


# RESEARCH NOTE

## COWORKING AFTER WEWORK'S POSTPONED IPO

October 2019



Coworking, also known as Flex Office<sup>1</sup>, has been under scrutiny following WeWork's recent failed attempt at an Initial Public Offering and subsequent CEO resignation. From our long-standing research into this sector, GWLRA research has concluded that WeWork's problems do not foreshadow a wholesale collapse of this usage type.

Change, however, is pending. The WeWork situation has coincided with a slowing of coworking growth that began in Q2 2019. Moreover, WeWork's financial challenges—brought on by a debt-fueled, rapid global expansion—likely marks the start of disruption in this sector that will play out over the coming 24 months, possibly coinciding with a mild recession in many countries. Below is our interpretation of WeWork and coworking's short-term future and the implications for the office sector.

### **Established WeWork locations are occupied = limited immediate risk**

First, although WeWork is one of the largest tenants in Manhattan, downtown Vancouver, and many other markets, its established spaces are occupied. Moreover, in places like Vancouver large enterprise users (Amazon for example) occupy the majority of the square footage. WeWork stated in its S-1 IPO filing document that 40% of its "members" (users) work for companies with over 500 employees. Vacancy risks in buildings and markets with these WeWork operations subleased to medium and larger businesses are therefore minimal.

Established WeWork operations have occupants paying premium rents. These contracts represent secure income, even if short term. WeWork will likely keep these cash-flow-positive operations. If WeWork did go into arrears on rents or otherwise be unable to continue managing the facilities, the landlord would have options to switch these users to headleases or find a new operator for the space, albeit with some legal costs and complicated negotiations. Most sub-tenants will not wish to move.

Although pure speculation on our part, WeWork may be able to generate cash from their well-located, successful operations—if the landlord agreed to transfer the lease to a competitor who would also pay WeWork a fee for the fully-functioning and profitable operation.

Some WeWork spaces may switch into a partnership or profit-sharing arrangement between a coworking services provider and the landlord, following the model created by Convene, Industrious, Knotel and others.

<sup>1</sup> In this piece we will use the term "coworking" to refer to flexible-term office space that offers private offices, reserved desks, as well as hot desking and shared amenities including meeting rooms as per the users needs, whether the user is an individual, a small business or a large enterprise company.

### **Coworking spaces leased but not yet built out = risk**

For those spaces leased but not yet in operation, there is a risk that WeWork will not continue with the build out. WeWork's new leadership along with the landlords involved may look to negotiate a termination on those locations that do not have a large enterprise tenant ready to move in upon completion; this will avoid additional capital investments by WeWork and the Landlord. Already, some landlords have taken the initiative and approached alternate coworking providers to take over future WeWork space.

Where there are large, enterprise sub-tenants ready to move in, a similar process of finding a new operator or switching them to headleases may occur as described above.

In prime locations in low vacancy markets, landlords may be open to ending the arrangement with WeWork (likely with a termination fee) and seeking a new tenant. In other locations with more elevated vacancy, the negotiations could be more tense.

### **The pace of coworking and flexible office expansion will slow**

The pace of coworking growth had already slowed prior to WeWork's IPO attempt according to JLL's US leasing activity tracking. And in Canada, anecdotally, leasing specialists also reported less activity in this sector in Q2.

Cost considerations may have been a drag on coworking growth in recent quarters, especially in the robust technology markets with low vacancy such as Vancouver, Toronto, San Francisco and Manhattan. The coworking model, and WeWork's rapid rise, happened in part because office sharing companies were able to lease space at low rates in modestly distressed markets following the 2008-09 global financial crisis. They have subsequently been able to charge a premium—not

only because of the added services and flexible lease terms—but because the rental rates on other office space in the area has increased—availability has diminished. The business case for coworking (as in many real estate businesses) is more challenged when real estate is more expensive to acquire, whether by headlease or ownership.

Additionally, the pace of global economic growth is slowing. Coworking has offered fast-growing global companies options for branch operations around the world. It has also offered small firms options to have quality space that can grow or shrink with their business and all without long term commitments. However, with the economy slowing and a recession probable in the next 12-24 months, fewer small businesses will look to start (or to move out of someone's basement or spare room), and global firms will slow expansion and hiring, thereby needing less office space in coworking operations. The slowing of coworking companies leasing space likely reflects this sentiment from coworking users.

Added to the late-cycle conditions described above is the aftermath of WeWork's recent challenges. Landlords going forward will be applying even greater scrutiny to any coworking deal, and those coworking operators that cannot offer a satisfactory covenant or other guarantee (bank LOC, surety bond, etc.) will find less interest from landlords who have options with stronger-covenant tenants.

The coming 12-18 months in coworking will be interesting to watch. As documented elsewhere, GWLRA Research has concluded the coworking or flex office usage is here to stay because it addresses twenty-first century business needs. This does not mean every operator or location will survive. As with any new industry, mergers, acquisitions and other changes are likely.

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### **Other GWLRA analysis of coworking:**

1. Wendy Waters, "Coworking's Impact on Global Office Markets," *PREA Quarterly*, Spring 2019. <https://tinyurl.com/y2cw4t8u>
2. GWLRA Research, *From Freelancers to Fortune 500 Clients: The Evolution and Future of Coworking*, October 2019

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