

DATA CENTRE FINANCINGS: WHAT'S NEXT?

Technology has transformed the way we live and dramatically increased the volume of data being stored. As a result, data centres, as an asset class, have risen in value. However, the cost of energy and the water usage needed to run them, are increasingly coming under the spotlight. It is estimated that data centres will account for over 3 per cent. of electricity demand in the EU by 2030 if development continues on the current trajectory. With spiralling energy costs, warnings of supply shortages, growing concerns about water resources and an increasing focus on sustainable lending, we look at what is next for data centre financings.

Data centre financing structures

Data centre financings are structured in a variety of ways which may follow real estate, corporate, leveraged or project/infrastructure financing principles. The approach taken can also depend on where the originator sits within a financial institution, the blend of lenders on a club deal, the type of data centre being financed and the offtaker (the customer/tenant) mix. As a result, data centre financings tend to be hybrid structures, borrowing from principles across the debt markets.

If following a traditional real estate financing model, the focus is likely to be on the value of the real estate, with more control by the lenders over cashflow and the business operations of the obligor group. These lenders attempt to ring-fence the real estate from the operating side of the business, dividing the propco and opco vehicles under two different ownership trees within the same obligor group. This gives them the option to enforce with, or without, the liabilities sitting on the operating side of the business.

Other structures seek to hive off the business operations into a separate management company sitting completely outside the obligor group. However, attempts to completely ring fence the property can be challenging, as key service providers to (and most influential customers of) the data centres, including (most crucially) their power providers, want to contract with an entity of substance with a track record of operating in the data centre space. Often, the only entity which meets that criterion may be within the security net of another financing.

Key issues

- There is increased demand for data storage capacity, but power and water usage is coming under the spotlight.
- A wide variety of financing structures are being used in the sector, including the development of rated data centre securitisations.
- Key Performance Indicators are not standardised but typically focus on energy and water efficiency and reducing carbon emissions.
- Sustainability is becoming an increasing focus for sponsors, borrowers and lenders.
- Regulators are introducing sustainability-linked reporting requirements and voluntary climate change agreements are being agreed.

If the financing follows leveraged principles, lenders tend to focus less on controlling what the operating business does on a day-to-day basis and instead look to net leverage and cashflow tests. On portfolio financings, the financings tend to have a more limited security package when compared with, for instance, a real estate financing, but that has not dampened market appetite for these transactions.

In the U.S., asset-backed financing with respect to data centres came to the fore with the first rated data centre securitisation closing in 2018. More recently, in August 2021, North American data centre operator Aligned Energy reported a US\$1.35 billion issuance of 'green' securitised notes. In November 2021, Vantage Data Centres raised US\$530 million in securitised notes and Edgeconnex recently completed its first asset-backed securitisation. These securitisation transactions are mortgage-backed securities, whereby the rental payments from data centre tenants generate the required cash flows to service the mortgage-backed securities. Whilst the regulatory regimes differ in the U.S. and Europe, it is probably only a matter of time before similar structures appear in the European market.

There has also been an increase in "Data Centre as a Service" (DCaaS), which is a hosting service in which physical data centre infrastructure and facilities are leased to clients. By outsourcing to a service provider, companies can resolve logistical and budgetary problems related to their on-site data centres.

The supply of DCaaS services may lead to some level of interest in the receivables space. DCaaS services generate a stream of cash flows which can be monetised using trade receivables financing, in particular asset-backed commercial paper (ABCPs). Trade receivables financing offers increased flexibility because it allows parties to structure their own transactions or to tap into existing ABCP financing platforms, often on a pan-European level. ABCPs can therefore be an attractive financing tool for data centre entities that operate cross-border.

Common themes

Notwithstanding the plethora of structures, there are some common themes, which include:

- The flexibility within the financing structures to allow data centre operators to grow capacity. Offtakers want the ability to increase their capacity as their data needs grow over time, resulting in "permitted development" concepts being common in data centre financings.
- SNDAs (subordination, non-disturbance and attornment agreements). These are agreements between the security agent and the offtaker (not dissimilar to non-disturbance agreements seen in hotel financings) which seek to establish a direct contractual relationship between the security agent and key offtakers. The finance parties, through the security agent, agree not to "disturb" the offtaker's use of the data centre and, in return, secure certain agreements from the offtaker, such as restrictions on termination of the offtake contract by the offtakers and the ability of the finance parties to sell to a third party on an enforcement (often with some kind of "suitable operator" test) without that sale triggering the change of control provisions in the offtake contract.

- Covenants of some description (which may be limited to information covenants) linked to the key drivers of the business of a data centre, for example power, humidity, temperature and security. As the offtake contracts often include a rebate or credit if certain thresholds are breached, lenders are rightly concerned that ongoing breaches will lead to a breach of cashflow covenants in the facility agreement.
- Regardless of the type of financing structure used, the key commercial concerns of financial institutions remain the same or similar. For example, potential supply chain interruptions driving up costs, limited land availability (and the potential for this to flow into the cost of acquiring land in the vicinity of the relevant data centre) and the availability of power.

Sustainability-linked loans

Sustainability is becoming an increasing focus for regulators, borrowers and lenders alike in the data centre space and these concerns have led to restrictions on the development of data centres in places such as Singapore, Amsterdam and Ireland. The European Commission has announced that by 2025 it will introduce an environmental labelling scheme for data centres, building on the monitoring and reporting requirements for energy consumption for data centres outlined in the Energy Efficiency Directive 2012/27. The operators are equally concerned; Microsoft announced in August 2022 that its new data centre region in New Zealand will be powered wholly by carbon-free energy when it launches, using electricity from solar, wind and hydro energy sources.

Against this backdrop, interest in sustainability-linked loans in the data centre space has grown, an example being the recent Edgeconnex US\$1.7 billion sustainability-linked loan. These transactions typically include margin ratchets which will depend upon whether certain key performance indicators (KPIs) are met. Many of these KPIs build on initiatives already in place for such a power-hungry industry and may focus on the targets already set by governments or regulators. For example, in the UK the Environment Agency has agreed voluntary climate change agreements with the data centre operators with a view to improving energy efficiencies without limiting growth.

The KPIs in data centre financings are not standardised and tend to vary from operator to operator but the core KPIs typically focus on power and water usage and may expand to support carbon neutral initiatives, so may include:

- procuring renewable energy and energy efficiency improvements and reducing carbon emissions
- increasing the power and water usage effectiveness of the data centre (metrics measuring energy efficiency and the quantum of water required for the business)
- promoting schemes which use hydrogenated vegetable oil instead of diesel for stand-by generators, rainwater as part of the cooling systems or excess heat to warm nearby buildings.

What's next?

The increased demand for data and the need to store that data means that this asset class is likely to remain buoyant for some time. The expectation is that the growth in user requirements will stay, due to a shift to cloud computing and growing demand for technologies such as AI, gaming and the metaverse.

As the consumption of power and water by these data centres collides with the urgent need to address climate change and the desire of investors and lenders to invest in green and sustainable projects, the focus of data centre operators will inevitably shift further towards sustainability. And lenders will increasingly require that sustainability-linked loan principles form an integral part of any financing of data centres in order to support their investment in these assets.

Relevant briefings:

- [Data Centres and the UK National Security and Investment Act 2021](#) (Nov 2021)
- [Data Centre Development: Real Estate, Security and Power](#) (Aug 2020)

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