



DATA CENTER FINANCINGS: WHAT'S NEXT?

Technology has transformed the way we live and dramatically increased the volume of data being stored. As a result, data centers, 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 centers account for approximately 2% of the total U.S. electricity use and these facilities' energy use is expected to increase as demand rises.¹ 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 center financings.

DATA CENTER FINANCING STRUCTURES

Data center financings are structured in a variety of ways which may follow real estate, corporate, leveraged or project/infrastructure financing principles. The approach taken can depend on where the originator sits within a financial institution, the blend of lenders on a club deal, the type of data center being financed and the customer mix. As a result, data center 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 centers, including (most

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 center 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 climate change agreements.

¹ <https://www.energy.gov/eere/buildings/data-centers-and-servers>

crucially) their power providers, want to contract with an entity of substance with a track record of operating in the data center space. Often, the only entity which meets that criterion may be within the security net of another financing.

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.

Asset-backed financing with respect to data centers came to the fore with the first rated data center securitization closing in 2018. More recently, in August 2021, North American data center operator Aligned Energy reported a US\$1.35 billion issuance of 'green' securitized notes. In November 2021, Vantage Data Centers raised US\$530 million in securitized notes and Edgeconnex recently completed its first asset-backed securitization. These securitization transactions are mortgage-backed securities, whereby the rental payments from data center tenants generate the required cash flows to service the mortgage-backed securities.

There has also been an increase in "Data Center as a Service" (DCaaS), which is a hosting service in which physical data center 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 centers.

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 monetized 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. ABCPs can therefore be an attractive financing tool for data center entities that operate cross-border as opposed to asset-backed securitizations which lack popularity in European markets.

COMMON THEMES

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

- The flexibility within the financing structures to allow data center operators to grow capacity. Customers want the ability to increase their capacity as their data needs grow over time, resulting in "permitted development" concepts being common in data center financings.
- SNDAs (subordination, non-disturbance and attornment agreements). These are agreements between the security agent and the customer (not dissimilar to non-disturbance agreements seen in hotel financings) which seek to establish a direct contractual relationship between the security agent and key customer. The finance parties, through the security agent, agree not to "disturb" the customer's use of the data center and, in return, secure certain agreements from the customer, such as restrictions on termination of the customer contract by the customers 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 customer contract.

- Covenants of some description (which may be limited to information covenants) linked to the key drivers of the business of a data center, for example power, humidity, temperature and security. As the customer 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 center) and the availability of power.

SUSTAINABILITY-LINKED LOANS

Sustainability is becoming an increasing focus for regulators, borrowers and lenders alike in the data center space and these concerns have led to restrictions on the development of data centers in places such as Singapore, Amsterdam and Ireland. In 2021, the U.S. enacted the New Energy Act to impose energy efficiency requirements on a variety of sectors, including the data center industry.² Further, the recently enacted Inflation Reduction Act provides tax incentives to data centers that meet certain sustainability goals such as reduced carbon emissions.³ The Federal Energy Management Program and Center of Expertise for Energy Efficiency in Data Centers under the Department of Energy provide information and technical support to organizations to improve data center energy efficiency.⁴ The operators are equally concerned; Microsoft announced in August 2022 that its new data center 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 center 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, tenants are requesting sustainability commitments to be incorporated into their contracts in the form of "green leases". These metrics are largely based on energy efficiency metrics developed by the non-profit The Green Grid, but can be altered and combined with other benchmarks.⁵

² <https://www.spglobal.com/marketintelligence/en/news-insights/research/sustainability-is-no-longer-a-nice-to-have-goal-for-the-data-center-industry>

³ <https://www.datacenterknowledge.com/sustainability/inflation-reduction-act-breakdown-how-your-data-center-benefits-new-legislation>

⁴ <https://www.energy.gov/eere/femp/energy-efficiency-data-centers>

⁵ <https://www.thegreengrid.org/>

The KPIs in data center 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 center (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 active for some time. The expectation is that the growth in user requirements will continue, due to a shift to cloud computing and growing demand for technologies such as artificial intelligence, gaming and the metaverse.

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

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