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Principal Real Estate

SPECIAL BULLETIN #5 | DATA CENTRES

THE ROLE AND BENEFITS OF JOINT VENTURES

Author: **Giles Smith,**
Head of Fund Management, Principal Real Estate Europe

At a glance – Data centres and JVs

- **Niche market:** Due to high costs and complexities, data centres require significant technical and location-specific expertise
- **Proven in real estate:** JVs are often used across real estate sectors, successfully matching capital with experience
- **Ability to scale:** By not having to maintain teams of in-house specialists, JVs grant investors the flexibility to expand quickly
- **Aligned incentives:** JV stakeholder interests are properly aligned, ultimately benefiting the property's long-term outlook

One of the most compelling ways to build, develop, and manage specialist sector real estate properties is through a joint venture (JV) partnership. This approach has yet to be widely adopted for data centres in Europe, but we believe it will be the most effective way for investors to gain exposure to these facilities going forward.

Data centres hold a somewhat unique position relative to other specialist sectors. Compared to most other real estate markets, the data centre industry is more thinly traded, with fewer individuals and investment managers that deeply understand and have access to the market. Unlike more traditional real estate asset classes, data centres do not have wide coverage by the largest real estate brokerages. Because of this, smaller firms and data centre specialists play an outsized role when it comes to building and managing these facilities.

The niche nature of the data centre industry is leading some investors to partner with asset managers that specialise specifically in data centres. JV partnerships allow asset managers to access a tenant network and source opportunities for data centre projects while investors provide the bulk of the capital.

A proven approach in real estate markets

JV partnerships are very common in real estate. Typically, these arrangements are between an investor providing the majority of the capital and an asset manager with sector expertise that provides a small portion of the overall capital. The investor and asset manager form a JV entity and agree on how the property will be managed.

Most often, the asset manager is a specialist in whatever real estate sector the JV invests, providing guidance on lease structure and finding high-quality tenants. While JVs are less prevalent in the data centre industry, the importance of these specialist asset managers cannot be overstated. Data centres are a highly specialised area of real estate, and an asset manager in a JV will provide the investor with invaluable guidance from both a technical and market penetration perspective.

There are other models for JV partnerships that do not include an asset manager, such as partnering with a developer or operator. However, partnering with a developer may expose investors to a higher level of capital risk, while a JV formed with an operator may open investors up to large single credit risk and potential operational liabilities (e.g., if the operator goes bankrupt then the investor could be left with a lot of vacant data centres). A JV with a specialist asset manager provides the diversity of tenants along with expertise to help manage these assets.

Leveraging specialised expertise to build scale

Data centre operators need to meet tight facility construction deadlines and ensure that there are no interruptions in uptime for tenants. This leads certain tenants—large hyperscalers in particular—to favor a handful of developers that have proven track records in operating these facilities. These developers end up owning large portfolios of data centres, allowing them to generate significant returns compared to their cost of capital and eventually fund more projects.

As institutional investors step in with capital via a JV agreement, economies of scale are increased for both the investor and their partner. In other words, because JVs are effective at matching capital providers with specialists, they enhance the ability to execute at scale. This helps create more opportunities and more potential returns for investors.

Investors also benefit by not needing teams of data centre specialists in-house. Some in-house expertise is important to enable good management of investments, allow investors to step in where required, and increase the volume of execution. However, to maximise economies of scale, it is better to work with JV partners who have more capacity and experience as data centre specialists.

The benefits of aligned incentives

Ultimately, we believe it is the alignment of incentives between the investor and JV partner that really drives the advantages of a JV partnership.

As noted above, investors benefit from leveraging specialists and economies of scale, while the asset manager or other JV partner benefits from being able to increase the number of projects as a result of the investor's capital infusion. Instead of acquiring data centre assets, these partners can essentially acquire a portion of these assets and roll out their model across all of them. This, in turn, also helps JV partners achieve a diversity of capital that allows them to target different assets with varying return profiles. Whether these incentives are realised through a co-investment or performance fee, this alignment serves as the critical connection that keeps the partnership productive.

As the exponential demand for data drives the need for more ways to manage and store this information, the data centre landscape will continue to expand. In this environment, we believe JV relationships between investor and asset manager will only grow in importance, becoming increasingly vital to the building and management of data centres across Europe.

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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