LATHAM&WATKINS

Unlocking Digital Infrastructure: European Market Drivers and Trends

Digital infrastructure assets, mainly fibre optics, data centres, and towers, have attracted significant interest from investors over recent years.

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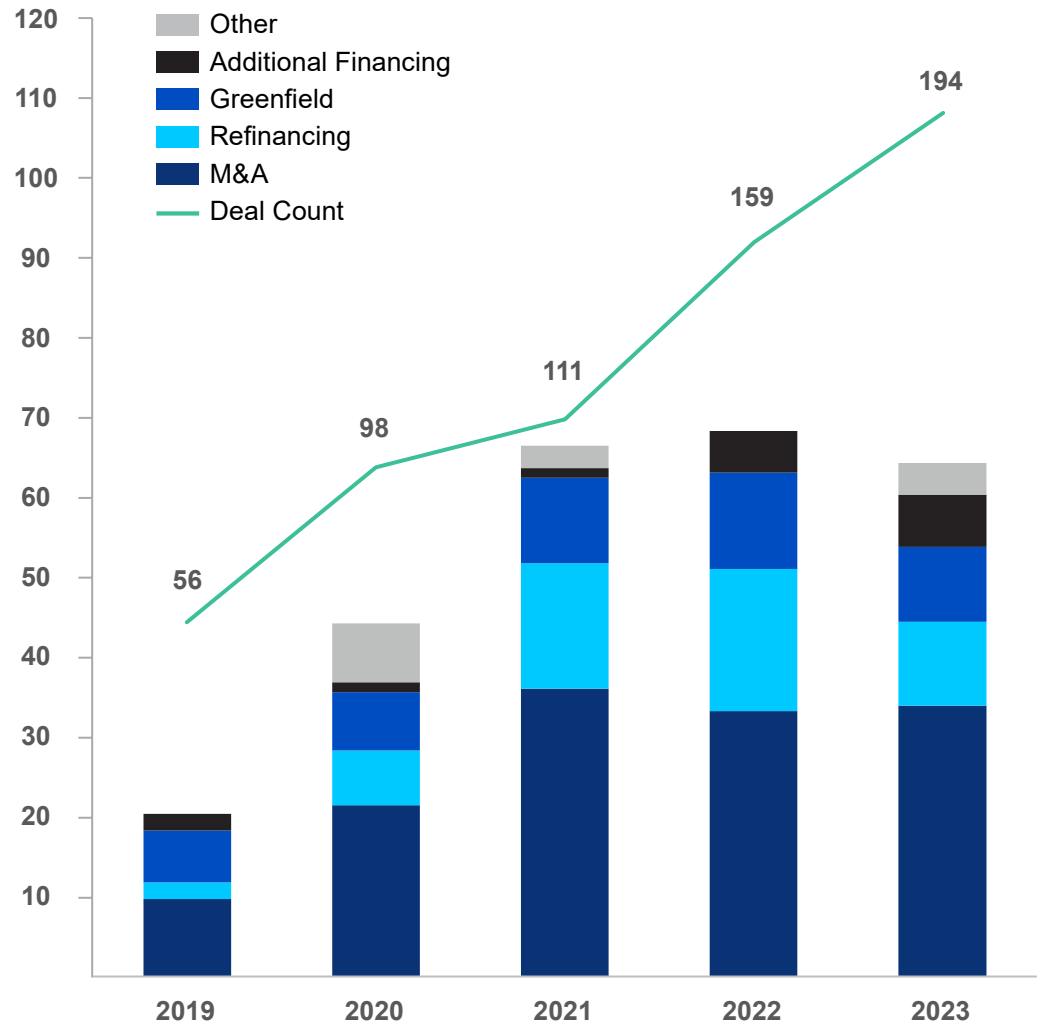
Digital Infrastructure Landscape

M&A activity in the digital infrastructure sector has been growing year-on-year in Europe, with deal counts and cumulative deal values highlighting the resilience of this asset class. 2024 is likely set to hit a new peak of transaction activities in volume and value of transactions, since at the end of 2023, the deal activity in the region already looked similar to the full-year 2021.

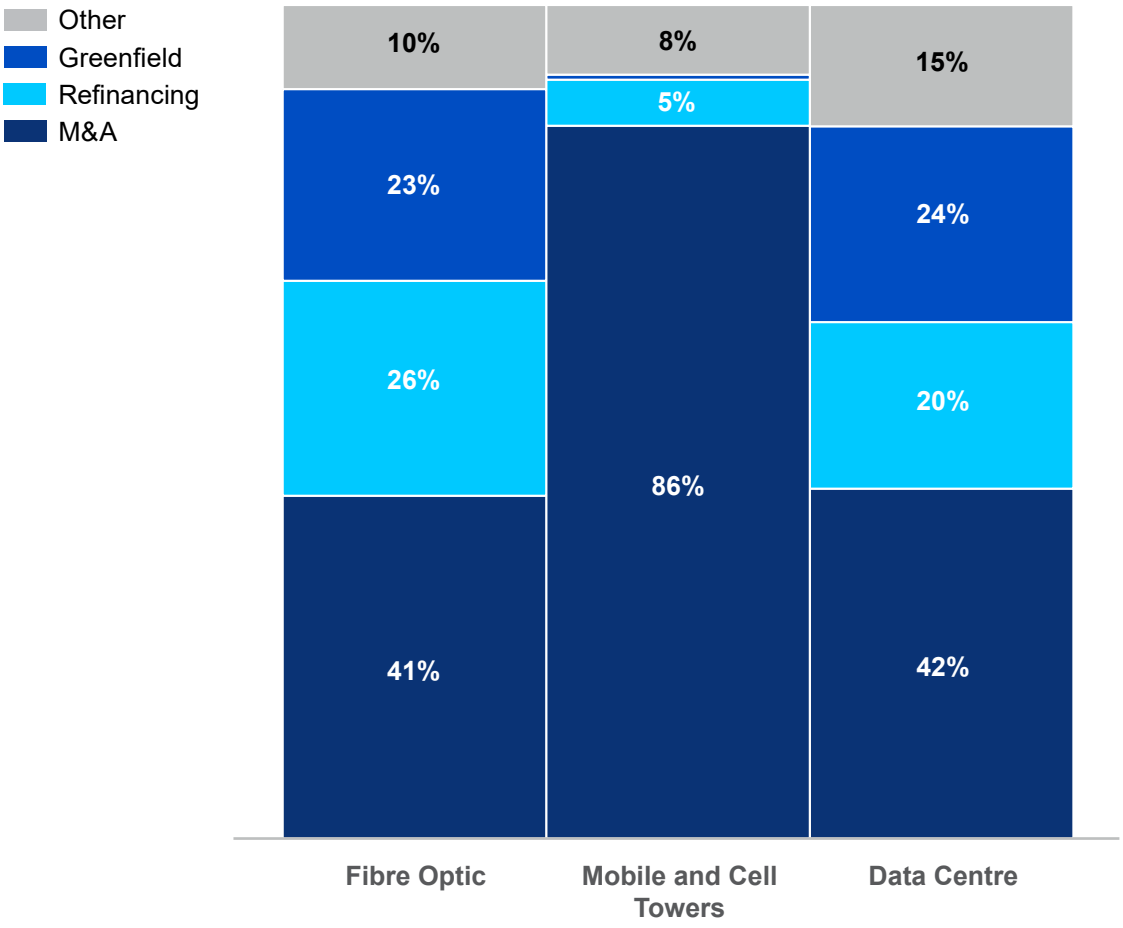
Digital infrastructure deal value in continental Europe (€bn)



The number of digital infrastructure transactions grew by **246% in the past five years**

The data also reveals a rather constant level of refinancing activity in general, but in particular in the fibre space as the sector matures and assets advance through their life cycles. Furthermore, the digital infrastructure sector, in particular the data centre segment, experiences an ongoing trend towards greenfield developments, which is driven by increasing customer demand on the one hand and by a growing reluctance to pay M&A premiums on the other hand. In addition, the sector is also influenced by the ongoing demand for data sovereignty, and governments and related institutions requiring cloud data to be stored in data centres in the relevant country. The following chart illustrates the breakdown of deal activity by market subsector and highlights the way in which fibre optics dominate transactions in Europe (while also indicating a high level of M&A in the towers category).

Digital infrastructure deal value in continental Europe (€bn, 2021-2023)



Going forward, the investor appetite for data centres should result in even more deal activity in that area, both in M&A and greenfield. This prediction is supported by the resilience of the data centre business model and typically robust cash flows (in particular in the hyperscale space), which also attract low-return investors targeting stable and yielding assets. In addition, the ongoing demand for artificial intelligence (AI) solutions and the underlying need for suitable infrastructure will also contribute to high deal activity in the coming years.

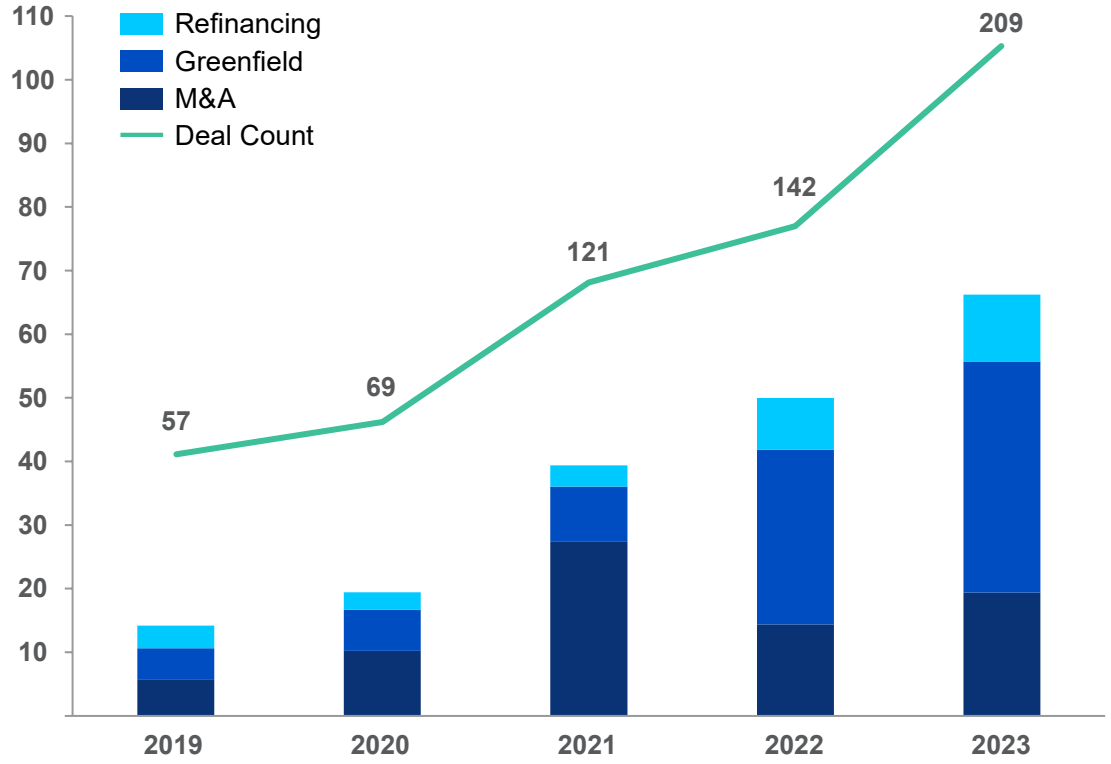
Data Centres: Trends and Hot Topics

Data centres sit at the heart of the digital economy, requiring a lot of space, electricity, reliable internet connectivity, cooling facilities, and robust IT and physical security.

Greenfield data centre projects typically comprise five stages, starting with (1) land acquisition, (2) permits and planning, (3) power supply, (4) construction, and (5) operation. Operators typically complete their land acquisition at the same time as obtaining the permits and grid connection agreements, since data centres cannot operate without meeting those requirements. In addition to securing the prerequisites for a successful development, the pre-contracting of customers for greenfield deals is equally important. As more and more projects are financed by or sold to investors at an early stage, securing a robust cash flow (so-called pre-contracting) is essential in order to comply with a lender's or investor's requirements.

As the focus of the public and the regulators shifts towards environmentally sustainable (i.e., energy-efficient) data centres, the reuse of waste heat is an increasingly popular option to increase the energy efficiency of the data centres. While some countries (such as Germany) are already enforcing a fixed quota for reusing heat in their statutory laws, developers find themselves under increasing pressure to assess the reusability of waste heat on and around the planned site. Pre-existing communal heating systems, which can process the waste heat, therefore become an important and new site selection factor.

Worldwide data centre deal value (€bn)



Generally, investment into data centres is growing globally. While greenfield assets are on the rise in particular based on the ongoing growth of the AI sector, we expect M&A activity on those assets to follow in the coming years.

Some of the key themes on data centre deals currently include:

- **Operating models:** We have observed that all types of operating models are growing in popularity. This includes, in particular, edge, co-location, and hyperscale-oriented operating models. While there are no strict definitions for each of those models, we often see edge models referred to for data centres with up to 2 MW IT load, co-location for data centres with up to 20 MW, and hyperscale for data centres above 20 MW.

  For hyperscale-oriented operators, a core and shell model would likely present the lowest risk, if a core and shell is constructed and leased to the customer. The opposite (high-risk) approach would be an operated data centre for which the landlord assumes all operating responsibility, while the middle ground would be a fully-fitted approach.

- **Transactions:** We currently see less activity in traditional, large auction processes, but instead note a growing number of bilateral off-market transactions. The market also currently features a growing number of carve-out deals run by corporates in order to offload non-core assets. New investors, including real estate and private equity investors, also show a lot of interest in this asset class.

- **Electricity:** Available capacity within the local electricity grid is undoubtedly the most important factor for choosing a site for development. In many European data centre hubs like Frankfurt, Amsterdam, Dublin, and London, the local grid has reached the maximum capacity, presenting additional challenges to successfully develop projects in the respective areas. As a result, data centre projects instead move to areas around the hubs where some capacity is (still) available.

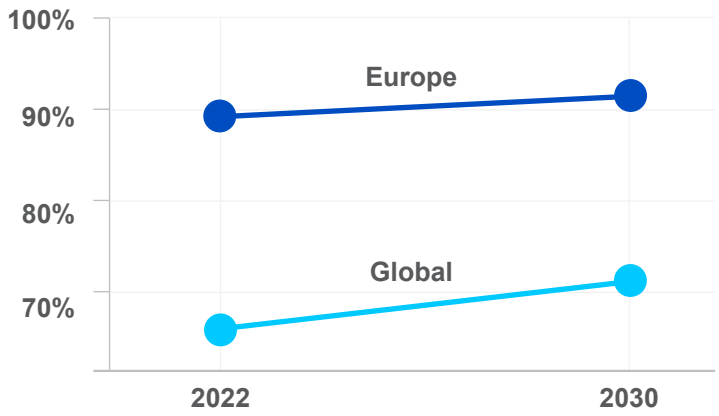
- **Project development:** When drafting contracts with hyperscale customers, investors need to focus on transfer restrictions, change of control clauses, and the underlying confidentiality agreements in order to avoid being restricted in their ability to sell assets by consent requirements. Many hyperscale customers are very sensitive about information security which can lead to some severe restrictions to information sharing in the event of an investor exit. A potential exit/entry of an investor should therefore be already addressed in the lease documentation and discussed with the hyperscale customer early on. Additionally, planning constraint issues are emerging to prevent the construction of data centres in specific areas and spaces, driving demand for new additional capacity.

Fibre and Towers: Trends and Hot Topics

Globally, the penetration rate of mobile phone and broadband subscriptions is strong, but there is ongoing growth in geographic markets and required bandwidth, which will continue to drive demand for fibre connectivity and towers.

In Europe, Germany is lagging behind many countries regarding the expansion of fibre networks and towers. Many businesses struggle to generate sufficient customer uptake for fibre networks (so-called customer activation), therefore sourcing additional equity and refinancing to meet increased construction costs.

Global unique mobile subscribers penetration 2022-2030, by region



Challenges and Risks for Investors

While the digital infrastructure space presents many opportunities, investors must be mindful of challenges, some of which are set out below:

- **Network overbuild:** In some countries, there has been a tendency to overbuild (i.e., establish multiple competing networks in the same geographical area), relying on low costs of debt and shorter-term contracts that increase risk.
- **Supply chain snags:** Issues related to materials and equipment shortages, rising costs of fuels and materials, and a lack of qualified workforce have delayed some projects.
- **Sustainability:** The digital infrastructure sector contributes as much as 2% of global greenhouse gas emissions. That number is set to double within three years based on current build plans. Data centres will therefore be under heavy scrutiny from investors.
- **Technological advancement:** With 6G already in the works, companies face an ever-present risk that technological innovations could render current infrastructure obsolete within a short space of time.

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