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CLOUDING THE AI ERA

How power, demand
and development
are reshaping
valuations



KEYNOTE INTERVIEW

AI reshapes APAC investment landscape



*The rapid rise of AI is changing not only where data centers are built, but also how investors need to assess risk and value across the sector, says PGIM's **Morgan Laughlin***

As demand for large-scale AI training campuses accelerates across Asia-Pacific, investors need to distinguish between this geographically agnostic compute capacity and the low-latency “cloud capable” assets that provide critical infrastructure to their local markets, explains Morgan Laughlin, managing director and global head of digital infrastructure at PGIM.

He notes that data centers providing hyperscale and enterprise customers with low-latency capability in supply-constrained markets offer a more compelling investment proposition than large AI training campuses. Growing institutional investor

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comfort with the sector is supporting the rapid growth of new development and stabilized data center transactions across Asia-Pacific.

Q How has the Asia-Pacific data center sector grown in recent years?

After initially lagging the US and Europe, for several years Asia-Pacific has experienced sustained strong growth in cloud demand. More recently, there has been tremendous

growth in AI-associated data center demand largely concentrated in a few countries, most notably Malaysia, India and Australia. The advent of this demand for AI training capacity in Asia-Pacific has clearly had a major impact on the industry and investor strategies.

Not so long ago, I would describe the data center sector as having two major components: one was retail co-location, the other was hyperscale, with a bit of enterprise in between. Today, the explosive growth of artificial intelligence or machine learning (AI/ML) demand has created a more meaningful bifurcation.

That is the split between latency-agnostic training campuses and the low-latency data center infrastructure that services the traditional cloud, enterprise and retail needs. Within the low-latency bucket we still have some meaningful differences in the assets servicing the different customer sets, but I would argue that these are less impactful on an investment analysis than the differences between high- and low-latency assets.

Q What are the investment implications of the split between low-latency data centers and AI/ML training campuses?

The major difference between data centers targeting low latency requirements and AI/ML workloads is location. Low-latency data centers need

“We are more comfortable investing in a low-supply story than an overwhelming demand thesis”

to be near the customers using their services, so they target sites near major population and economic concentrations – and therein lies the challenge and opportunity.

Securing powered land in these locations is extremely difficult, and we believe this challenge will only become greater with time, further exacerbating the already pervasive constraint on new supply. Coupled with our belief that the demand for low-latency capacity coming from both traditional cloud applications and AI inference will continue to grow at pace, we are anticipating long-term value growth in these assets.

While the explosive growth in AI/ML training needs is also creating a disequilibrium of supply and demand in the higher-latency sector, the fact that this capacity is much less

Q How are data centers changing the way capital is allocated across real estate and infrastructure?

I do think that there is a bigger point to be made around capital flowing to the data center sector. Whether you look at it as infrastructure or real estate, data center demand is sucking in a huge amount of capital that would have otherwise been invested in other strategies. As a result, I think investors need to consider digital infrastructure not only on its merits, but also on the impact it is having on the rest of their investment portfolio. There is only so much capital available to be invested into real estate and infrastructure.

The rapid growth and compelling returns are causing investors to shift out of other investments to free up capital for more digital infrastructure. I think that we are only at the beginning of the capital shift. As stabilized data center investment opportunities increase and institutional investors become more comfortable with the long-term value metrics, the sucking noise is going to grow much louder.

Today, stabilized data centers are trading anywhere from 75-125 basis points wide of stabilized logistics with similar credit profiles, according to global financial services provider Morgan Stanley. For low-latency data centers, I think that gap offers a great arbitrage. The supply-demand story for cloud-capable data centers is

more compelling than logistics – data center supply is tighter and demand growth greater.

As a result, I think increasingly knowledgeable investors looking at risk on a data center and risk on logistics facilities with a circa 100-bps gap are going to gravitate toward the data center option. The likely result will be cap rate convergence. Driven by a shift in capital into data center assets, data center caps are going to come down and other sectors are going to widen. So, whether or not an investor takes a position in data centers, their portfolios will be impacted.



geographically constrained means that it will exhibit greater supply elasticity. It may well be that AI/ML training requirements continue to grow at a scale to absorb all the new capacity, but we are more comfortable investing in a low-supply story than an overwhelming demand thesis.

Cloud-capable data centers have also benefited directly from the hypergrowth in AI training needs. We have experienced data center capacity designed for traditional central processing unit workloads converted to graphics processing unit workloads. This has increased the upward pressure on rents in the cloud space. Over time, we expect that much of this low-latency space that has been hijacked for AI training workloads will transition back to latency-sensitive applications as more dedicated AI capacity gets built out.

Q Has that shift impacted how investors address the opportunities in the market?

For us, the focus has always been on the latency-sensitive side because of our strong belief in the compelling investment thesis. It is also relevant that PGIM developed its digital infrastructure strategies out of our real estate business. This background means we naturally approach the sector with an asset-level focus. The low-latency model, where location is such a major factor driving value, naturally rings with us as real estate professionals. This bias is probably enhanced by our operator-independent investment model.

By primarily investing via development joint ventures with established data center operators, we can put all our fund capital to work in the physical assets, compared with the private equity strategies followed by our peers that center on investing via an operating company. Investing via a captive operator introduces different manager considerations due to the desire to grow value in the operating vehicle on the back of the cashflows generated by the assets.

“Interestingly, all the stabilized fund strategies being marketed are focused on low-latency assets”

In comparison to cloud-capable assets, I think of AI/ML campus investments as more of a credit play, as their value is largely derived from the strength of the tenant offtake. This view extends from the long-term elasticity of supply combined with less certainty around future demand. Over the long term, we are quite comfortable with the possibility of re-tenanting one of our low-latency assets without it negatively impacting the asset value. I would find that much harder to say for a 1GW, single-tenant campus.

Q Is that also a factor of higher perceived risk or competition for AI-capable space?

I would not make a huge generalization one way or another, apart from observing that a lot of the capital that has gone into the data center space comes either from private equity firms that want to buy a platform, or from infrastructure investors who also tend to invest via operating companies. Investors investing via operating platforms are not just thinking about the real estate returns, but also those of the platform itself. This mindset lends itself to having a greater interest in owning and operating these large-scale AI data center campuses.

There is much less capital pursuing our model of investing directly in real estate. I do not see a lot of direct competition from fund managers in this

space. Most of our direct competition for investor partnerships comes from very large pensions and sovereigns managing their own money. There are a handful of people looking at it on a low-latency, asset-by-asset basis like we do, but not many.

Interestingly, all the stabilized fund strategies being marketed are focused on low-latency assets. I believe this reflects the more easily understood sustained value thesis in this component of the industry versus the large training campuses. Scale is also a factor. Most any fund strategy will want to show diversification of assets, tenants and operators. This is much more easily done with the smaller scale, low-latency, single-asset data centers than with large campuses.

Q Looking ahead, is there enough capital available to satisfy demand for new data center assets?

For the foreseeable future, the industry overall will remain short capital, power and people. Unconstrained by these shortages, the industry would be growing much more rapidly. So, I suppose my answer is no – but from my perspective as capital provider to the sector, I do not see that as a bad thing. A prolonged shortage of capital to the industry will support attractive investment returns.

To date, the lion's share of the capital raised for data center investments has been targeting development. And this capital raised has been concentrated in a relatively small percentage of the total institutional investor universe. As a result, there is a real shortage of capital allocated to buy stabilized assets.

However, I strongly believe this is going to change, given the many attractive characteristics of the asset as a core investment delivering outsized returns. On a risk-weighted basis, the stabilized space is extremely interesting as it potentially delivers low double-digit returns on cashflows supported by great credits with long-term upside. ■

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