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Coworking, Friend or Foe?

REAL ASSETS | REAL ASSETS INVESTING TEAM | INVESTMENT INSIGHT | NOVEMBER 2018

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For coworking operators, superlatives are easy to come by. Coworking spaces in the U.S. accounted for 17% of all office net absorption in 2017, 12% in Europe, and 14% in Asia.[1] WeWork, the world's seventh largest startup and Manhattan's single largest office tenant, currently has a valuation larger than any office REIT, a chained annual growth rate of 90+% since its founding in 2010, and set out to open 1 million square feet of new space each month in 2018.[2] It's no surprise that many participants in the office universe are searching for the right way to position themselves with respect to coworking, whether through imitation, collaboration, or differentiation.

For tenants, the primary factors in choosing coworking space are its flexibility, amenities, technology, community and immediate availability. At WeWork spaces in particular, the common areas' leather sofas, coffee and beer bars, neon slogans, and mix of entrepreneurial and innovative tenants all offer the opportunity to mix and connect with a vibrant broader community in spaces architects have designed to function as a "third place" between home and work.

[1] Jones Lang LaSalle, Property Market Analysis LLP, as of October 2018

[2] Sharespost, Craft, https://www.wework.com/blog/posts/wework-becomes-biggest-private-office-tenant-in-manhattan, TechCrunch, *WeWork's Powered By We Product Is Central to 2018 Growth Strategy*, December 2017

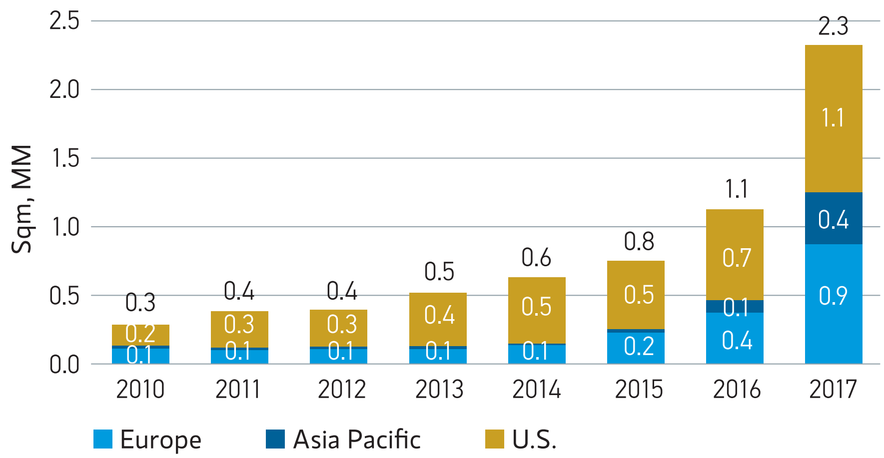

Proprietary smart technology lets its users easily connect with each other and eventually, seamlessly customize their office space to their physical specs and preferences. And flexible lease lengths unlock the ability for tenants to grow or shrink their footprints as needed over the short run, providing optionality that typically isn't available in institutional real estate markets, albeit while adding to the risk in a coworking operator's cash flow.

For coworking operators, value is created by signing leases with office landlords at a meaningful discount to the revenue earned from its members. WeWork and other coworking spaces' operating margins are estimated to reach breakeven levels once locations reach 75% occupancy; or for more space-constrained markets like London or New York where per-square-foot revenues are higher, breakeven occupancy can be as low as 60%.[3]

For landlords, having a coworking space as a tenant offering brings a collaborative, creative millennial demographic to their buildings, and can highlight their other floors as the first place for tenants to look, once they are ready to expand into a traditional office lease. Coworking tenants can also help lease smaller spaces and layouts that may be less desirable for a traditional single tenant and harder for a landlord to fill. WeWork states that its locations can win 29% in rent premiums for landlords, and additionally, by increasing the utilization rate of existing office space as much as two- to three-times over, coworking can support significant added footfall and demand for ground floor retail and other building amenities.[4]

DISPLAY 1

Rapidly Increasing Global Coworking Leasing Volume

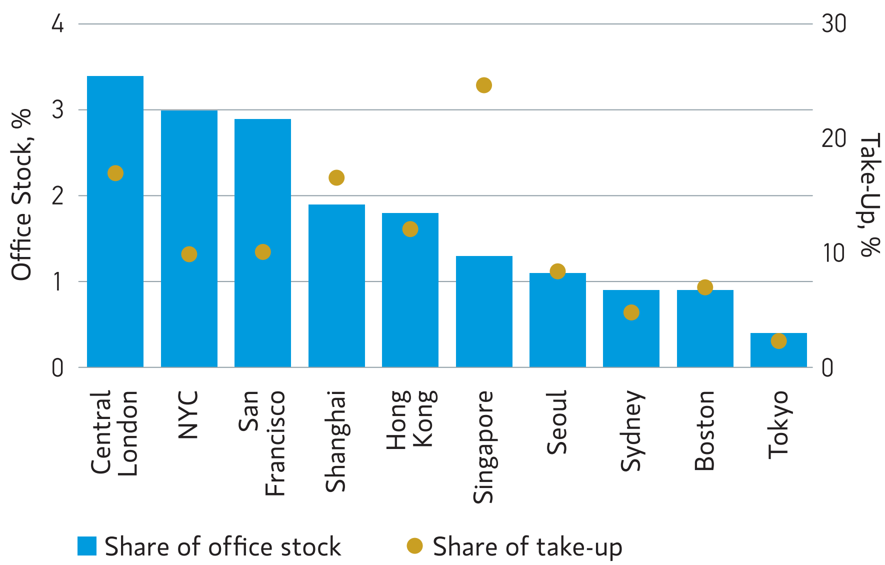


Source: PMA, JLL, MSREI Strategy, as of October 2018

DISPLAY 2

Coworking Share of Office Stock and Take-Up

Global Gateway Markets



Source: JLL, PMA, Cushman & Wakefield, MSREI Strategy, as of October 2018

[3] Green Street Advisors, Eastdil, MSREI Strategy, as of November 2017

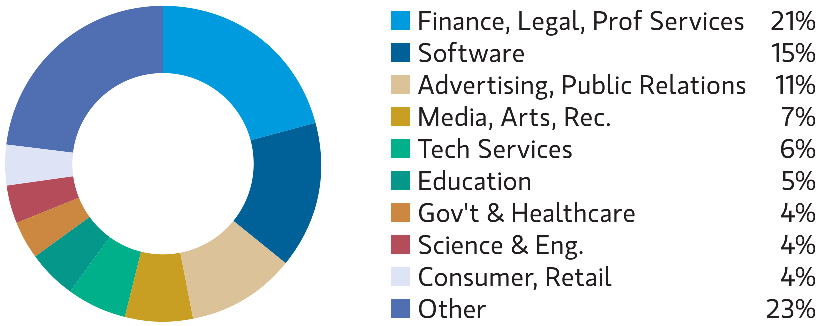
[4] HR&A Advisors, WeWork Real Estate Impact, as of June 2018

With millennials rapidly becoming the largest generation in the labor force worldwide, reshaping office space around their workstyles will, in our view, be a natural evolution for real estate investors. CBRE's Asia Pacific Occupier Survey 2018 identified four trends—a younger workforce, tight labor markets and the battle for talent, better mobile technology, and increased preference for agility and flexibility—driving decision-making among occupiers today.[5] WeWork's pursuit of highly amenitized, collaborative, personalized, flexible, and centrally located office space is clearly intended to capitalize on these themes. Traditional corporate users, including consumer businesses and tech titans from IBM to Spotify, have also begun working with coworking operators to manage their real estate needs and workspaces more efficiently. Around a quarter of WeWork's revenue now comes from large companies like GE, Facebook, and Microsoft.[6] For WeWork, these corporate users provide longer-term leases than its month-to-month business. For the users, new FASB requirements to capitalize leases longer than one year on their balance sheets may spur more demand for coworking.[7] Additionally, technological advances enable corporate real estate design and predictive data analytics teams to offer insights on how and when tenants use space most productively, and further minimize the space needed per employee, to maximize per-square-foot productivity. For example, one project for a large corporate client consolidated three floors of occupied space to two, while increasing common areas, programming space, and amenities to promote collaborative encounters and interaction.[8]

DISPLAY 3

WeWork Membership by Industry

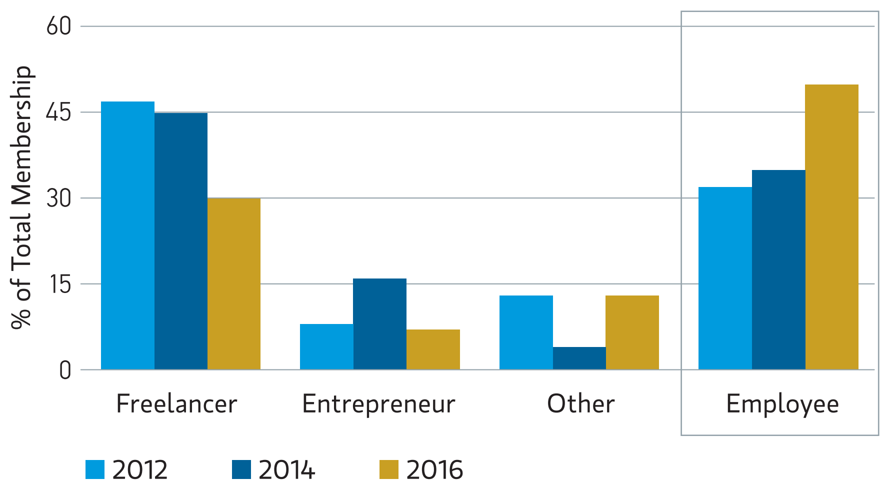
2017



Source: The Economist, MSREI Strategy, as of September 2018

DISPLAY 4

Employees are Rising Share of Coworking Members



Source: Deskmag, HOK, MSREI Strategy, as of September 2018

[5] CBRE Asia Pacific Occupier Survey, 2018

[6] The Economist, *Big Corporates' Quest to be Hip is Helping WeWork*, July 12, 2018

[7] International Financial Reporting Standards, *IFRS 16 – Leases*, Financial Accounting Standards Board, Accounting Standards Update *2016-02 – Leases (Topic 842)*, issued January and February 2016, Deloitte, *Operationalizing the New Lease Standard*, May 2017

[8] WeWork Boston Overview, June 2018

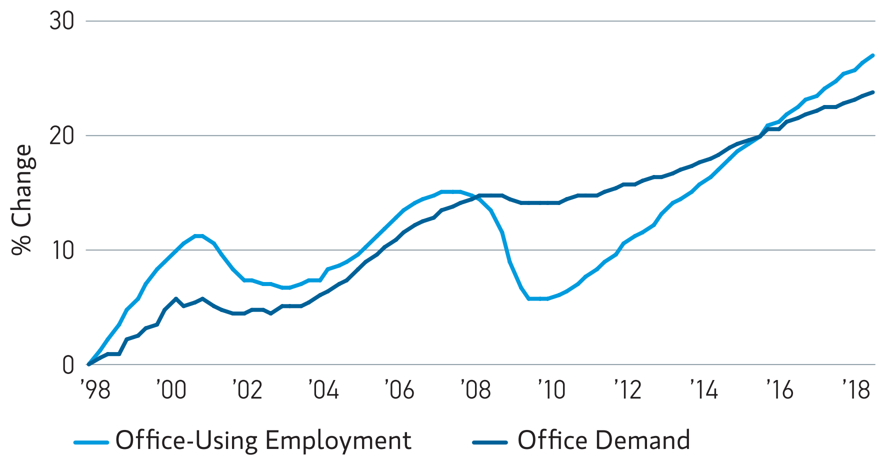
Therefore, because coworking both expands demand by bringing new users into office space, and compresses it by densifying the space per worker, the effects on office demand, in aggregate, are expected to be mixed. An estimate by Cushman & Wakefield suggests that of coworking's total net absorption, 30% to 40% is accretive to office demand.[9] Bringing telecommuters and freelancers out of home offices and coffee shops and into rented office space falls in this accretive category. However, coworking space is also capturing and densifying a share of corporate flex demand, small tenant leasing, and core corporate office users—in effect filling the same market demand in a smaller amount of office space. This suggests that the long-term impact to office demand could range from a 3% increase to a 10% decrease, depending on how much core corporate office demand shifts into higher-density footprints.[10]

How far WeWork or other coworking operators can densify office fitouts also remains to be seen, with important long-term implications for office demand. While traditional rules of thumb of 225 square feet of space per worker have fallen to the 150 to 175 square foot range, a typical coworking space minimizes this to approximately 55 to 100 square feet per person. The base case usage factor is 75 square feet per person. However, because this average number includes expansive commons areas and flexible conference areas as well as personal seating, the dedicated space per person is typically much tighter: as low as 25 square feet. Trends in office design evolve over time, and it is possible that workers may conclude 75 square feet per person is not enough, particularly given the scarcity of talent may require landlords to expand space per worker as an incentive.

DISPLAY 5

Office-Using Employment and Office Demand

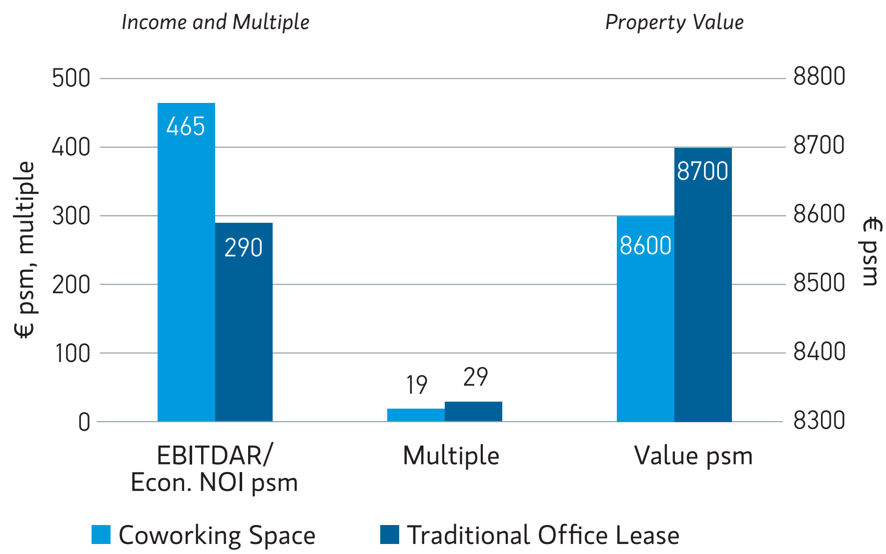
1998 – 3Q 2018



Source: BLS, Moody's Analytics, CoStar, MSREI Strategy, as of September 2018

DISPLAY 6

Attractive Margins but Negative Impact on Multiple



Source: Green Street Advisors, MSREI Strategy, as of November 2017

[9] Cushman & Wakefield, *Coworking and Flexible Office Space*, August 2018

[10] Green Street Advisors, *Property Insights: The Coworking Impact*, November 2017

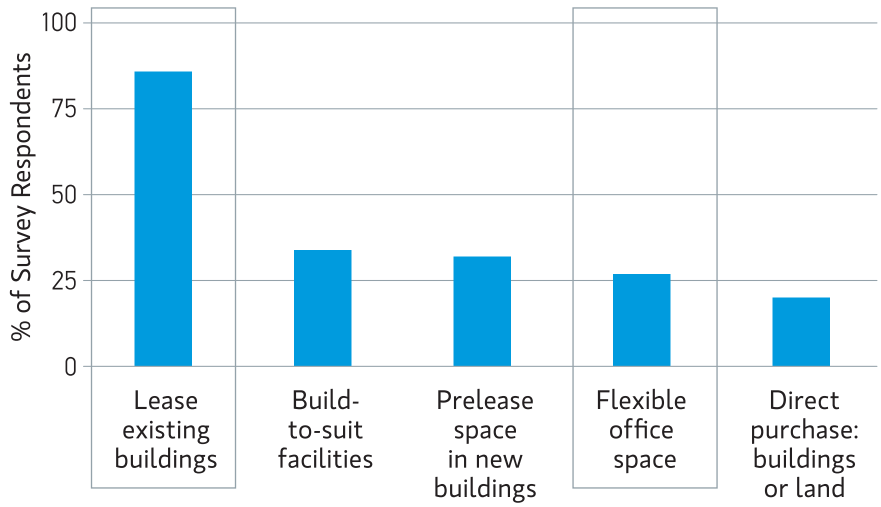
The higher density of coworking spaces also brings several new considerations to the forefront for office landlords. Estimated capital expenditure requirements are up to 50% higher than traditional office.[11] High density buildouts put added burden on buildings' physical systems, increase security concerns, and typically have low reusability should a landlord get the space back. There is also the potential for coworking space to compete for the same tenants, and landlords must consider the credit of coworking operators. Even in a strong economic cycle, the average coworking member stays 20 months while an average traditional office lease duration is 5 years, and as industry giant WeWork pursues strong growth in membership, its revenue per user has fallen on a year-over-year basis. One analysis found that 23% of coworking centers are unprofitable.[12]

And while it's important to consider these tradeoffs in an economic up-cycle, they come before considering the downside risk. Industry skeptics note that coworking revenue is generated by short term subscriptions, typically month-to-month, which creates downside risk from the duration mismatch with long-term lease contracts. The shared workspace provider IWG, originally known as Regus, pursued a slightly differentiated space-as-a-service business model ahead of its October 2000 IPO, offering corporate clients global flexibility and turnkey office solutions, before declaring bankruptcy during the economic downturn when its revenues dried up while rent payments were still due. Today, IWG has a market capitalization of $2.9 billion with 52 million square feet leased worldwide,[13] and WeWork's resiliency through a downturn has yet to be seen. Historically, office-using employment displays

DISPLAY 7

Office Occupiers: Preferred Ways to Acquire Space

As of April 2018

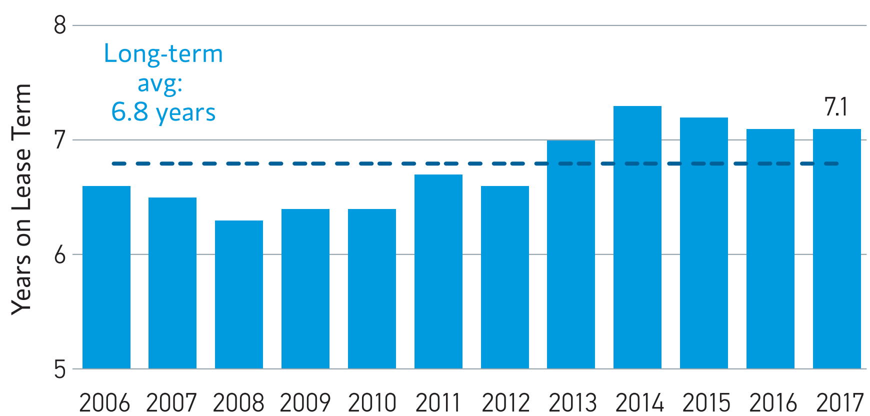


Source: CBRE Asia Pacific Occupier Survey 2018, as of April 2018

DISPLAY 8

Average Annual Lease Term on Signed Leases

U.S. Leases, Public REITs



Source: Company disclosures by BDN, BXP, CLI, DEI, HIW, KRC, OFC, SLG, VNO, WRE, Green Street Advisors, as of July 2018

[11] Morgan Stanley Real Estate Investing estimates and calculations

[12] HOK Workplace, CoreNet Global, *Coworking: A Corporate Real Estate Perspective,* Servcorp Annual Report 2015

[13] IWG *Annual Report and Accounts* 2017, as of May 2018

much higher economic sensitivity than does office demand, given the greater stability of contractual lease terms.[14] The next recession, which many economic forecasters expect may occur in 2020-2021, will be a true test of the coworking model and may lead to significant consolidation among providers.[15]

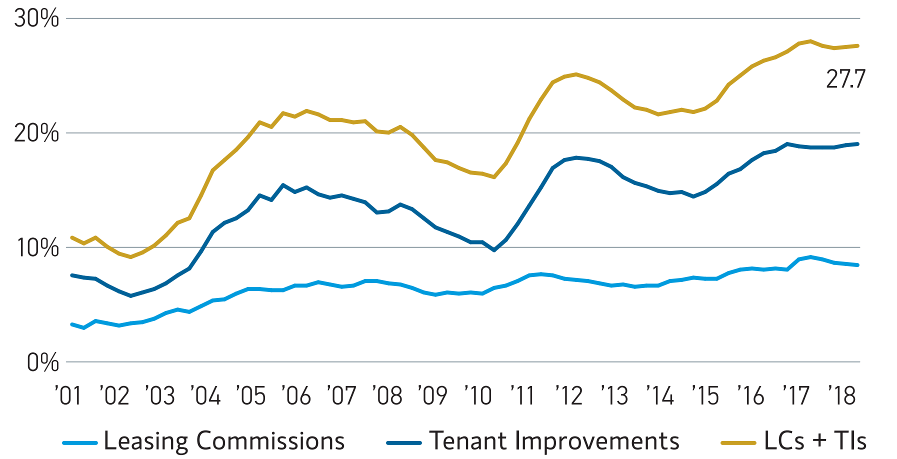
Recognizing the downside risk to demand, WeWork's leases are often structured with a capped corporate-level guarantee that burns down over time, limiting its corporate liability for the rent, but this doesn't provide comfort for the landlord who has WeWork as a tenant. Cap rates can reflect this uncertainty on the durability of WeWork leases, widening out by around 35-65 basis points for properties with 50% of net rentable area leased to coworking ventures. Therefore, although the pricing model and spatial buildout of coworking can increase the revenue per available square foot and NOI by as much as 50% to 60% over a traditional office lease, the inherent risk to this income increases as well. Ascribing a higher capitalization rate (or lower earnings multiple) to the higher income to reflect this increased risk, as per a Green Street Advisors analysis, has so far been relatively neutral to property value.[16]

Even so, structural forces—including technology, urbanization, and the sheer size of the millennial generation—along with regulatory changes and the corporate objectives to attract talent, increase productivity, and minimize costs, will continue to drive demand for more amenitized office space, with concierge-type services and flexible lease structures. Anecdotal data from large corporate tenants who are in the market for space demonstrates that, all else equal, some are requesting to locate in buildings with third-party

DISPLAY 9

Select Capital Expenditures as % of NOI

Gateway U.S. Markets, Trailing Two-Year Ratio



Source: Green Street Advisors, NCREIF, MSREI Strategy calculations, data through September 30, 2018

coworking fitouts, considering the in-building access to coworking seats an attractive way to address their long-term need for flexibility. Accordingly, many landlords, brokerages, and other property management entities are beginning to offer coworking buildouts themselves. For landlords with higher structural vacancy in their buildings—whether older space, smaller floorplates, or unusual layouts—adding a coworking space and potentially partnering with an operator in a revenue-based rent structure, may be a natural way to raise property income and increase tenant engagement.

For core office property, typically with lower structural vacancy to fill and long-term, high-credit leases in place, Morgan Stanley Real Assets anticipates there may be a long-term need to design and offer office space with elevated service levels and higher-touch amenities. Pairing concierge/hospitality level service with better fitness centers, conference facilities, lobbies, personal care providers, restaurants, and top health and wellness fit-outs including superior air and water purification, will enhance the property experience and should support optimized rents and translate to better tenant retention through the economic cycle. Rising capital expenditures (particularly tenant improvements as a share of NOI) reflect this increased focus on providing top-tier amenities; so far, with new lease terms signed remaining above the historical average. Concierge property managers—whether the well-known coworking operators or new entrants with modern, agile facilities management capabilities—could increasingly support higher tenant satisfaction, better productivity in existing office space, and optimized demand.

Regardless of whether you believe WeWork or any other coworking ventures will ultimately succeed or fail, the coworking trend in and of itself is forcing landlords to rethink the design of their traditional office space to better cater to the needs of the technology-driven millennial labor force.

[14] Moody's Analytics, CoStar, as of October 2018

[15] Moody's Analytics, Oxford Economics, Bloomberg, as of November 2018

[16] Eastdil Secured, *WeWork Operating Overview*, Green Street Advisors, *Property Insights: The Coworking Impact*, November 2017, Morgan Stanley Real Estate Investing, as of November 2018

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