GRANT'S
INTEREST RATE OBSERVER®
Vol. 34, No. 07e Two Wall Street, New York, New York 10005 • www.grantspub.com APRIL 8, 2016

Wide open spaces

"You have LPs giving a bunch of money to venture firms, that are giving a bunch of money to tech companies, that are giving a bunch of money to landlords." David Bergeron thus describes the cycle of life in the digital-themed West Coast real-estate business. Bergeron, managing director of T3 Advisors, property consultants to the tech economy, contends (and we concur) that the landlords are about to get a pay cut. Another update on Kilroy Realty Corp. (KRC on the New York Stock Exchange) is under way.

Constant readers may feel the need to rub their eyes or check their ears. Have they not heard this song before? Indeed, they have. Kilroy, the West Coast office real-estate investment trust with a focus on tech and media, is a known *Grant's* pick not to click (see the issues dated Oct. 2 and Feb. 26). We return to it here not because we are stalking Kilroy but because (a) the company and its clients are living out, in real life, the theory of interest-rate-induced market distortions and (b) Bergeron has a newsworthy, disinterested view to share on the business prospects for a certain kind of West Coast property owner—a view, we hasten to add, that Kilroy doesn't share (of which more below).

You wouldn't necessarily assume that zero-percent interest rates still have the early-stage financing markets on the boil. If SecureWorks Corp. succeeds in pulling off its reportedly imminent initial public offering, it would be the first tech-company debut of 2016.

Debt deals do get done, but not at the uproarious valuations of yesteryear. Recent financings rather call to mind a penitent nursing a hangover. Last week, Spotify AB, the music-streaming site, issued $1 billion of convertible debt bearing an initial 5% coupon and an initial conversion price set 20% below a prospective Spotify IPO price; terms become more stringent the longer Spotify waits to raise equity. Even 5% would have seemed usurious at the height of the high-tech incubator boom last year. The new Spotify coupon could be pushed as high as 10%.

"If this were such a good deal, it would be a private-equity deal," John Fichthorn, the co-founder and managing member of Dialectic Capital Management, remarks to *Grant's*. "This is basically a deal that private equity passed on. . . . The public is the new dumping ground."

Fichthorn complains that Spotify makes no money. Chamath Palihapitiya, the Sri Lankan immigrant who founded the top Silicon Valley venture firm Social Capital (and who bought a piece of the Golden State Warriors, to boot), levels much the same complaint at his confreres in the venture-capital industry.

"The reality is," Palihapitiya tells *Vanity Fair* magazine, "great companies can go public in any market. When we talk about the IPO slowdowns, what we're really saying is that there really just aren't that many good companies being built. We need to divorce ourselves from venture capital as an occupation and focus on using capital in a way to take really big bets on things that seem totally audacious. Right now, we haven't done enough of that, and the result is that most of the things we've funded are mostly crap and largely worthless."

Perhaps the lack of discernment stems from a glut of money. Janet Yellen did not specifically set out to supply the $120 million that financed the development of a $700 countertop fresh-vegetable juicer. Still, that money was forthcoming, and Juicero is taking orders.

Neither did the chair of the Federal Reserve Board personally stick a $2 billion valuation on Instacart, the money-losing San Francisco-based grocery-delivery business that raised $8.5 million in first-round financing only three years ago. If Instacart is Webvan 2.0, as its detractors contend, it is a Webvan with its own shopping algorithms, its own chief data scientist and its own bespoke accounting metrics. Unprofitable though it happens to be on a GAAP basis, the fledgling is "unit economic profitable." No, a qualification: It is unit economic profitable in 10 of its markets, or so reports *Fortune* magazine.

Anyway, says Bergeron, addressing the real-estate angle, point (b), office rents are about to fall. "It is a great time to be a venture-backed technology company," he says. "We believe that all signs are pointing towards a softening, particularly in San Francisco, amongst a lot of the tech users and the tech-focused buildings," Bergeron tells colleague Evan Lorenz. "I think that there are probably some healthy corrections that will occur in the next six to nine months."

Simon Yoo, the founder and managing partner of Green Visor Capital Management Company, a San Francisco venture-capital firm with a focus on financial technology, seconds Bergeron.

"A year ago," Yoo explains to Lorenz, "every landlord with whom we spoke about securing office space for ourselves wanted a 10-year lease with price escalators. Whenever a landlord wants you to sign a 10-year lease, you know you are closer to the top of the market than not.

"Fast forward to today: No one is getting 10-year lease commitments. There is also no doubt that many startup companies have been less than responsible in how they've managed their [cash] burn. A lot of that has to come down to spend on real estate because the founders were under the impression they could continue to raise money at ever high pre-money valuations. I think that dynamic is changing. It is probably early in the cycle, but sentiment is definitely changing."

Office space available for sublease in San Francisco has doubled over the past year to around 2 million square feet, or approximately 3% of the city's total office supply. Bergeron says he expects it to double again over the next six months, and that the resulting vacancies will set up an exploitable tension between in-place rents, on the one hand, and pop-up, sublease rents, on the other.

"There are going to be a lot of opportunities to take down small and large blocks of space that have been built out," Bergeron goes on. "This allows flexibility for someone to come in at under market rates [of rent] and do a deal. From where I sit, which is purely on the advisory side of technology companies and not working for the landlords or developers, I am really excited about what the future has to hold for my clients. There is a lot of existing infrastructure out there that requires zero money/out-of-pocket expense for these companies to move into."

The reciprocal of better news for tenants around the Bay Area is—of course—worse news for landlords. San Francisco delivered 40% of Kilroy's 2015 net operating income, and Seattle, 18%; San Diego, Los Angeles, Ventura county and Orange county chipped in the balance. Kilroy has a $1.2 billion pipeline of properties due for completion by 2017, of which 47% are pre-leased. Then there's what the company terms its "future development pipeline," the land and properties it owns but has not yet presented to the market in finished form. Green Street Advisors estimates that these unmobilized assets may represent $1.3 billion of additional investments. At last report, the value of total un-depreciated real-estate came to $6.3 billion.

You can't build a bearish story on Kilroy based on past results, which have been exemplary. Nor, by Bergeron's telling, is it advisable to doubt Kilroy's potential in the way-off, beckoning future. "If you told me that in three years the average rent in San Francisco would be $150 per square foot," says he, "that wouldn't be crazy in my mind relative to what we know is happening in the global market relative to the other hubs of commerce." (As to what's happening on the residential side of the San Francisco market, Bloomberg on Tuesday reported that unaffordable housing is driving some tech companies out of San Francisco and into places where software engineers can lay down their heads for less than $4,500 a month.)

It's the immediate future that strikes us as risk-fraught. Though, at year-end 2015, fully 96.1% of the company's stabilized portfolio was leased and only 5.8% of those leases were set to expire in 2016; expiries pick up in 2017 (to 10.4% of overall holdings) and 2018 (to 11.2%). Then, too, the aforementioned development properties will be opening their doors, and there may or may not be enough tenants to go around at the prevailing $75-per-square-foot lease rates, never mind the $150 rates of tomorrowland.

Mike L. Sanford, executive vice president at Kilroy for Northern California, says that he sees no cause for concern, not with subleases, not in the market as a whole. "Demand is up," he tells Lorenz, "supply is down, and constrained in San Francisco. Rents are still up. Concessions from our perspective are still relatively the same. We haven't seen a material shift in our markets and the product type we have in Northern California."

Since the February lows, Kilroy's shares have rallied by 11% to $61.25 per share, thus valuing the company at 18 times trailing adjusted funds from operations and a 2.3% dividend yield. For comparison, other public office REITs trade at an average 15.4 times trailing adjusted funds from operations and are priced to a dividend yield of 3.3%. We remain bearish.

•