Brexit Implications on the UK Data Centre Market

First Quarter 2017

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On 29th March, nine months after the referendum took place to exit the European Union, Theresa May invoked Article 50, committing the UK to withdraw from the EU by 29th March 2019 marking a pivotal event in the history of the UK. There was a softening of language from Theresa May and her ministers after the official letter was handed to Donald Tusk. This indicated both increasing pragmatism, and possible areas of compromise. On trade there was a douse of realism as the government appeared to be backing away from its threat to leave the EU without a deal, acknowledging it cannot "cherry pick" during Brexit talks. On citizenship, rhetoric has become more conducive to negotiation ("we respect that" was May's response to EU leaders' assertions that Britain cannot stay in the single market without accepting free movement). Regarding the UK's bill to the EU, there is an implied acceptance. Philip Hammond refused to back the conclusion of a House of Lords' report stating the UK had no legal obligation to pay the EU after it left. The markets were fairly subdued by midday on 29th March, likely a result of this more balanced language by ministers. But in the words of chief Brexit negotiator Michel Barnier, this is the very beginning of a "very long and difficult road".

A report published by independent think-tank Civitas concluded that there has been no appreciable benefit arising from the UK's membership of the Single Market, and that leaving the EU with no deal is '*an acceptable option for the UK'*. It goes on to state that *'The mean rate of intra-EU export growth of EU members from 2004 to 2012 was lower than the rate of growth of the services exports of 27 non-members to the EU'*. Whilst noting that some sectors do benefit from the Single Market (banking and aviation singled out); a conclusion that the overall benefits are *'imaginary'* may give some confidence to the negotiators who are now faced with leaving it as a distinctly possible outcome.

The anxiety immediately after the vote was palpable with many forecasting doom and gloom for the UK economy. Many forecasted an immediate recession and a decline in GDP; however, we have seen continued growth in GDP over initial forecasts with the 2016 3Q and 4Q respective growth at 0.6%.and 0.7% In addition, although the Bank of England forecasted 1.4% growth for 2017, GDP estimates have been revised upwards to 2%.

Source: tradingeconomics.com

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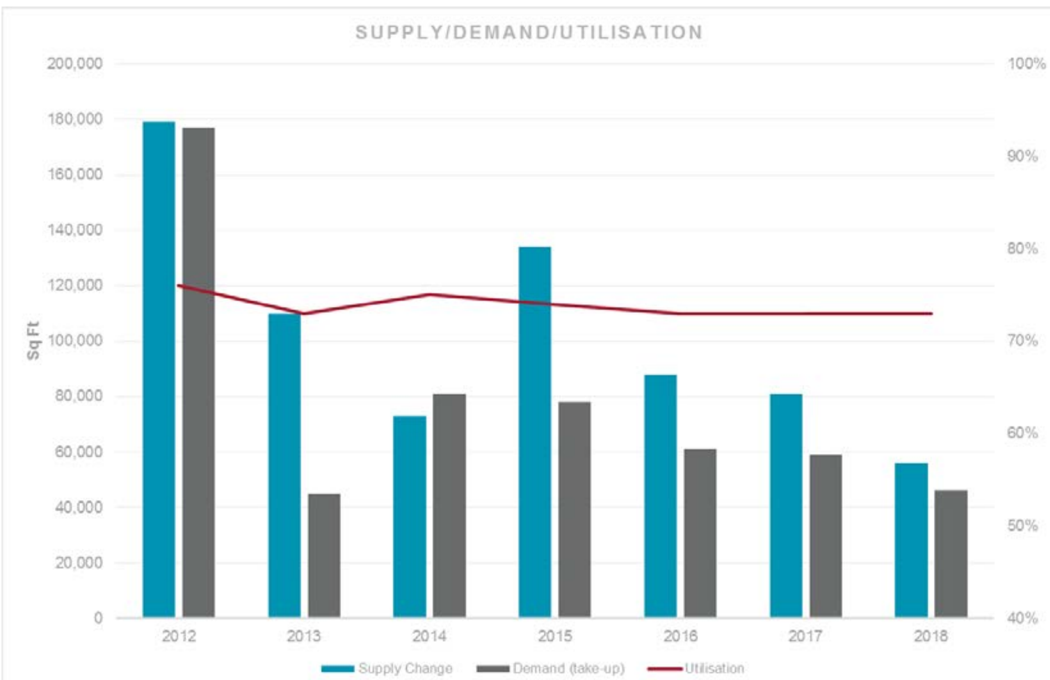
With a stable economy and no threat of recession, we turn our attention to the impact of Brexit on the data centre industry in the UK.

The UK Data Centre Market

The UK is the largest data centre market in Europe and second only to the United States globally. With unequalled network connectivity, a stable political climate, relatively low tax base and a solid regulatory environment, growth of data centres in the UK has been significant.

451 Research at 2Q 2016 estimated there were 53 providers operating 127 data centres in the greater London MTDC market. The market represents 484 MW over a footprint of 367,000 sq m (3.947 million ft^2). The data suggests continued growth in the wholesale supply with in excess of 18,600 m^2 (200,000 ft^2) of operational space to come on line in 2017. Consistent with the United States, retail colocation continues to trend lower here, as well.



Source: 451 Research – London Multi-Tenant Datacenter and Hosting Market

The UK is followed by Germany (approximately 200 MW) and the Netherlands (approximately 170 MW) for the top three slots in the European data centre market. Germany faces challenges of having the highest power costs in Europe. Accordingly to Eurostat, Germany has the second highest cost of power in Europe (Italy tops the list). In addition, taxes and levies represent nearly 48% of the total power cost in Germany. This cost combined with tougher government regulations and transition to renewables is restricting expansion. While the Netherlands enjoys favorable undersea cable connectivity, the country faces infrastructure challenges as well as limited areas of growth.

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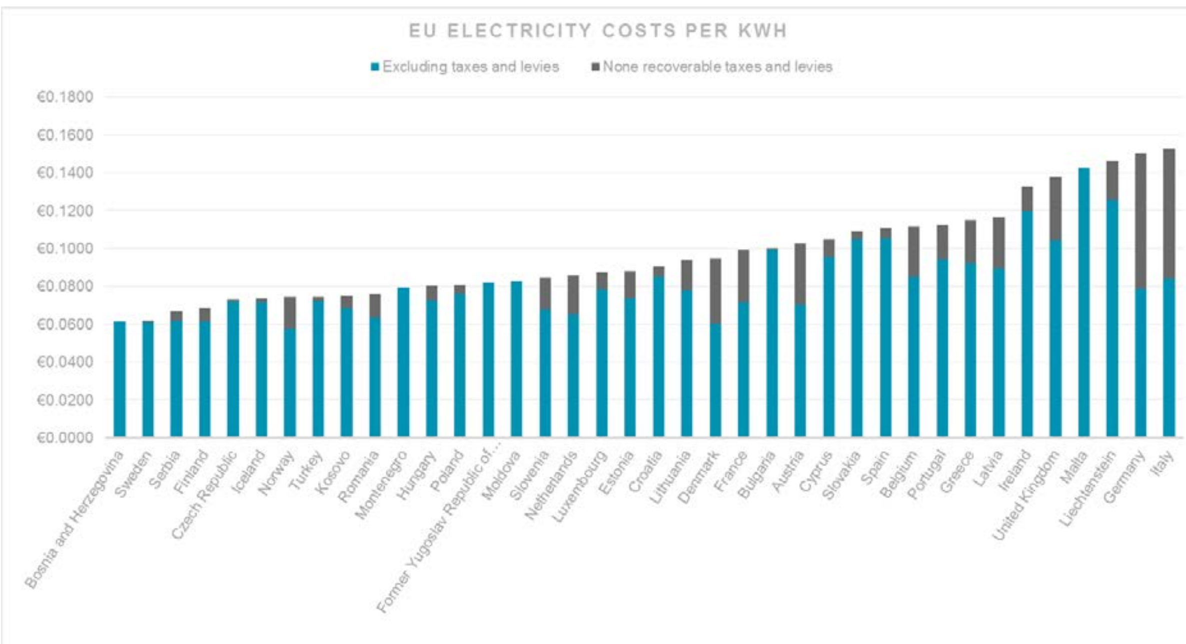
Contrary to industry concerns of contraction in Cloud service sector, IBM, Microsoft, Google and AWS continue to expand their data centre footprint in the UK. This commitment to growth has reduced fears of an exodus of providers to mainland Europe. This can be partially attributed to the strength of the financial services industry which represents 80% of the UK economy.

As per the recent 451 Research report, the top five data centre providers ranked by percentage of revenue are Equinix, Digital Realty, Global Switch, KDDI Telehouse and Level; however, the pending acquisition of Level 3 by CenturyLink may significantly increase Level 3's share of the market. All five providers continue to expand their IT footprint in the UK data centre market.

Headwinds facing the Data Centre Market in the UK

With uncertainty of Brexit waning, it is important to focus on the tangible concerns that may adversely impact the UK data centre industry. The UK is facing issues with power generation and high cost of delivering power. The UK has been fortunate that the cost of power in mainland European countries has risen above the UK (Eurostat 2015-2016 comparison).



Source: Eurostat (2016)

While the UK is near the high end in power costs, taxes and levies on power are the lowest in the EU. This is a conundrum for government planners as any increase in taxes and levies to fund improvements in the power grid will push the UK to the most expensive power rate in the Europe. Accordingly, any increase in non-commodity pricing will also directly impact energy pricing.

The recent report from techUk details much of the issues facing the UK data centre industry. In the report, energy costs, inward investment, data protection and skills were identified as priorities to be addressed.

Labor/skills will be greatly impacted by the restrictions in free movement. In the techUk report, there is a concern for an "acute skill shortage especially technical skills' that are needed for all aspects of the industry. The Bank of England is projecting an unemployment rate of 5%, as well as a labor participation rate of 63.5% for the first three quarters of 2017; however, there is uncertainty here as a confluence of economic drivers relating to productivity and Brexit that may impact these figures.

We are also looking at the decline in Sterling and the threat of inflation. Although the Bank of England's monetary policy is a target inflation rate 2% (Source: BoE February 2017 Inflation Report), short term and long term interest rates are trending up slightly. The steep decline in the GBP against the US Dollar has created significant opportunities for US-based providers to enter the UK market.

Inward investment, data sovereignty and environmental regulations will need to be prioritized as the UK moves through the separation process. Although much of these policies will mirror current EU standards, the UK will have flexibility to reduce regulations which will create a competitive advantage over the remaining EU states. Furthermore, unfettered by EU financial regulators, the UK will have the opportunity to create new financial and tax incentives packages to attract foreign investment.

Our Takeaway

It is clear that the post-Brexit UK economy has exceeded expectations. With a stable economy in place, the government can approach the separation process without concern of a market collapse. This will allow flexibility is addressing the above referenced issues and developing appropriate solutions.

As a practice, we are bullish on the UK data centre market. Although there are potential impediments along the way, the European mainland will have many of the same chokepoints along with the pressure of keeping the EU intact. In our opinion, there are no compelling reasons for relocating from the UK data centre market to Germany, France or the Netherlands. The issues facing the UK are no different on mainland Europe and from certain aspects, even less attractive than the UK.

Our confidence in the UK data centre market is attributed to the following:

- A large and very established data centre ecosystem with reliable power supply and world leading connectivity.
- A stable political environment with relatively low tax levels.
- Clear focus and direction on data protection and security.
- The continued expansion of providers and commitment of the major cloud providers to the UK market.
- The underlying UK financial market is favorable with GDP projections revised upwards for 2017.
- The Bank of England's forecasts for inflation and unemployment are in-line with a stable and viable economy.
- The government's increased flexibility from Brexit will be instrumental in working with the business community. The ability to deregulate in certain areas where otherwise restricted under EU mandates will provide a competitive advantage.
- The weakness of the GBP is attractive for foreign investment.

We believe that the flexibility gained from Brexit will allow the UK to navigate the shifting IT landscape. We recommend that our clients consider the exposure to potential shifts in energy costs and labor fluctuations. Furthermore, diligence in reviewing pending legislation and the impact of same is critical.

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About Cushman & Wakefield's Global Data Centre Advisory Group

We are the leader in the data centre industry with a robust offering of enhanced services to support the enterprise-end user. Our track record managing data centre requirements is robust and our industry experience relevant.

We can ensure that your business needs and objectives always come first. This is important as it is critical to the enterprise and cannot be compromised.

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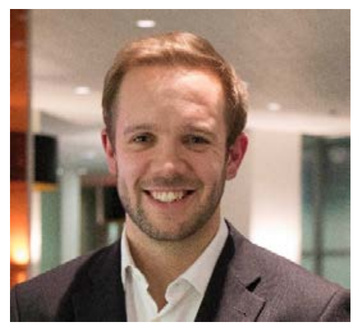

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