FROM FREELANCERS TO FORTUNE 500 CLIENTS: THE EVOLUTION AND FUTURE OF COWORKING

GWLRA Research Services and Strategy

GWL REALTY ADVISORS

Coworking companies have become the fastest growing tenant type across office buildings in North America and globally, especially in the technology-focused gateway centres.

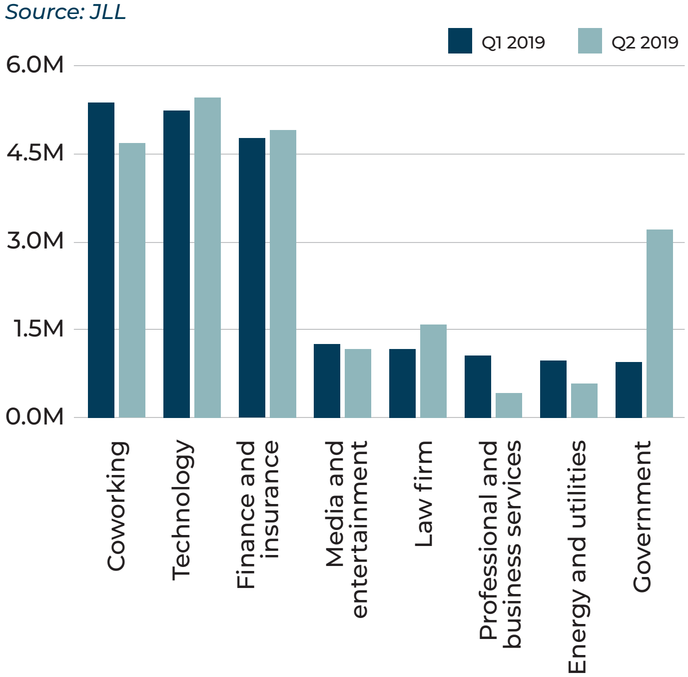
Their offering, focused on esthetically pleasing, functional workspaces combined with hospitality, flexible terms, and trouble-free technology has attracted users from freelancers to start-up companies to giant financial services and technology companies into these spaces. Whether a company or a freelancer wants private offices, open plan within a private space, or a mix of both, coworking companies offer this. Or, clients can choose to use a hot-desking open area workstation. Flexibility is a key attractant.

In Q1 2019 Coworking generated the largest share of leasing activity, according to JLL. While activity declined modestly in Q2, it remains a top three sector for office leasing YTD.[1]

Coworking providers—including brands such as WeWork, Spaces (IWG), Industrious, Knotel and Convene as well as myriad niche and local players have given office tenants new options. Moreover, they demonstrated to traditional landlords that a market exists of tenants ready to pay a premium for a higher level of service and workplace quality–as well as for lease terms by the month instead of the decade. Traditional office tenants now will choose to pay the coworking premium whether at other locations, or upon lease expiry and relocation. And now some landlords are offering their own coworking brands such as Hines Squared, Tyshman Studio and Oxworks.

US Office Leasing Activity by Industry, Q1 + Q2 2019

Source: JLL



A FEW THOUGHTS ON THE BUSINESS MODEL

WeWork's Initial Public Offering (IPO) discussion provides a context for distinguishing the coworking business model and its place in the evolution of office space, from issues specific to WeWork which are well documented elsewhere.[2] WeWork has a similar core business model to other coworking companies. However it has a faster pace of growth, greater appetite for debt, and more unusual relationship with its founders and investors than similar companies. The remainder of this white paper focuses on the broader coworking trend and its implications for office investors.

Coworking as a throw back real estate venture

Some observers have expressed concerns about the business model itself, which are probably overstated. Coworking companies must enter longer term leases with office landlords, build the space to a standard to attract workers and companies, and then lease it on short terms.

This is actually similar to what office landlords and investors do themselves: buy buildings (a long-term position) and lease them at shorter terms of 5 to 20 years. Although building owners have benefited from capital appreciation more recently, this was not always the case. Office building investors of the past often owned assets for net rental revenues, making this aspect of coworking a throw-back, rather than an innovation. (Indeed, with cap rates low, some office buildings may have similar limited potential for long-term capital appreciation.)

Profitability and stable growth

WeWork reports that a location typically becomes profitable after 18 months of operation. Although the other providers do not offer this information, their experiences are likely similar. Some coworking providers choose to expand at a measured pace, avoiding debt. Others such as WeWork have been more aggressive in order to capture market share.

1 JLL Research, United States Office Outlook – Q2 2019. Accessed 11 September 2019 at https://www.us.jll.com/en/trends-and-insights/research/office-market-statistics-trends

2 For example: Maureen Farrell, "WeWork Parent Weights Further valuation Cut." Wall Street Journal, 8 September 2019 and Lisa Eadicicco, "WeWork IPO reveals company loaned millions to CEO Adam Neumann and other company execs" Business Insider 14 August 2019.

Risks from a downturn

Certainly, in downturns office landlords sometimes struggle to maintain occupancy and revenue levels. The best locations and buildings typically see a flight to quality and sometimes rents can be maintained while lesser buildings see rents move downward. When the next recession hits, coworking companies may similarly encounter a lower demand from occupiers and will need to reduce rents to maintain occupancy.

Coworking companies may face challenges in locations where reduced fees now cause the operation's expenses—including headlease rent, salaries, and operational costs–to exceed its revenues. Those operators with less debt, good locations and that are expanding at a measured pace may survive the downturn with minimal pain. For landlords, if coworking fees from members start to fall, there may be pressure to reduce rents or face having the space returned to them in a sluggish market.

Geographic diversification will also help many coworking firms endure the next down cycle. Those operating across markets and in regions with different economic drivers may find it easier to ride out any downturns felt unevenly across regions and industries (which is often the case save for the Global Financial Crisis, the last recession). This said, some locations in distressed markets may still close.

Moreover, because many businesses start during downturns (when their founders are suddenly jobless), they need flexible space options; coworking in some ways has "built-in recession insurance" within the business model. The shorter term, flexible leases also make the decision to occupy a coworking office almost risk free in a downturn, rather than risky as a 10-year lease would be.

COWORKING'S DIFFERENTIATING FEATURES

Flexible lease terms starting from a one-month or even daily commitment distinguishes coworking from traditional landlord-tenant relationships that require long-term commitments. However, packaged office providers such as Regus (IWG) have been offering simple monthly desk rental for decades. **What distinguishes coworking from packaged office is the overall experience** that meshes with 21st century business and individual needs.

How coworking is meeting 21st century business and worker needs:

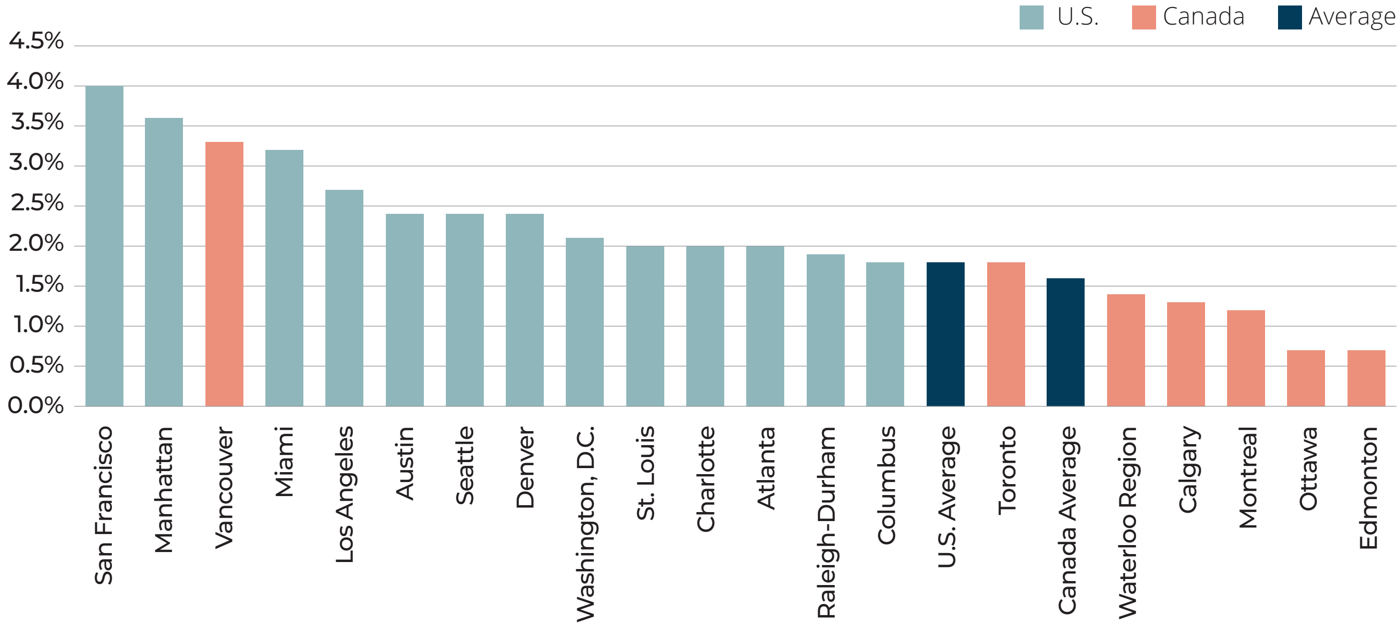
1. Coworking companies have **rebranded and elevated the packaged office business** into one with **a superior customer experience alongside a superior technology backbone.** Initial coworking space users were often freelance computer programmers and web designers who needed uninterrupted high speed internet. They also wanted that technology company vibe of more creative interiors and places to socialize as well as attractive spaces in which to host clients. Coworking companies provided this and most members today see value in this combination as well as the all-inclusive offering. Video conference facilities, wireless printers, and both ethernet and wifi options come included in the monthly price. This allows freelancers and larger companies using coworking spaces for branch offices or project space to focus on their core business rather than trouble shooting IT.
2. **Coworking meshes perfectly with the rise in importance of the experience economy**. A structural change has occurred in which people have become less focused on consuming goods and more interested in prioritizing experiences. In the battle for talent, offering a superior workplace experience is now a way to attract and retain employees and coworking offers employers an office space solution should they decide not to create this environment in house.
3. The creative **turn-key space with private office as well as open plan options** offered by Coworking companies works for individuals needing space, small businesses unsure of their growth and larger firms wanting project space or simply attractive, hassle-free office options especially for branch locations with fewer employees. This flexibility seems to work for everyone.

   WeWork reports in its 2019 IPO filing that 40% of its members now work for companies with 500 or more full-time employees, up from 30% in 2018. Combined with companies with fewer than 500 employees and coworking spaces are increasingly an alternative office space option for employers rather than an aggregation of freelancers.

4. **Flexible lease terms** are a key innovation from coworking companies, and the aspect of the arrangement most attractive to many firms. In the 21st-century business environment, companies and divisions are often growing and changing quickly but also at the whim of the economy or contracts. Predicting how much office space will be required in 5 to 10 years is challenging. Coworking companies do the long-term leases with the landlord and sublet at a premium. However, when combined with the services noted above, it becomes an attractive value proposition for some firms.
    a. **4b. New IFRS accounting rules further the attractiveness of month-to-month leases**. A long-term lease must now be listed as a liability on a balance sheet. A 10-year deal could therefore be a significant obligation relative to revenues, whereas month-to-month leases can be treated as an operating expense.
5. **Coworking also fits with a desire for human connections, whether one lives in suburban or high density locations**, two key American living styles today. Technology enables many workers, whether freelancers or employees of large and small firms, to work from anywhere. Yet, people often prefer to work near others– to collaborate, receive inspiration, or simply to be "alone together" in a way that seems less isolating. Coffee shops have long served as third places, but lack the secure wifi and cannot offer privacy when needed. Now there is coworking, even outside the dense downtowns where locals may be escaping cramped apartments. Suburban coworking spaces, sometimes in struggling shopping centers, have proven popular with suburban freelance workers as well as employees of larger firms with the permissions to work from anywhere (Boston-based WorkBar, for example).

Q2 2019 Overall Penetration of Flexible Office Space (% of Overall Inventory)

Source: CBRE



THE FUTURE OF COWORKING

Coworking is here to stay. Flexible lease terms work for the fast-pace of business evolution in the 21st century. Moreover, outsourcing the effort to provide a superior workplace experience allows everyone from freelancers to larger firms the opportunity to focus on the core business.

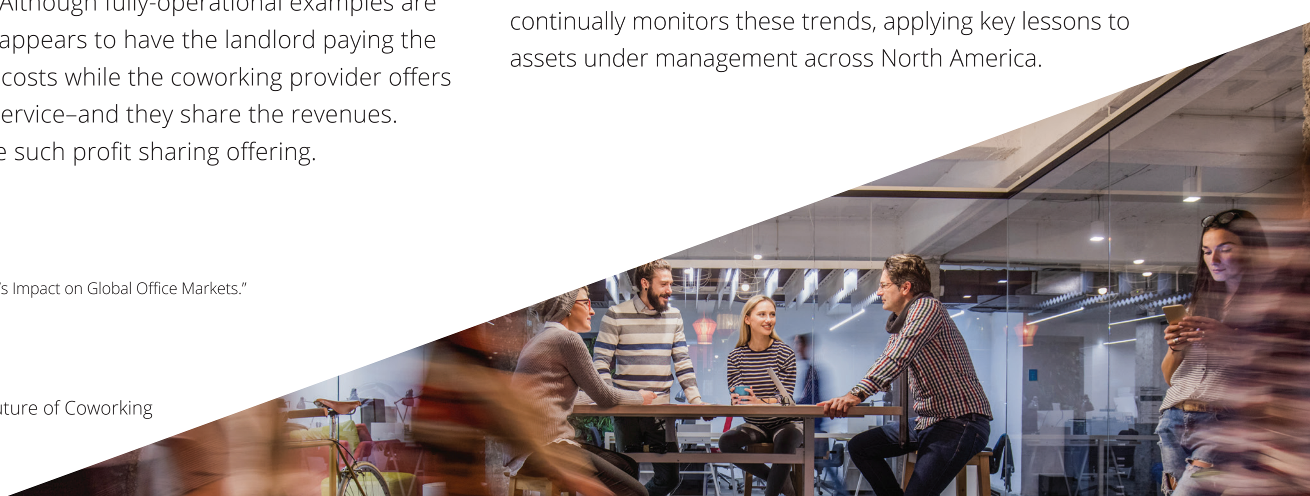
This said, more change is ahead. Some brands, and some locations regardless of brand, may not survive an economic disruption. For landlords reviewing potential leases with coworking companies, it is important to consider whether your location is a likely survivor. In addition, most landlords take steps to mitigate risks to cash flow should a coworking operation go dark. As documented in our PREA Quarterly article, these include bank letters of credit or surety bonds to ensure—as with any start up—some compensation should a coworking location in the building fail.[3]

The relationships between coworking providers and landlords are also changing. Profit sharing alongside risk sharing has begun to emerge. Although fully-operational examples are scarce, the model appears to have the landlord paying the up-front build-out costs while the coworking provider offers the platform and service–and they share the revenues. CBRE's Hana is one such profit sharing offering.

Office landlords are also taking inspiration from coworking, evolving their own offerings and finding ways to learn key lessons from these new players. Some landlords are creating their own coworking brands. Several have become investors in the leading proponents, perhaps as a way to become insiders on this trend. And in more distressed markets, such as Calgary Alberta (with the energy downturn resulting in a 25% office vacancy rate) landlords are offering turn key spaces at flexible lease terms, and with upgraded building amenities, in order to fill vacant space; for tenants, this is at a substantial discount to coworking, although without the high-touch coworking service offering.

Coworking is part of an evolving workplace experience, changing to match business needs. The next phase will likely include greater involvement from office landlords. This is already visible in new building designs in which a greater amount of space is dedicated to high-quality, shared amenities. EverWest, along with its parent company GWL Realty Advisors, continually monitors these trends, applying key lessons to assets under management across North America.

3 Wendy Waters, "Coworking's Impact on Global Office Markets." *PREA Quarterly. Spring 2019.*



Corporate Profile

GWL Realty Advisors is a leading real estate investment advisor providing comprehensive asset management, property management, development and specialized real estate advisory services to pension funds and institutional clients.

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