Boosting digital infrastructure with private market investment

Digital infrastructure represents one of the fastest growing subsectors of the infrastructure asset class. Cloud computing and AI, for example, are showing rapid growth driving the need for ever greater connectivity and processing capacity.

Matteo Colombo, Managing Director in Legal & General's private markets business, delves into why he believes it's crucial to ensure there's adequate capital invested in digital infrastructure assets and how these may appeal to investors in private markets.

Matteo, when we talk about "digital infrastructure assets" what do we mean specifically?

In today's world, the transportation, storage and processing of data are essential infrastructure acting as the backbone that allows modern society to work. Data centres compute that data, towers transmit it over air and fibre provides direct connections at the speed of light.

Modern digital infrastructure is a newer terminology for a sector that's been around for a while but used to be called "media and telecoms". Largely, legacy telecoms was about the passage of sound. As new technologies have emerged that require more data – initially the internet, then streaming and more recently AI – more demand has been placed on legacy infrastructure. As a society globally we need to upgrade.

Why is it so critical to ensure there's adequate capital to support the development of this infrastructure?

In basic terms, it's essential because otherwise society can't function. You only have to think of the travel chaos caused by the global IT outage in July to see this.

But it's also important from a social inclusion standpoint. Most often, a country's capital city is where digital infrastructure gets the biggest focus. These centres are only home to a minority of the population, however.

We need to build out the infrastructure across countries from a resilience perspective but also from a connectivity standpoint to enable a competitive society nationwide. It's really about backing the growth in data for everyone's benefit.

This means, for example, there's an opportunity to focus on "second cities" which represent sometimes faster growth opportunities. In the UK, for example, we see an opportunity in Greater Manchester as the second region to London.

The economics behind some of these digital infrastructure projects are clearly what attract the capital. Can you talk a little bit about why these assets might be appealing to investors?

Firstly, this is a fast-growing space. Cloud computing, for example, is seeing something like a 20 %-plus compound annual growth rate[1]. There aren't that many sectors growing at that speed.

The growth in digital is structural, reflecting the fact that society is evolving and driving infrastructure demand. The contracts, and therefore cash flows, in the sector are often long dated. In our view, investors may benefit from stable and predictable income streams.

Digital infrastructure is also a way to play technology exposure with a real-asset backing without having to invest in the stock of individual large technology companies. Today, the six largest publicly traded companies in the world are data tech companies. So, if you aren't exposed to this sector then you're missing out on that growth. And, of course, these tech firms rely on the underlying digital infrastructure to function.

Another interesting aspect is that these assets can frequently be built for around 8-10 times profit. Once they're built and let, they can be worth at least double that. This relies on the infrastructure being successfully used by customers. Capable stewards can make sure it's utilised and leased out on appropriate contracts. That's where investors like us and our partners come in.

L&G is now a longstanding investor in the sector, having made our first investment not long after the advent of the cloud in Europe[2]. We're thrilled that our investments have generated strong returns since then. As we've scaled up, we welcome interested partners to invest alongside us.

With that last point in mind, expertise is surely critical in this area?

Absolutely. The amount of capital required is very significant. For, say, a data centre, it costs about £10 million per megawatt of capacity[3]. For perspective, modern data centres at the small end account for about 30 megawatts.

It's essential, therefore, that you're working with people that have experience. As I noted earlier, it's important these assets have customers they're serving, who'll pay for their usage over a contracted timeframe. Unless you're investing with a group that's able to suitably lease out these assets, you could end up with underutilised and under-returning assets.

We typically work not in isolation but in partnership with others. In order to serve investors appropriately we need to form global collaborations. We're working with JV partners that can bring differentiated and incremental capabilities to the partnership (for example via their geographic coverage or network). Therefore, we believe we are ultimately better placed to serve our customers.

Why is this sector well suited to investment from private markets?

As mentioned previously, digital infrastructure is really taking off. The amount of new capacity required is very significant – and that requires substantial investment.

The lead time to develop these assets is often more than two years. They are unlikely to generate significant yield or a running income during that time. When you look to the public markets for financing, you typically require a yielding income profile. So, these assets, in their growth phase particularly, aim to benefit from private capital.

Of course, there are historical assets which are already yielding. Some of those are accessible through the stock market via real estate investment trusts. But the majority of customer demand is for newer infrastructure. That suits private market funding, where there's a more patient capital approach.

For us at L&G, we have only a 5-10 year investment horizon. For these assets that often means 2-3 years of development spend, 3+ years of customer generation and then by the time they get to around year five and beyond they're yielding and quite suited to an exit – which could be either to the public or private markets.

Lastly, how does sustainability fit into your decision making around digital infrastructure assets?

We see sustainability as an excellent way to add value to our investments, whether that be, for example, from sourcing renewable energy or replacing backup generator fuel from diesel to hydrogenated vegetable oil.

Another example is district heating. Some of the assets that we're investing in – like data centres – create some heat as they function. Rather than releasing waste heat, as many facilities currently do, we're looking to tap that heat to nearby properties. And our renewables team, with whom we work very closely, are investing in the infrastructure of that heat network, so we can ensure that it actually works.

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[1]Source: Grand View Research

[2]Source: European data centres on track for "biggest growth yet"_

[3]Source: Kao Data.