Data Centres Case Study

NextDC

A confluence of technology trends – cloud computing, big data, social media, and mobile computing – is leading to an avalanche of data and computing requirements. At the same time, higher power requirements for new servers are pushing equipment out of in-house server rooms and into large scale data centres.

As Australia's only independent data centre operator with a national scale, NextDC stands to benefit from the continuation of these trends. Independence means that NextDC only offers data centre services, as distinct from data centres run by Telcos and IT consulting firms. It's an important characteristic for the following reasons.

First, it increases the potential customer base. A Telco like Optus would be reluctant to use data centre space at a competitor like Telstra, but they are using space in NextDC. End customers benefit from flexibility too. Arrow Energy recently outsourced its IT management to HP, but opted to house the equipment in NextDC's Brisbane facility. This makes it easier for Arrow Energy to change IT providers down the track, should the need arise, than it would be if they were locked up in a HP data centre.

Second, this customer diversity can lead to a thriving ecosystem over time as customers connect directly to each other within the data centre. Such connections (called "cross-connects") save transmission costs and increase speeds for customers, and as the number of connections increases, the data centre transforms from a mere provider of power and cooling to a valuable place to do business.

NextDC opened its Brisbane centre in 2011, Melbourne and Canberra in 2012, and is on track to open Sydney and Perth in 2013. As data centres take 1 to 2 years to build and another 3 to 5 years to fill, the company is still in its build phase, during which cash flow is negative. The economics are similar to an infrastructure company – high upfront capital spending in exchange for high-margin cash flows over time as utilisation increases.

Like an infrastructure company, what matters to an investor is not how much money the company generates this year, but what return on capital they generate once its data centres are mature. We estimate that the company should be able to generate at least $50m in pre-tax cash flow once its five centres are mature, which represents a 25% return on the $200m in capital the company has raised to date.

The best examples of similar companies are international data centre operators like Equinix and Telecity, who generate returns in excess of 30% on their mature data centres.

As utilisation increases and confidence rises in its return metrics, we think the stock will trade towards 2.5x book – an appropriate multiple for a capital intensive business that can invest at 25%. This would imply a valuation of $500m, which compares to the current market capitalisation of $300m (1.5x book). Equinix and Telecity, by comparison, trade on 4-5x book.

During the quarter we bought a 3% position in NextDC for the Australian Opportunities Fund. The key from here is ensuring that NextDC gets its customer mix right in order to build a thriving ecosystem, as this will maximise future earnings and long-term value for shareholders.

Asia Pacific Data Centre

To use its capital more efficiently, NextDC has opted to lease the land and building shell where possible, and to fund the internal capex itself. During the quarter NextDC set up Asia Pacific Data Centre (APDC), an independent property trust that will own the land and building shell of NextDC's Melbourne, Sydney, and Perth data centres.

The way the trust has been set up gives it more in common with a long duration inflation-linked bond than a listed REIT. There is a single credit risk (NextDC), the leases are triple-net leases (NextDC covers all property costs), the leases are long-term (15 years with options to extend to 40), and the rents are fixed (grow by CPI with a +0-10% market review every 5 years). We estimate that a NextDC data centre only requires 15% utilisation to cover its rent (30% to cover all of its operating costs), making APDC's rents a stable and secure income stream.

APDC collects rent, pays the costs associated with a listed structure, and passes the remainder through to shareholders by way of a quarterly distribution. At the IPO price of 61c, this represented a 9% distribution per year with 23-25% of the distribution tax-deferred largely due to depreciation allowances. This distribution grows each year as the rent increases.

This strikes us as an attractive yield given our view on NextDC's business, along with NextDC's capital structure ($200m capital raised, no debt). Apart from being an attractive stand-alone yield, we think there will be further capital appreciation as the market re-rates this yield to 7-7.5% over time.

We used the IPO to buy a 3% position in Asia Pacific Data for the Australian Opportunities Fund (for a 6% combined position with NextDC), and a 0.75% position for the Enhanced Yield Fund.

Thomas Rice, Portfolio Manager