Coworking and Flexible Leasing:
What's a Fad and What's for Real?

Coworking is hardly a new concept in real estate. Regus, one of the leaders in the industry, was founded in 1989[1], and over the years, the concept has evolved to carve out a small but meaningful niche within the office market. Original options were largely constrained to plain-vanilla serviced offices as coworking firms were laser focused on providing office necessities for individuals or small teams.

Fast forwarding to today, the growth in scope of coworking offerings rivals the growth of the industry itself. Free beer and coffee, ping pong, arcade games, yoga classes, and now even on-site child care are amenities increasingly standard at locations around the world. Now, the concept is making its way into the larger corporate office market.

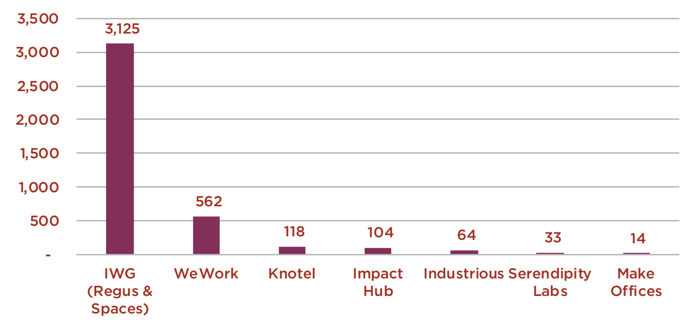
ARA Research anticipates that growth in the concept will continue but may be volatile in interim periods, faster when real estate fundamentals are improving and slower when they are not.

The Growth and Landscape of Coworking

Although WeWork gets the headlines, Regus is in fact the largest provider of flexible office space globally, first enjoying impressive growth in the late 1990s but stumbling into Chapter 11 bankruptcy in the dotcom bust[2], and then emerging thereafter. It remains a formidable player in the space.

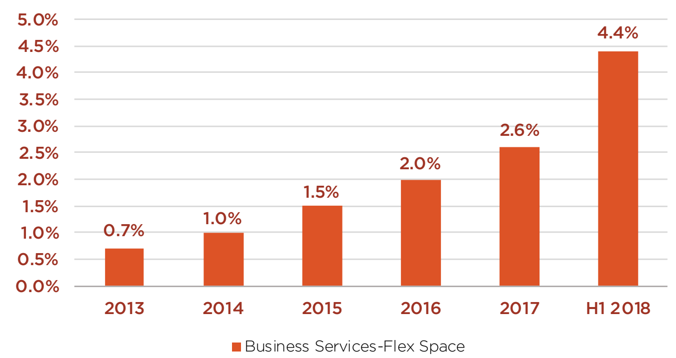
WeWork has led the most recent wave of working expansion and changed the narrative. Founded in 2010, WeWork's first location was in New York's SoHo and by 2014 WeWork was considered "the fastest-growing lessee of new office space in New York"[3].

Number of Locations



Source: IWG, WeWork, Knotel, Impact Hub, Industrious, Serendipity Labs, Make Offices

Coworking - A Growing Part of Office Leasing*



*Based on Top 25 transactions for top 35 largest markets

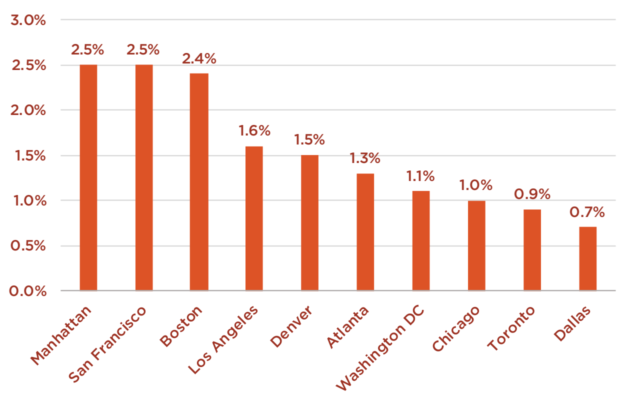
Source: CBRE

WeWork's funding success and rapid growth fueled many smaller entrants into the space, often catering to very specific sectors or demographic cohorts with their space design and amenities. Likewise, IWG (the parent company of Regus) was once again expanding under both the Regus brand and their Spaces brand – a modern shared concept that is more directly comparable to WeWork. In between the patchwork of small specialized providers and the major players such as WeWork and IWG, there are quickly growing midsized firms vying to compete such as Knotel, Industrious, and Impact HUB[4].

The Markets Where Coworking is The Most Prevalent

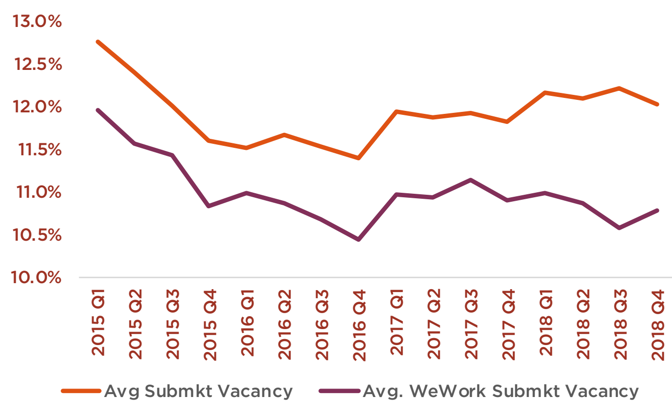
The rapid growth of coworking during this expansion so far has been concentrated in larger metros and in metros with an elevated tech presence.

Top 10 North America Coworking Markets - % Of Total Office Stock



Source: CBRE

Coworking Focuses on Lower Vacancy Submarkets



Source: CoStar

The focus of these models on markets/submarkets with elevated tech industry presence is worth exploring:

1. Where there is tech work there is freelance work.

The freelance segment so heavily targeted by WeWork in the company's earlier years is skewed toward the tech and media industries. Individuals and small companies in these industries are usually more heavily concentrated in these larger tech centric metros.

2. Quickly growing tech occupiers require flexibility.

Coworking providers have been successful in attracting corporate tech users looking for more flexible space that can accommodate growth as well as shifting business and personnel needs.

3. These markets generally have low vacancy rates and more rapidly growing rental rates on average.

This allows coworking firms to more quickly realize a positive spread between the rents they pay landlords and what they collect from their subtenants. In the event the coworking company has a partnership agreement with the landlord, the landlord can also participate in the higher profits generated from this strategy given favorable market conditions.

What Coworking Means for Office Demand

Coworking brings with it both positives and negatives for office space demand. The primary positive impact will come from increased adoption by freelance workers and smaller firms. Through this channel, coworking creates net new demand for office space as many of these individuals and firms would not work in traditional office space if not for the availability of turnkey flex space.

While coworking remains a smaller slice of the market, it will likely increase its share over time. Corporate sponsors find value in flex space compared to the greater rigidity and investment of traditional lease models, and full-service venues come at more efficiency and lower cost. A negative is the densification in modern coworking layouts, which can be twice as much as more traditional buildouts[5].

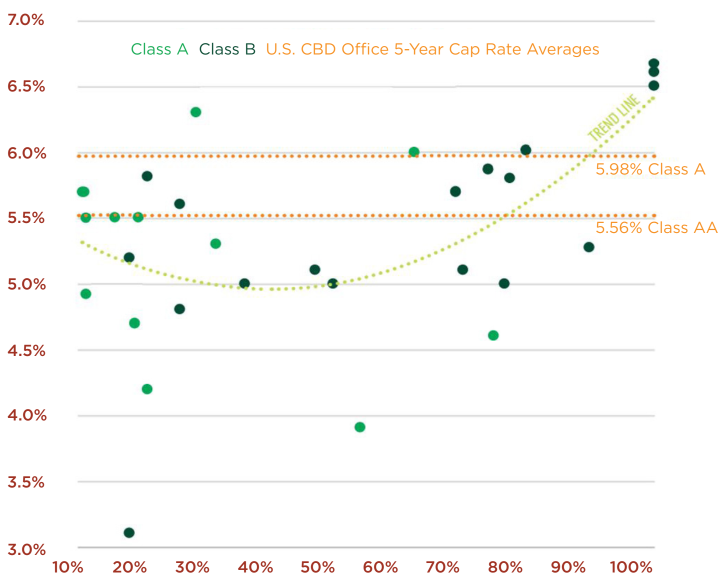
During downturns, these factors will be negative as downsizing by smaller occupiers outweighs increased adoption by larger corporate users. This may change during the next cycle as it will likely feature increased adoption of coworking by corporate users as they increasingly come to expect the greater flexibility offered by the proliferation of coworking options.

What Coworking Means for Office Asset Pricing and Lease Trends

Does having a coworking tenant lead to a lower cap rate? Is there an optimal amount of exposure? Analysis of sales comp data[6] has examined the relationship between coworking operator exposure and transaction cap rates, but the results thus far have been inconclusive.

Higher Concentrations of Flex Space are Correlated with High Cap Rates

Points represent buildings sold in 31 flex transactions

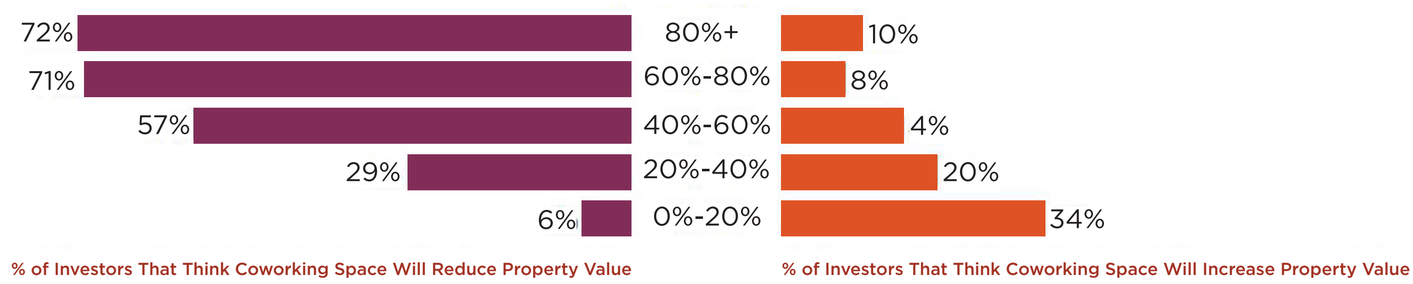


Source: CBRE

Due to the heterogeneity of buildings and inconsistent availability of cap rates, even taking into account factors such as building age, location, tenant mix, tenant credit quality, and lease term influence transaction cap rates, it is difficult to draw strong conclusions.

Alternatively, one can analyze the responses of investors surveyed on the topic.

% of Building Occupied by Coworking Operators



Source: CBRE

In this case investor sentiment is very telling. If a building has 20% or less exposure to coworking, investors perceive this will increase the value of the building on average. Sentiment is much more mixed with respect to coworking exposure in the 20-40% range. Any exposure beyond 40% of a building's occupancy is considered to reduce value. Investor attitudes are likely to evolve in response to the performance of coworking tenants during the next downturn.

The Future of Coworking and WeWork

Looking to the future, the boldest predictions anticipate coworking could become 30% of corporate leasing by 2030[7]. Newmark Knight Frank proposes a range of outcomes under various scenarios, from rapid acceleration to 20% of inventory by 2023, to a reduction in current occupancy by half due to difficulties arising in the next downturn[8], with a middle of the road scenario the most likely.

Essentially, coworking companies are value-add middle-men between owners of office space and their tenants. They lease space, divide it further, and sublease it to tenants. Like the fundamentals of the space they lease, this model is cyclical. To enhance the model, WeWork has been forward thinking sometimes offering tenants access to health insurance and internal social networks, and by using machine learning to optimize square footage per worker and tracking work patterns using sensor technology to optimize space design. Despite all this, their greatest feat might merely be that they have branded themselves as a tech company and not a real estate company, resulting in a wave of venture investments[9], including such luminaries as the SoftBank Vision Fund, a $100 billion-dollar fund that has placed its largest bet on WeWork[10] and is largely responsible for their lofty valuation[11].

WeWork's valuation and rapid growth partly distract from an important fact – the company has yet to turn a profit. The firm argues this stems from the costs of its rapid expansion and that existing spaces running at stabilized occupancies are profitable. While credible, when accessing the debt market, the company did report a bespoke earnings calculation referred to as "community adjusted EBIDTA" which was widely panned[12]. It remains to be seen what will happen to the company's ability to turn a profit once it is subjected to the volatility of public markets, has debt coming due, and an adverse economic shock leads to falling demand for real estate.

Strategic Implications

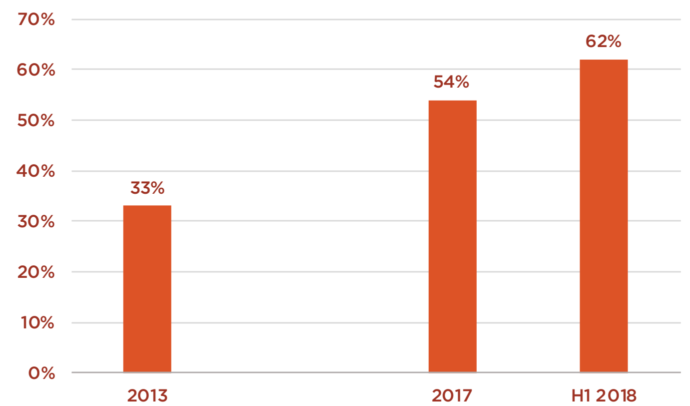
As of the first half of 2018, coworking accounted for 33.1% of all major leases by business services companies. If leases signed by WeWork are removed from that equation, that share would fall in half, and during this time, WeWork accounted for 62.0% of top coworking transactions double the number five years ago. Even without WeWork, coworking is still rapidly growing.

Our strategy in this sector is focused on maintaining high tenant and building quality as a tool for risk mitigation, and the most likely strategic implications of coworking for our portfolios include:

- Well located, high quality properties in markets with tight property fundamentals will continue to be able to command longer term leases to credit tenants.
- Coworking will continue to pull prospective tenants out of coffee shops and home offices, with varying success tied to the economic cycle.
- Coworking space creates significant opportunities for companies to be flexible and adaptable during times when space is not needed rather than warehousing space in anticipation of growth. The offset to this may be some loss of on-site synergy but innovations in video communication can mitigate this to a large extent.
- Coworking will increasingly place pressure on lease terms of buildings struggling to fill space as increasing coworking options force some landlords to compete on lease term, not just price.

Coworking is an intriguing concept with definite room to grow further. Growth will be in fits and starts as it is more susceptible to the vicissitudes of economic cycles. While likely reducing lease durations gradually and moderately within the office sector over the long-term, the impact on quality traditional office space is likely to be minimal as higher quality buildings will continue to command longer lease terms to strong credit tenants. Conversely, lower quality buildings with less market power will be most impacted having to compete both on price and lease duration.

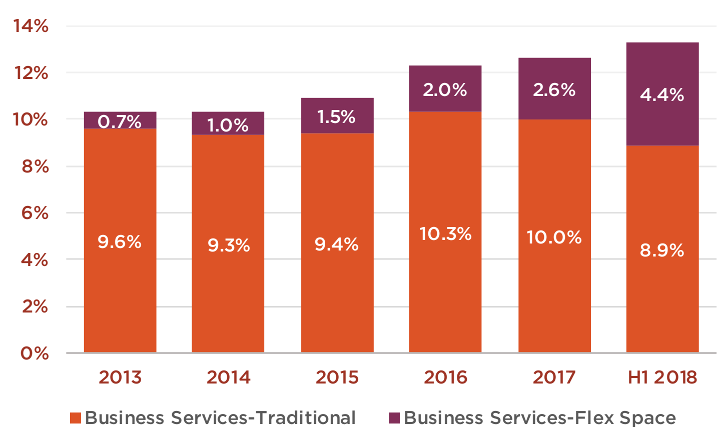
WeWork Share of Top Coworking Transactions**



** Data only available for 2013, 2017, and H1 2018

Source: CBRE

Coworking is a Growing Percent of Office Leasing*



Source: CBRE

Footnotes

[1] https://en.wikipedia.org/wiki/IWG_plc
[2] https://www.theguardian.com/business/2003/jan/15/money
[3] https://www.forbes.com/sites/alexkonrad/2014/11/05/the-rise-of-wework/#57d43e576f8b
[4] https://www.coworkingresources.org/blog/largest-coworking-companies
[5] Green St. Property Insights: The Co-working impact.
[6] We analyzed work from both Cushman & Wakefield and CBRE but elected to present the CBRE analysis as it had been conducted more recently and included more trades. Both pieces of analysis were inconclusive.
[7] https://www.us.jll.com/en/coworking-market-growth
[8] http://ngkf.com/Uploads/NKF_White_Paper_The_Future_of_Coworking_and_Flexible_Office_Space.pdf
[9] https://www.wsj.com/articles/wework-a-20-billion-startup-fueled-by-silicon-valley-pixie-dust-1508424483
[10] https://www.recode.net/2018/10/9/17957916/softbank-wework-vision-fund-talks
[11] https://www.bloomberg.com/opinion/articles/2018-06-14/softbank-s-wework-investment-would-rapidly-double-valuation
[12] https://www.businessinsider.com/wework-community-adjusted-ebitda-is-reminiscent-of-tech-bubble-albert-edwards-says-2018-5

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