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Focus on software over managed services is driving datacenter business growth at QTS Realty Trust

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The datacenter REIT says that several deliberate choices, which included getting away from offering private clouds and managed services, investing in developing its Service Delivery Platform software and refining its customer strategy, have led to record growth over the last two years.

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Introduction

At a recent analyst event at its offices and facility in Ashburn, Virginia, QTS Realty Trust (a datacenter REIT) outlined strong performance since refocusing its efforts away from managed services and private cloud infrastructure, and toward a distinctive software-enabled delivery of datacenter services. This transformation, along with refinements to customer strategy and its approach to expanding its footprint, have led to record financial performance over the last two years (including revenue growth of about 14% in 2019), the company says.

QTS believes it has developed an approach to operating in the datacenter market that has equipped the company to be competitive and differentiated over the long term, despite the incoming pressures it expects the datacenter market to face. In the immediate term, the strategy has enabled the company to continue to perform in the face of the COVID-19 pandemic.

451 TAKE

QTS's move away from managed services ran counter to a common trend in the datacenter space. As enterprise operations continue to expand into public clouds, and a growing proportion of their workloads are placed in these environments, we have observed a broad selection of facilities-focused companies pivoting to include managed infrastructure and managed public clouds as parts of their portfolios.

There is merit in this strategy, since many enterprises are seeking to include the input of their datacenter partners strategically in their overall hybrid and multicloud approaches. Responses to 451 Research's Voice of the Enterprise: Cloud, Hosting and Managed Services, Vendor Evaluations 2018 study suggest that cloud connectivity (70%), private cloud offerings (43%) and datacenter or colocation space (30%) are all considered important complementary capabilities to cloud enablement services. QTS continues to address cloud enablement through a combination of colocation, connectivity and partners focused on managed services and private cloud infrastructure.

The company's determination that it could operate more effectively by focusing more completely on facilities was a departure from the widely held belief that managed infrastructure and hybrid cloud services are a key opportunity for datacenter companies. But its performance supports the wisdom of the decision.

Context

Founded in 2005 by current CEO Chad Williams, and headquartered in Overland Park, Kansas, QTS built up a portfolio of datacenter assets via building and acquisition. Traded publicly as of 2013, the company now operates 24 datacenters in 11 US markets, as well as in the Netherlands. That footprint represents more than three million square feet of operational datacenter space, and the company says it is just over 50% built out, leaving it with a large amount of capacity that it says can be built out and delivered quickly. It also reports 730 acres of expansion capability. The company expects its accelerated pace of buildout to continue.

QTS has more than 1,200 customers and 600 employees. Annual revenue for 2019 was $480m, which represents a 14% year-to-year increase. The company's stock price grew 46% from 2019 to 2020, which was a strong performance relative to the REIT market average. Like the REIT market overall, QTS saw its stock price rebound quickly following the initial dip caused by the COVID-19 pandemic. The company indicates its financial performance remained strong throughout.

Technology: Differentiating datacenters with software

QTS believes many of the players in the datacenter market have seen success in the last 5-10 years partly due to serving a growing need at the right time. However, it expects the introduction of capital into the market to put pressure on a market where the defining characteristics are largely capacity, cost and time to deliver.

In order to differentiate its datacenter services in that market, QTS has invested heavily in the development (including an estimated 200,000 man hours) of its Service Delivery Platform, a proprietary tool for automating and analyzing datacenter resources, which clients are using to gain insights into their environments and take actions to operate more efficiently. The tool pulls data inputs from a variety of systems (from DCIM tools, hybrid IT management systems and business support systems to external weather data), can map the datacenter down to the inch, and uses AI-driven analysis to develop operational insights that can improve operational efficiency at the QTS level (in areas like power utilization, environmentals, network traffic and hardware performance).

The company also exposes this data to clients, providing them with the same kind of operational insights, as well as information on employee access to the facility, and access to services like remote hands, network provisioning and management of deliveries. QTS says usage of the platform is still ramping up, but it reports approximately 1,100 hours of usage in Q1, an increase of 50% over the previous quarter. The company considers the tool to be a competitive advantage versus other datacenter providers, with a development lead time measured in years.

Strategy: Diversity of target clientele

QTS's position is that its best avenue for consistent growth is to build its customer base across three distinct customer segments that it characterizes as hyperscale, hybrid colocation and federal. It believes approaching a mixture of markets allows it to pursue distinct growth opportunities without becoming over-reliant on a single source of business, or overly subject to fluctuations in its demand.

While the hyperscale market segment as it's defined by QTS includes the hyperscale public cloud vendors (AWS, Microsoft, Google), the company's conception of 'hyperscale' also refers to a variety of the largest technology companies, including SaaS, social media and e-commerce companies whose requirements often range from 10-30mw. It is also seeking to serve what it describes as the 'hyperscale enterprise,' which includes businesses like Salesforce, Oracle, Twitter, Dropbox, Adobe and others whose capacity requirements land more in the 1-10mw range.

This segment offers the obvious attraction of very large prospective deals, but requires the capability to deliver large-scale capacity in specific locations (tied to existing availability zones) quickly and at a low cost. The hyperscale market has a long sales cycle, and demand is subject to the changing needs of a small number of key companies. For these reasons, QTS limits focus on hyperscale to a small independent sales unit representing a subset of the company's overall market strategy.

The company uses the term 'hybrid colocation' to refer to its more traditional enterprise colocation business. It currently accounts for approximately two-thirds of the company's revenue. With a larger number of smaller deals, it provides a more sustained level of demand and growth. QTS believes its offering here is differentiated by the availability of its Service Delivery Platform, and expects this to drive growth in the hybrid colocation market going forward.

QTS's view of the US federal government market is slightly different from its view of the others, since the federal government is still becoming comfortable with outsourcing the operation of things like datacenters. However, QTS says, the demand is growing. By building out ahead of it, the company hopes to be well positioned to support it. An added benefit of designing facilities to meet the additional levels of physical and information security auditing required by federal government contracts is that some of those higher security standards find their way into the operation of the company overall.

Product: Exiting private clouds, managed services

In 2018, QTS revealed its plans to exit the managed services and private cloud business, which at the time contributed a significant portion of revenue (between $65m and $75m). This decision was met with skepticism at the time, because it runs counter to the notion that these services are a good complement to a datacenter business (a model more than a few datacenter companies consider key to their adapting to the cloud transformation of their clients). However, QTS suggests that business was subject to significant competitive pressure, difficult to scale profitably, and declining in financial performance. The company feels its performance since making the shift validates the strategic direction.

QTS says one of the most significant challenges of delivering managed services and hosted private clouds was the level of customization it tended to require on an individual customer level. As a piece of the company's overall portfolio, this was at odds with the standardization and automation it is pursuing in its facilities operation business. It also required a completely different approach to sales, and was applicable only to a subset of the company's target markets. Ultimately, QTS felt placing attention entirely on operating the facilities would allow it to become more focused, as well as sell more effectively (and without competing) into the cloud provider and managed services market, which makes up a substantial portion of the company's business.

To that end, QTS confirmed that managed services remains a part of the its datacenter and partner ecosystem. Its buyer, GDT, is itself a large QTS datacenter customer, but a better operational fit for that kind of business. While QTS has a large datacenter investment cost but a comparatively small staff, GDT's larger workforce is a cost center associated with delivering managed infrastructure services. QTS continues to rely on GDT and other partners to support the managed services and private cloud requirements of customers, and it offers public cloud connectivity options to further support hybrid architectures.

Operating through adversity: COVID-19 impact

Like most businesses, QTS has seen the impact of the global pandemic directly on its operations. However, with a limited amount of strategic adjustment, the company feels it is well positioned to sustain its operations and meet customer demand, even where it is increasing.

The company says it is seeing growing demand from hyperscalers and large enterprises, including a very large increase in the demand for bandwidth. It has seen increases in usage (number of users and length of session) of its Service Delivery Platform software (including for mapping, requesting remote hands, and managing employee access to facilities).

Operationally, QTS made some adjustments to how clients and contractors accessed its facilities (for example, using separate entrances), and it was quick to approve forward purchase of the equipment it anticipated it would need for 2020 and 2021. Construction of new facilities has continued uninterrupted. The company reiterated its guidance for 2020.

Competition

QTS competes in the same market space and in many of the same geographic markets as the major publicly traded datacenter REITs (and many of the biggest MTDC market players), including Equinix, Digital Realty, CoreSite and CyrusOne. Its customer focus also puts it in the same group, competing for both hyperscale and enterprise datacenter business. At a regional level, it competes with a larger number of local players, which vary by region. Its move into the Netherlands may also put it into competition with the likes of Interxion and Iron Mountain.

SWOT Analysis

STRENGTHS	WEAKNESSES
QTS has a strong core focus on the operation of facilities, an existing up-front investment in capacity that positions it to meet new demand, and a differentiating feature in its proprietary Software Delivery Platform.	Operating at an international scale as a publicly traded REIT puts it into competition with some of the largest players, which are likely to compare favorably to QTS in terms of footprint or capacity.
OPPORTUNITIES	**THREATS**
The company's available capacity, investment in additional acreage, and development of the capacity to deliver datacenters and services that meet US federal government outsourcing requirements all position QTS well to adapt to new demand for capacity.	Although QTS actively targets hyperscale public cloud vendors as a market for its facilities, those same public clouds are a force opposing enterprise demand for its hybrid colocation offerings. As enterprises continue to use public clouds for more, appetites for colocation will decline among some.