

How Investors Can Manage Asia Data Center Acquisitions

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Fueled by the rapid pace of digitization and the resulting surge in demand for cloud-based services, global acquisitions of data center businesses are booming.

The market has not skipped a beat, despite the global pandemic and the economic fallout caused by COVID-19. The global pandemic has accelerated the demand for cloud-based services, which has resulted in increased demand for data center capacity.[1]

In fact, the value of closed M&A deals during the first quarter of 2020 has already eclipsed the annual total for all of 2019. During the first quarter of 2020, 28 data center-oriented M&A deals have closed with a total valuation of approximately \$15 billion.[2]

More than 100 data center-oriented M&A deals closed during 2019.[3] This represented a 6% increase compared to 2018 and was more than double the number of deals closed in 2016.[4] The Asia-Pacific market is a key driver of this growth.

The Asia-Pacific data center market has grown rapidly in recent years and is expected to continue expanding steadily at a compound annual growth rate of 12% between 2019 and 2024. At this rate, it is expected to overtake North America to become the world's largest data center market by 2021.[5] [6]

This article first briefly examines the current growth landscape of the Asia-Pacific data center market. Then, we describe several key considerations that acquirers and investors should be focused on when buying or investing in data centers in Asia.

These considerations arise primarily within the context of the following areas: (1) customer contracting terms, (2) real estate and environmental due diligence, (3) power supply arrangements, and (4) governmental regulatory and permitting requirements.[7]



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Asia Data Center Market and Growth Trends

The size of the Asia-Pacific market for co-location data centers is forecast to approach \$28 billion by 2024. To put that into perspective, this figure is 20% higher than the \$23.4 billion forecast for North America.[8] The primary data center markets in the Asia-Pacific region are Singapore, Hong Kong, Sydney and Tokyo.

Singapore is the largest data center market and accounts for the majority of the Asia-Pacific data center supply.[9] Singapore is ranked as the third most robust data center market in the world behind Iceland and Norway.[10] Singapore became the first mature data center market in the region for a number of reasons, including its strong network infrastructure, pro-business environment, economic and political stability, low corporate tax rate and low risk of natural disasters relative to other countries.[11] [12]

Many content operators also take advantage of Singapore's prime geographical location to service their regional clients in Malaysia, Indonesia and Thailand.[13]

In terms of the future growth trends in the Asia data center market, Southeast Asia is poised for growth and expected to become the fastest growing region for co-location data centers over the next five years despite a current moratorium on new data centers in Singapore.[14] Global technology companies such as Google Inc., Facebook Inc., Amazon.com Inc., Alibaba Cloud, Microsoft Corp. and Equinix Inc. are making the region a favorite destination to relocate their data centers and this momentum is expected to continue.[15] [16] [17]

The explosive growth in digitalization, e-commerce and digital banking in countries such as India, Indonesia, Thailand and Vietnam is also likely to present opportunities for data center operators in those countries.[18] [19]

As the Asia-Pacific data center market continues to grow and mature, increased M&A activity in the sector, including private-equity backed acquisitions, is inevitable.

Recent examples of data center investment in Asia are numerous. On April 21, Equinix and GIC announced a \$1 billion joint venture to build and operate three data centers in Japan for the cloud computing market.[20] In January, Macquarie Group's infrastructure arm agreed to acquire AirTrunk, a hyperscale data center provider, in a deal valuing the data center operator at approximately 3 billion in Australian dollars (\$2.1 billion).[21]

Lendlease, an Australian-listed property and infrastructure group, teamed up with an unnamed institutional investor in July to invest \$1 billion in data centers across Australia, China, Japan, Malaysia and Singapore.[22]

Customer Contracting Terms

Within the data center business, there are significant differences between hyperscale and co-location

centers that affect how investors should consider customer contracts. A hyperscale data center serves a limited number of customers, which are often large technology giants and cloud operators such as Amazon, Microsoft and Google, each of which requires a large amount of space and significant power commitments within a single data center. A co-location data center, on the other hand, sells space to companies of all types and sizes by the rack, cabinet or cage.[23]

Hyperscale data centers feature a limited number of long-term contracts with anchor tenants. The cash flow and profits of the data center are generated via these small number of key customer contracts. The loss of just one of those customer contracts may significantly impact an investor's assumptions underpinning its financial model and accordingly the viability of the deal.

The terms of customer contracts are heavily negotiated and could vary significantly, as the tenants often have significant bargaining power and insist on contracting on their forms. Therefore, investors need to understand these contracts in detail, particularly terms related to price increases over the contract term, required service levels and the impacts of related service credits (including termination or step-in rights in more extreme circumstances), rights of first refusal over additional capacity, and customers' ability to reduce capacity during the contract term.

In contrast, co-location data centers often have hundreds or even thousands of customers, each of which occupies a small amount of space within the data center. To manage such a large number of relationships, co-location data center operators often require customers to contract on the operators' standard terms and conditions. It may also be the case that no individual customer contract will be of significant economic importance to the business, and therefore a comprehensive review of such contracts in due diligence may be impractical and unnecessary.

Regardless of the type of the data center, a key focus in the course of diligence is to determine if there are any provisions that give a customer the right to terminate the contract as a result of the proposed transaction. Investors should also look for any termination-for-convenience provisions whereby a customer may terminate its agreement without cause and without penalty.

Real Estate and Environmental Due Diligence

In any data center acquisition, a threshold real estate issue is whether the underlying land on which the digital infrastructure sits is owned or leased. Where data center land is owned, investors should verify that the target company has clear title to the land by conducting title/land searches. Investors should also review the purchase agreement that the target company entered into when purchasing the land.

Beyond the basic ownership issues, investors must ensure that the land is properly zoned for data center operation. The latter may be particularly important in Asian markets such as Singapore and Hong Kong, where land is generally scarce and large lots suitable for data center development and operation are even more limited.

Where data center land is leased, potential acquirers need to (1) conduct the title/land searches to

ensure the lessor is the legal owner of the land, and (2) review the lease between lessor and lessee to understand in detail its key terms (e.g., term, change of control, landlord's consent rights, step-in rights) and how these terms could potentially impact the valuation of the acquisition.

Investors should ensure that no termination right will be triggered by the proposed transaction. The deal will be jeopardized if the landlord can reenter the premises and take back the land as a result of the proposed transaction. If the lease gives the landlord a consent or notification right as a result of the proposed transaction, investors could consider adding a closing condition or a closing deliverable in the purchase agreement that requires sellers to deliver such consent or notification prior to closing — with no material changes or requests to change the existing lease terms.

Investors should also understand whether the lease permits the data center operator to sublease the space to its customers, as customer contracts may be drafted in a manner which creates a sublease. If there is such limitation, investors should seek to understand whether there is structuring alternative (e.g., licensing the space to customers) that is permitted under the lease.

Investors should also be aware of the identity of the landlord — whether the landlord is government or private entity/person. If the landlord is a government entity, policy considerations, rather than pure economic factors, could impact the lease terms.

These could include preferential lease economics to encourage data center development, but these may be coupled with draconian restrictions on alienation of the lease which may provide government landlords with an ability to renegotiate the lease or take back the land if transactions are not properly structured.

Because the real estate on which any data center sits is a key component of the value of the data center business, environmental due diligence should be carried out to the same degree as in any real estate deal.

Investors need to understand what environmental risks might exist on the property based on past uses and ensure that liability is properly apportioned between (1) if the target company owns the land, the previous seller of the land and the target company or (2) if the target company leases the land, the landlord and the target company.

Investors should factor the environmental risks into the valuation of the deal.

Power Supply Arrangements

Uninterrupted and reliable power supply is critical for data center operations. A power supply outage in the data center, even if only for a brief period of time, could rapidly increase the service credits payable to the customers and cause irreparable harm to the data center provider's reputation.

Therefore, during the course of diligence, investors should (1) ensure the data center has secured

sufficient power supply for its contracted capacity to the customers from a reliable source, and (2) review the power supply agreement between the data center provider and the power supplier, in each case with a view to ensuring the uninterrupted power supply and cooling of the facilities.

Investors should also understand the service level credits applicable to any power outages and carefully review the performance history of the data center, including whether any service level credits have been granted to customers.

Ideally, there would be an indemnification clause in the power supply agreement where the supplier agrees to indemnify the data center provider for any loss caused by a power outage.

However, in some Asian markets this is not realistic given the power supply is controlled by the government, resulting in a de facto monopoly in these markets. This is the case in Hong Kong, for instance, where customers have very limited bargaining power with China Light & Power. In contrast, the Singapore power market is more competitive and data centers may be able to negotiate more favorable power supply arrangements.

Because power costs constitute a substantial part of overall data center operating costs, investors should also confirm how power costs are passed to customers and that any permits required in respect of the pass-through arrangements have been obtained.

Investors should also determine if there are any minimum commitments in the power supply agreement, i.e., where the data center provider commits to a minimum payment obligation for a specified period of time regardless of how much electricity the data center actually consumes during such period. This will negatively influence the data center's valuation if the data center provider does not have a large enough demand pipeline and fails to pass on these minimum commitment costs to its customers.

Governmental Regulatory and Permitting Requirements

Although data centers do not generally require a large number of permits, the regulatory requirements vary by jurisdiction, and investors need to ensure that the target data center has all of the required operating permits. It is also important to understand whether such permits can be transferred as part of the transaction or, if not, how new permits can be obtained.

To the extent that permits related to operational data centers have not been obtained, or are necessary with respect to data centers in development, investors should consider requiring the target to have all such permits as a condition to closing.

Conclusion

Investors who understand these key issues related to data center acquisitions will be best positioned to

take advantage of what is certain to be a competitive M&A landscape in the Asia-Pacific digital infrastructure sector in the years to come.

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[1] CRN, Why the Coronavirus isn't Slowing Down Data Center M&A.

[2] Id.

[3] Synergy Research Group, Data Center M&A Deal Volume Up in 2019 Thanks to Big Jump in Private equity. One significant new feature of the crop of 2019 transactions was the proportion of such deals completed by Private Equity funds. During 2019, there was a 50% increase in data center deals led by PE funds. This volume more than offset the sharp 45% drop in data center acquisitions closed by public companies. Private equity firms are increasingly mining the digital infrastructure sector for deals, accounting for approximately 80% of all data center acquisitions in 2019. Data center assets are well-suited to private equity acquisitions, as their sticky customer bases provide stable revenue sources, and scalability can be achieved either through organic development or buy and build strategies.

[4] Synergy Research Group, Data Center M&A Deal Volume Up in 2019 Thanks to Big Jump in Private equity.

[5] Data Economy, Why the Data Center Sector Continues to Attract New Investors.

[6] Cushman & Wakefield, Southeast Asia to Lead Data Center Growth in the Next Five Years.

[7] The specific considerations related to these issues may also vary depending on whether the data centers to be acquired are hyperscale centers or co-location centers.

[8] Cushman & Wakefield, Southeast Asia to Lead Data Center Growth in the Next Five Years.

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