pass plant, machinery, and operational costs to the tenant, common in real estate properties) have become more prevalent for data centres.

As such, we believe evaluating data centres using a real estate framework and underwriting methodologies is the most instructive.

At a glance – Data centres as a portfolio enhancer:

- **Diversification benefits**: Low correlations to traditional assets and other real estate property types
- **Long-term income**: Lease structure and the unique profile of tenants helps to create stable income over time
- **Resilient**: Less vulnerable to short-term economic cycles, performing in periods of growth and contraction
- **Broadening debt markets**: Increasing sophistication in underwriting will help enhance returns

**Diversification benefits with compelling returns**

Data centres share characteristics that make them an attractive portfolio diversifier. Many of these features uniquely position the segment to add value as a separate allocation in a real estate portfolio. This is especially true given the currently elevated correlations among investable asset classes.

The long-term focus of tenants is among the most compelling feature. Whether they are enterprises, colocation providers, or cloud service providers, data centre tenants tend to prefer 10- to 15-year leases and are likely to renew lease terms once established. Initial data migration and other set-up costs are expensive, and most tenants require customised infrastructure, making it difficult and cost-prohibitive to relocate. In fact, in worst case scenarios, where there are strict lease reinstatement provisions in place, the cost of relocations can be up to 40 times annual rent. The sticky nature of tenants helps create long-term income streams for investors, offering exposure to cash flows from high-quality tenants at higher yields than other property types.

Additionally, data centre service contracts typically contain strict requirements for the upkeep of site equipment, providing an additional level of assurance for investors that these properties will be maintained over time.

For long-term investors—particularly those aiming to fund obligations by matching income and liabilities—data centres can offer inflation protection, as most leases are linked to inflation with generous cap and collar terms. This is a particularly attractive benefit as the uncertainty surrounding the impact of loose monetary policy persists, and the protection of cash flows remains critically important to...
maintain liability matching for institutional investors. Further, while sourcing opportunities in growth sectors during economic uncertainty is challenging, data centres are among the few areas where the structural growth story appears to remain intact.

The level of financial capital and specialised expertise needed to find and then manage a population-proximate facility with ample access to power is significant. Power restrictions in many major markets create a particularly challenging environment for new entrants, placing a higher intrinsic value on sites within markets that already have access to power. These factors create a barrier to entry and, together with sticky tenants, set up conditions for stable income streams, particularly important for institutional investors in search of continuous income.

Improved credit risk, a result of the consolidation and growth of operators, has also helped enhance income security for investors. The growing availability of debt allows investors to improve total and leveraged cash returns and because of the highly specialised nature of data centres, knowledgeable debt providers can improve returns by creating loan term structures specific to different traits within the industry. And since most data centre projects are refinanced after a few years, the depth of the debt market is expected to grow. More sophistication in underwriting debt and greater comfort for lenders willing to recognise the different traits of data centres—along with the current low cost of capital in Europe—will broaden the debt market and help enhance returns.

Finally, it’s worth noting that data centres have proven to be the most resilient real estate property type in the current environment. As the impact of COVID-19 began to unfold in the first half of 2020, and social distancing and other pandemic-induced restrictions took shape, data centres maintained income levels, benefiting from the digitalisation of home and work life.

Enhancing real estate portfolios for the future

Investors may consider several strategies regarding data centres. These may include:

- an aggregation approach that gains exposure to a geographically diverse set of data centres,
- investing in Europe’s established core markets of Frankfurt, London, Amsterdam, Paris, and Dublin (FLAP/FLAP-D) to benefit from the supply/demand imbalance in these regions,
- investing in emerging data centre markets such as Zurich or Madrid, or
- targeting leased assets to add value via lease restructuring and repositioning, without taking operational risk.

Regardless of how investors gain exposure, data centres will remain a highly attractive segment of real estate markets. These facilities present a sustainable secular growth opportunity that allows investors to bolster their real estate portfolios and capitalise on the accelerating digitalisation trends taking shape in every corner of our lives.

Property type resiliency and COVID-19 impact

Impacts will vary depending on property type and exposure to reduced demand and social distancing

- High street retail
- Shopping centres
- Hotels
- Leisure
- Traditional offices
- Multifamily residential
- Healthcare
- Affordable/social housing
- Single-family residential
- Convenience retail
- Logistics
- Warehouse
- Data centres
- Co-working office
- Serviced apartments
- Retirement/assisted living
- Impact of COVID-19

Source: Principal Real Estate, July 2020
Risk Considerations

Investment involves risk including possible loss of principal. Past performance is no guarantee of future results. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk.

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