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Scaling up to meet the wave-on-wave of demand for data centers

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Matt A'Hearn,** head of digital infrastructure with Blue Owl and formerly managing partner of predecessor firm IPI Partners. The following is an excerpt of that conversation.

Why did Blue Owl Digital Infrastructure begin investing in data centers?

We began investing in data centers about seven years ago with our predecessor firm, IPI Partners, to be a strategic capital partner to the sector and a solutions provider to some of the largest technology companies in the world as they were growing their business, particularly as it relates to cloud computing. We wanted to get into the data center sector, and to support their growth on a flexible basis and in a scaled way, so that as their businesses grow, that growth would be viewed as a tailwind for us and synergistic to our Digital Infrastructure platform.

What are your views on the current and future market environment?

We continue to view where we sit today as a generational market opportunity in data centers and digital infrastructure, more broadly. We like to think about where we are today as a wave on a wave, with the first wave starting with growth in data centers and infrastructure to support the cloud. The cloud business is growing at 20 percent to 30 percent per year. In November 2022, we saw the second wave – the AI wave – which became commercially known through the launch of ChatGPT. That additional wave on top of the original wave has dramatically increased the demand for data center capacity today. Not only is there demand for large-scale sites, but power is now the most critical component from a demand standpoint.

How do you plan to capitalize on this opportunity within the current and future market environment?

Our partners are hyperscale companies. To best serve them, scale is a key component of our business, as well. And scale factors into a few different elements. One is the scale of the footprint and the power associated with it. Our portfolio has a large global footprint, but we also have large sites within that footprint and a significant amount of power we're able to bring to bear. Having a deeply experienced team is another important element of scale. This business is complex. It is difficult to develop data centers and operate them. Gone are the days of buying a nice rectangular piece of dirt and asking the utility to provide the power. Today, you must have scaled expertise and scaled relationships with the end users. Data centers are the most critical infrastructure these companies have, and they want partners who understand their business and are able support it. The last point on scale is capital. The amount of capital that goes into a data center has been growing meaningfully over the years. To be relevant, to continue to be that partner of choice, you have to have capital to be able to support building and owning the infrastructure that hyperscale companies need.

While there are a number of groups that talk about getting into the data center sector with smaller funds, it takes a lot of capital to be relevant – even with a $1 billion fund.

Is there too much capital chasing deals, as it relates to the current supply in the market?

We consider some of the groups saying they are in the data center market as "data center tourists." These are people who are trying to raise capital by saying they're investors in data centers, but who, in many instances, have never invested in a data center or have done it on a small scale. Maybe they were industrial developers and now want to build data centers. There are a number of groups trying to enter the market, thinking they will just buy land, and the power will be there. But it is not easy. You have to have a ground game to be able to understand development in these markets, which means working with local stakeholders – communities, regulators, utilities, grid, construction companies – to be able to put a development together. Without that expertise, you can get burned in a meaningful way – and more importantly, the hyperscaler's business could be compromised.

There are also a number of "wildcatters" that are speculating on land and trying to tie up capacity. Municipalities and utilities are starting to understand that and understand that people are coming into the market who have never built a data center.

How have tenants' appetites changed throughout this growth?

Tenants continue to look for partners who can help them solve today's problems, as well as tomorrow's. It is actually a fairly small group of firms with the capacity and capital to put into these projects. There is a considerable supply/demand imbalance here – there is a far greater need by hyperscalers to build data centers than there is capital available. With that in mind, tenants tend to be more willing to have constructive dialogue with organizations such as Blue Owl, who can help solve problems for them. We go back to our original thesis of being a problem solver.

Expand on these barriers to entry.

The barriers start with power and trying to find capacity. If you want to be in the development business, which is where people are active today because so much of the business now is build-to-suit large-scale campuses, you need to have power in the sites. If you're talking to an end user and you can't answer the question about how much power you have and when you're going to have it, it tends to be a very short conversation. You can't help them in a meaningful way. Expertise is critically important, as well. Bringing in the infrastructure needed to support large-scale sites involves building roads, bringing in water and building substations, which is very different from what industrial developers are used to doing. And then you need significant capital – $300 million, $500 million, $1 billion. New groups often don't have the scale of capital to be relevant in this market.

How can capital solutions providers best partner with hyperscalers?

Partnering involves working with them up and down a capital stack on a development project or even doing sale leasebacks. Real estate is not necessarily a big component of a hyperscaler's business. They are investing capital in many situations to support their core business. We're able to look at projects, look at some of the problems a firm is trying to solve and figure out what kind of capital solution we can bring to bear, whether that is equity, debt or development expertise. Having a variety of tools in your toolbox is important. If you are working at a hyperscale business and trying to find capacity, it can take a long time to actually bring capacity online, and you are trying to match needed capacity in a short time frame for the business, given what is practical to deploy.

What markets are hyperscalers targeting?

Markets that were part of that first wave supporting the cloud tend to be in some of the largest markets in the United States and the world. Northern Virginia, Chicago, Dallas, Atlanta, Phoenix and Portland are all major cloud markets historically, and they will continue to be. In Europe, those prime markets are London, Frankfurt, Milan and others. In the broader Asian market, a few key locations are Singapore, Tokyo, Sydney, Melbourne and Malaysia.

For companies in that second AI wave, the markets are more bifurcated depending on use. Training, computing and large-language models, for example, can happen in more remote or rural areas where large-scale power is available. But the revenue-generating part of the AI business, or inferencing, will target larger-scale, traditionally cloud markets. Latency is important still in those markets, as well.

Where is the current and projected demand?

When we look at demand, it goes back to the wave-on-wave concept, where we continue to see strong demand coming out of both cloud and AI. We think both are going to continue to grow at a very strong pace.

The AI demand initially will be for larger-scale, large-language model, gigawatt-plus type sites. AI certainly is a massive driver, with cloud remaining foundational.

How has the integration with Blue Owl gone so far, and where do you see the synergies, going forward?

Joining Blue Owl has given us access to additional tools in our toolbox and enables us to be an even better partner for hyperscale technology companies.

As the predecessor firm, IPI Partners, we were able to bring certain solutions to these companies. But now, combining the expertise within Blue Owl's net-lease strategy and real estate credit strategy and tapping into the insights within the broader Blue Owl ecosystem gives us more depth and breadth as we think through solutions for hyperscale companies.

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Matt A'Hearn is a senior managing director at Blue Owl and the head of digital infrastructure. In this role, he is responsible for leading the overall management of the digital infrastructure platform, including strategy, investments and portfolio management, as well as other corporate initiatives. A'Hearn also serves as chairman of the digital infrastructure investment committee.

COMPANY OVERVIEW

Blue Owl (NYSE: OWL) is a leading asset manager that is redefining alternatives. With more than $235 billion in assets under management, we focus on providing businesses with private capital solutions to drive long-term growth and can offer institutional investors, individual investors and insurance companies differentiated alternative investment opportunities that aim to deliver strong performance, risk-adjusted returns and capital preservation. Together with more than 1,050 experienced professionals globally as of Sept. 30, 2024, Blue Owl brings the vision and discipline to create the exceptional.

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