Tomorrow's world: The digital infrastructure opportunity

Forecasted growth for cloud computing, AI and data processing has created an increasing need to support digital infrastructure assets and, in our view, a substantial opportunity for investors.

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The phenomenal growth of the digital sector is structural, reflecting that our society and economy are evolving. Today, the computation, transfer and storage of data is essential and the infrastructure facilitating this is fundamental.

The digital connectivity underpinning so many of our everyday activities would simply not be possible without fibre networks, transmission towers and data centres. Key societal goals – from increased financial inclusion to creating a more environmentally sustainable world – will also need to be facilitated by increased investment in digital infrastructure.

Key takeaways

- Sectors like cloud computing and AI are already seeing **exponential growth**, creating an increased demand for infrastructure assets that can support the fast-developing digital economy.
- Digital infrastructure represents a way to gain **exposure to the technology** sector with a real-asset backing. With the potential to attract blue-chip tech names as customers, these assets could provide **stable long-term cash flows**.
- With multiple governments committed to funding digital infrastructure over the next five years, we believe these assets are well positioned to benefit from strong **policy tailwinds**.

Key risks
The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Investors are also increasingly seeing opportunities to support digital infrastructure. Today, deals involving these assets account for roughly 21% of the total infrastructure sector[1]. That compares with just 10% of deals focusing on digital infrastructure five years ago.

In our view, the space could offer investors the attractive combination of return potential and societal impact. We see three overarching trends converging, which should continue to bolster the case for investors seeking out these assets.

Exponential growth opportunity

The long-term structural growth in digital can be seen in the pronounced increases in data generation over the past decade. Roughly 90% of the world's data was created in the last two years[2], and there are no indications this will slow down – in the US alone, monthly data traffic is expected to almost quadruple from 45 exabytes in 2019 to approximately 166 exabytes by 2026[3].

In addition to the long-term structural growth seen in digital, the sector is also experiencing near-term demand drivers. The increasing relevance of technologies like AI has only increased already high demand for digital infrastructure assets.

These drivers look likely to persist. End user spending on cloud services is presently seeing a CAGR of around 20%[4], expected to continue through the end of the decade. Spending on AI is set to have a compound annual growth rate (CAGR) of 27% by 2026[5]. These are fast-growing sub-sectors that, we believe, will create an increased demand for infrastructure assets.

Today, the six of the world's seven largest publicly traded companies are technology firms with a heavy focus on data[6]. These, of course, rely on underlying digital infrastructure to function. It is our view that the continued growth of the digital sector will maintain a favourable demand/supply dynamic that could benefit those investing in this infrastructure.

Typically stable income, technology upside

Digital infrastructure revenues have remained stable across market cycles[7]. The contracts for these assets, and therefore their cash flows, are often long dated with clients frequently being comprised of large blue-chip technology companies. Strong free cash flow generation, coupled with the continued expansion of the sector, means these assets have the potential to offer investors stable and predictable income streams.

While costs have risen over the last 24 months, the critical nature of digital infrastructure has allowed a significant portion of these to be passed on to customers. Cost increases have led to margin pressures from which sub-sectors are emerging at different speeds – for example, over the last 12 months data centres have effectively been able to more than offset cost headwinds with volume and price increases. Thus, revenue growth has resulted in overall profit growth and minimal impact on valuations.

Generalising, we see that valuations for more mature businesses have declined by a few turns of EBITDA, while yet-to-be profitable start-up businesses have declined further. With tower and fibre valuations dropping, we are also seeing potentially attractive investment opportunities emerging outside of data centres.

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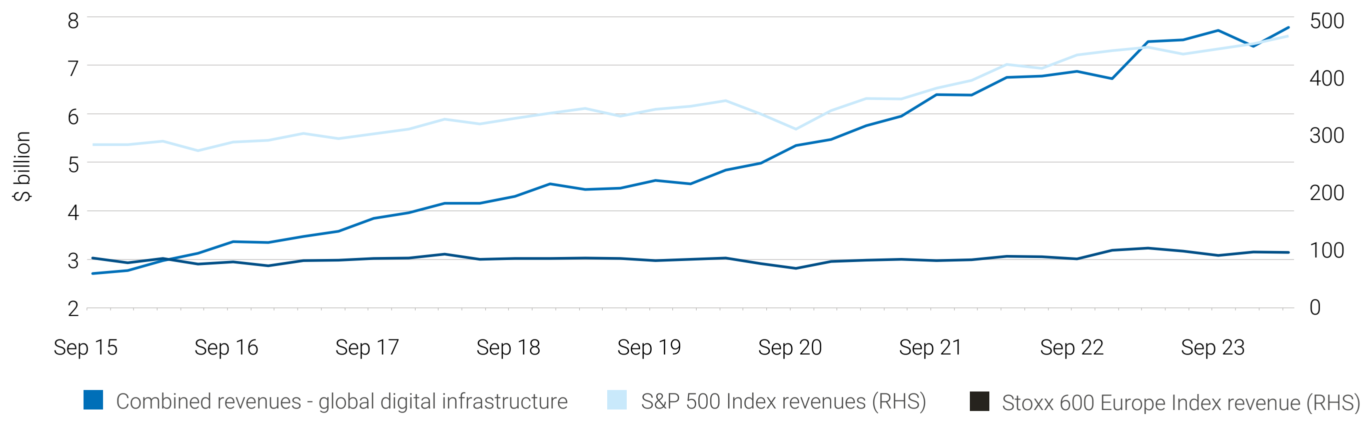
Digital infrastructure revenues have remained stable and growing across market cycles



Source: L&G internal data, as at August 2024

Overall, we believe digital infrastructure can provide a way to capitalise on the upside associated with mega-cap technology stocks – via exposure to real assets – without requiring exposure to individual names. Furthermore, with the emergence of technologies like AI, the power base among tech giants is diversifying away from the largest tech hyper-scalers of Amazon*, Microsoft* and Google*.

Policy tailwinds

Future government policy should potentially create a greater demand for digital infrastructure. Levelling up initiatives, for example, may seek to expand connectivity on a nationwide basis. Sustainability efforts – such as those focused on the more efficient utilisation of renewable energy – will likely be dependent on the effective transferring and processing of data.

Against this backdrop, significant commitments to improve and financially support digital infrastructure have been made at the legislative level.

Initiatives including the UK's Project Gigabit[8] and the EU's Digital Decade Strategy[9] are seeking to extend giga-bit capable broadband to hitherto under-connected communities. In the US, the Infrastructure Investment and Jobs Act[10], passed in 2022, also sets aside funding for closing the 'digital divide', with plans to build out broadband networks to improve access.

It is our view that these commitments represent significant policy tailwinds that bolster the sector.

Investor view

By 2030, we estimate there'll have been an approximate cumulative investment of €2.5 trillion digital infrastructure[11].

Presently, however, we believe the growth in digital infrastructure has created a funding gap. Adding to this, we've seen borrowing costs rise over the last 24 months. While the sector enjoys good appetite relative to other areas, a drop off in lenders has led to an increased focus on equity funding as a facilitator of its growth.

Though data centres, on average, account for much of the investing landscape, we increasingly see opportunities to diversify across fibre networks, towers and managed services. The sector has seen some divergence in terms of valuations, and, for investors, these variations show the importance of a nuanced understanding of sub-sectors married with careful asset selection.

With the digital infrastructure space poised for continued growth and evolution, we believe there are ample opportunities to benefit from its potential so long as investors can navigate the sector's dynamics.

1. Source: Preqin as of Q1 2024
2. Source: Statista as of November 2023
3. Cisco Visual Networking Index 2017
4. Grand View Research as of May 2024
5. International Data Corporation, Worldwide AI, March 2023
6. The Motley Fool, as of September 2024
7. L&G internal data, 2024
8. Project Gigabit, Building Digital UK, February 2024
9. Digital Decade Strategy, The EU Digital Decade, September 2021
10. US Infrastructure Investment & Jobs Act, November 2021
11. L&G estimate, as of August 2024

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