AI Companies are Leasing Office Space: What is Their Credit

Thinking about AI Credit | August 2023

Artificial intelligence (AI) has garnered substantial attention in the media of late, possibly indicative of a hope that it will drive an economic engine that can transform a technology sector that was initially battered by central bank monetary tightening over the last 18-months. While there are some companies making extraordinary strides in the field, the economics of the sector remain uncertain, adding to the speculative nature of AI and how it will impact commercial real estate, particularly in the San Francisco Bay Area.

Be wary of AI leasing demand

Leasing activity remains sluggish in key technology markets as of July 2023, though demand appears to be growing around AI based companies that are willing to take on both direct and sublease inventory. Despite this demand, even the most advanced AI specific companies present risks that commercial landlords and owners should consider before making long-term commitments. Evolution in the industry will likely track monetary policies, and in a tighter interest rate environment, even the most exciting advancements in technology may lag due to higher costs of capital.

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AI IS SPECULATIVE

KEY POINTS

1. Global venture funding fell 18% quarter over quarter in the second quarter of 2023 to ~$60 billion, restricting the near-term capital to drive early growth in AI companies.
2. AI business models remain unrefined and untested, making most companies reliant on venture capital or strategic investors for the near- to medium-term.
3. Legal and regulatory challenges are rapidly evolving, leaving key use cases and business models in limbo.

AI CREDIT OVERVIEW

Generative AI has been heralded in the media and by technology industry cheerleaders as a transformational technology with the potential to dramatically alter the way many of us live and work. It's easy for us all to let our imaginations run wild with the possibilities of our future with generative AI, but the reality is that in the near-term, it will remain a fledgling technology in search of a business model. As such, there are numerous factors to keep in mind when leasing to AI companies.

First of all, what is generative AI? In short, it is complex software capable of using language learning models to do a range of tasks, including creating art, content, and code, while also synthesizing vast quantities of data with applications in healthcare, finance, law, and entertainment. Does this mean we are all doomed to work for AI? Probably not anytime soon, though many of us will likely incorporate generative AI in our personal and professional lives as the machine learning diaspora spreads.

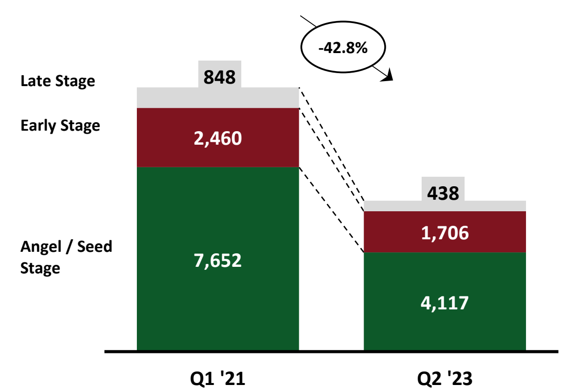
Industry leaders such as OpenAI's ChatGPT-3 and -4, Google's Bard chatbot, and systems including Stable Diffusion, Midjourney, and DALL-E were recently launched to the general public free of charge and through premium access. These nascent business models are not the end state of the technology. We don't currently know where the future implementations of the various AI platforms will go, and proselytizing the industry's future is not likely to be a profitable endeavor.

What is knowable at this point is that AI technology and the industry around it are evolving quickly, and with that evolution comes the classic speculative bubble around everything from valuation to use cases. At present, the reality of the AI landscape is that there is limited measurable fundamental value in place (from an accounting standpoint). Venture capital funding is slowing down, with all deal categories seeing between 30% and 50% between the first quarter 2021 and the second quarter of 2022. Valuations are also likely to be exaggerated given the unknown future state and the challenged venture funding environment.

EXHIBIT 1

Global Venture Capital Deal Volume

Thousands of deals



Source: Crunchbase, July 5, 2023

As Silicon Valley companies move fast in the development of AI technology, they will inevitably encounter resistance from peers, governments, industry, and labor. We are already seeing the manifestations of the disruption ranging from the [Hollywood Writers' strike] to the [U.S. Presidential campaign]. Regulation and other outside factors need not be viewed as a threat, but rather as direction for the industry. Competition from companies outside the U.S. is also likely to hint at U.S. AI investment. In the meantime, we can take solace in the notion that while venture funding is broadly down, average angel and seed stage funding deals remain stable, which provides a bedrock for further growth.

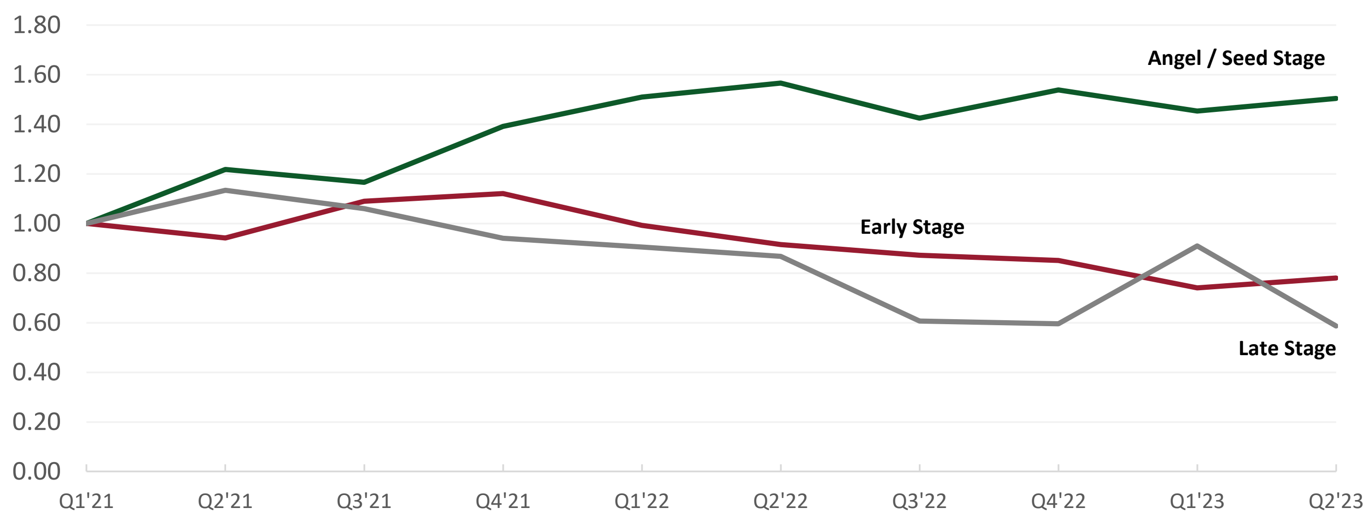
LANDLORD CONSIDERATIONS

With the funding landscape as it is, and rates poised to remain elevated relative to historic averages, it is reasonable to expect that funding will be challenged. But as mentioned, angel and seed stage deal size is actually stronger today than it was in the first quarter of 2021. That enthusiasm is in part a lagging effect of the low rates brought on by the pandemic, but also due to the transformative nature of generative AI. Funding for established businesses, however, appears to be weakening, with down rounds and distress hitting less transformative or less protected segments of the tech space.

EXHIBIT 2

Venture Capital Average Deal Size

Change in Commitments per Deal



Source: Crunchbase, July 5, 2023, TRA Analysis

Landlords are being approached for new leases, especially in lagging office markets like San Francisco, Washington, DC, and points in between. We encourage landlords not to be mystified by dizzying valuations and overly optimistic claims by these tenants. Instead, be certain to structure these leases and subleases with adequate protection. Below are a few considerations:

- Ensure that breakeven periods, inclusive of free rent, tenant improvement allowances, and commissions are less than two years
- Use a high discount rate when projecting NOI on these leases, ranging between 15% and 20%. The discount rate should reflect the uncertainty
- Ensure that the tenant has sufficient cash and liquidity to sustain operations breakeven and generate sufficient NOI to cover future commission expenses (or consider staggering portions of the commission throughout the first two years of the lease to share in the risk)
- Focus on speculative buildouts with high residual value. Think more like an industrial owner than an office owner with space that is easy to demise