WeFumbled: On the Future of WeWork and Co-Working

savills

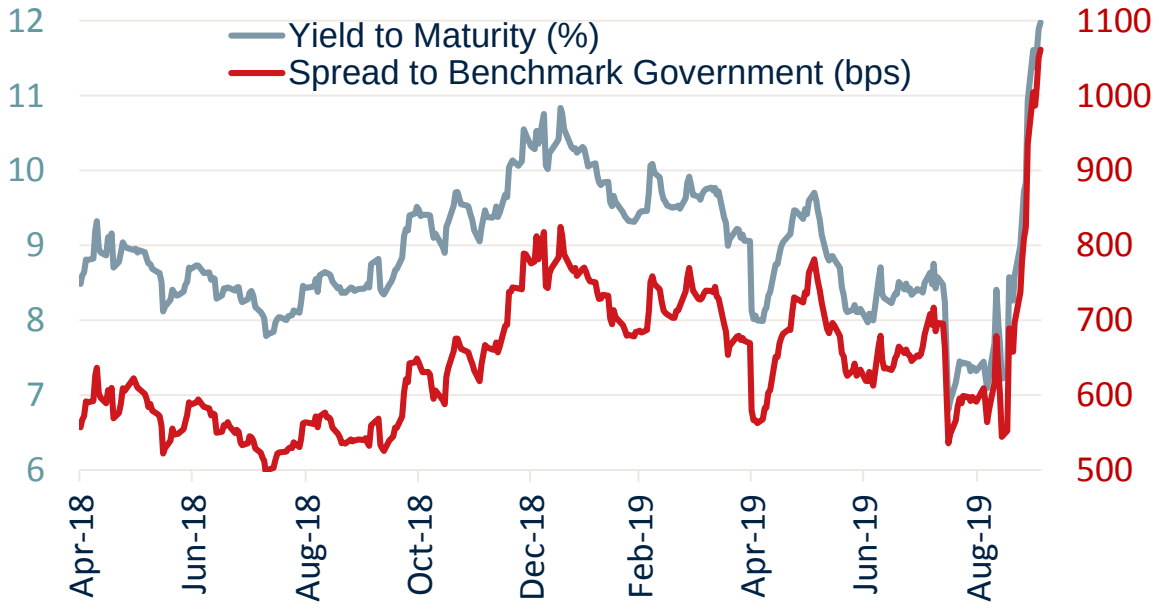
A Look at What WeWork Means For Co-Working

Is WeWork the End of Co-Working?

WeWork's recent fall from grace has given investors, landlords and potential tenants pause as to the viability of the co-working model going forward. Once a private equity darling with a valuation in the tens of billions of dollars, the firm now faces an uncertain path, as the prospects of an IPO (and a $6B contingent credit line) are off the table for the foreseeable future.

The firm's co-founder and wunderkind, Adam Neumann, is no longer CEO, and his influence on the company going forward has been severely curtailed: the voting power allocated to the firm's Class B and Class C shares has been cut from 20 votes a share to 10 votes a share. The firm's sole bond offering is trading with double-digit yields, and multiple rating agencies have downgraded the issue to speculative (or "junk") status. Next on the chopping block are thousands of layoffs and divestitures of companies and technologies that WeWork acquired that are peripheral to the firm's core business: (re)-renting office space to firms large and small.

WeWork's Bond Issue: Historical Yield-to-Maturity and Spread to Treasuries



Source: Bloomberg

As those who experienced the penultimate recession may recall, however, Regus parent IWG went through its own over-expansion and ensuing bankruptcy, only to emerge in a different—and now profitable—form. In much the same way that the bursting of the internet bubble of 2001 was not the end of the internet, WeWork's implosion does not spell the end of co-working.

In the Short Term: Consolidation…

In the short term, expect to see few changes. WeWork will likely continue to focus on filling its co-working spaces, perhaps with an emphasis on minimizing vacancies in its HQ by WeWork spaces. (These full-floor offerings, which come with a minimum two-year commitment, would bring much-needed stability to the firm's cash flows.) Equally certain will be attempts by competitors to take advantage of WeWork's uncertain future by aggressively marketing to WeWork's current members with the intent to sign them to their own spaces. Landlords with larger leases out to WeWork may be quietly marketing their space to other tenants, and in some cases, are ending lease negotiations altogether. And while significantly less disconcerting, it's possible that WeWork members will see a decline in services—or at least some of the "freebies." (Did anyone think that free beer in the workplace was a good idea from an HR perspective?)

Many expect that 424 Fifth Avenue—the 676,000 SF Lord & Taylor building that WeWork purchased for $852.8M earlier this year— will come to the auction block. However, this is unlikely to be WeWork's first course of action, particularly if the asset can be profitably leased (and the firm has not breached any of the covenants in its debt agreements.) Amazon was rumored to have been in discussions with WeWork to take the majority of space at 424 Fifth but talks appear to have ended without a deal. If a new tenant does not materialize by year end, the building may very well be put up for sale in 2020.

To date, the barriers to entry for co-working providers have been exceptionally low, and one outcome may be consolidation, with some of the larger co-working players potentially stepping into WeWork's leases. Co-working configurations, where floors have been filled with rows of seats and a multitude of glass offices of varying size, are not ideally suited for the majority of non- co-working tenants. It's likely that landlords are eager to salvage these installations by re-leasing the space to another co-working provider rather than demolishing the space and funding a new tenant's fit-out.

Co-Working Providers in New York City with a Minimum of Three Locations

BOND COLLECTIVE
breather
COALITION SPACE work.cowork.network
convene
THE FARM
GREENDESK
INDUSTRIOUS
JAY SUITES
Regus
SPACES.
SPACIOUS
THE WING
THE YARD

…And Hand-Wringing

Landlords who have substantial exposure to WeWork may be filled with anxiety over the next several months. The leases that WeWork entered into were long term (as of June 30, 2019, the weighted average remaining lease term for all operating lease obligations was 14 years) and operating lease obligations are significant, totaling $2.2B in 2020 and $2.3B in 2021.

Shown below is a list of buildings in Manhattan where WeWork occupies at least 100,000 SF; however, note that there are a handful of smaller buildings where WeWork is the only tenant, such as Zar Properties' 349 Fifth Avenue, a 46,000 SF building in Midtown Manhattan and Centaur Properties' 100,000 SF building at 35 East 21st Street. (A full set of all of WeWork's occupancies by Manhattan submarket are shown in the Appendix.)

Manhattan Locations Where WeWork Occupies 100,000+ SF

Address	Owner	WeWork SF	Building SF	Lease Expiry
424 Fifth Avenue	We Company & Related Entities*	676,000	676,000	Outright purchase
437 Madison	Kaufman Organization / Travelers	362,000	850,000	Lease begins 2021
110 Wall Street	Rudin Management	270,000**	270,000	2041
368 Ninth Ave / 21 Penn Plaza	TIAA-CREF (TH Real Estate)	258,000	379,000	Unknown
500 Seventh Avenue	Moinian / Chetrit / Minskoff	256,000	606,000	Unknown
85 Broad Street	Ivanhoe Cambridge	242,000	1,119,000	2031 or 2033
1440 Broadway	CIM Group	236,000	736,000	Unknown
620 Sixth Avenue	RXR Realty	212,000	719,000	Unknown
199 Water Street	Jack Resnick & Sons	201,000	1,160,000	2034
1460 Broadway	Himmel + Meringoff / Swig	178,000	220,000	2034
18 West 18th Street	C.A. White	167,000	194,000	Unknown
12 East 49th Street	Kato International	159,300	750,000	Unknown
79 Madison Avenue	Colliers (Williams Real Estate)	154,000	287,000	2029
950 6th Avenue/ 2 Herald Square	SL Green	152,000	369,000	2036
609 Fifth Avenue	SL Green	139,000	160,000	2035
315 West 36th Street	Walter & Samuels	136,000	267,000	2030
25 Broadway	ACTA Realty	129,000	858,000	2034
135 East 57th Street	Cohen Brothers	125,000	340,000	2031
33 Irving Place	Belvedere Management	123,000	174,000	Unknown
154 West 14th Street	Rosen Group	122,000	167,000	2033
205 East 42nd Street	Durst Organization	122,000	532,000	2029
222 Broadway	L & L Holding	121,000	750,000	2029
575 Lexington Avenue	Angelo Gordon / Normandy Real Estate / George Comfort & Sons	117,000	744,000	Unknown
115 West 18th Street	ABS Partners	115,400	280,000	2030
750 Lexington Avenue	Cohen Brothers	111,500	390,000	2033
300 Park Avenue	Tishman Speyer	110,000	770,000	Unknown
575 Fifth Avenue	Beacon Capital Partners / MetLife	101,000	506,000	Unknown
214 West 29th Street	Walter & Samuels, Inc.	100,000	186,000	Unknown
35 East 21st Street	Centaur Properties	100,000	100,000	Unknown

Source: Various news articles, CoStar and owner websites. All information is believed to be accurate but could not be independently verified in all cases.

*****Hudson's Bay, the Canadian-based retailer that previously owned Lord & Taylor, also retains a $125 million stake in the building.

******WeWork occupies 5 floors of co-working space with the balance of the building dedicated to the firm's WeLive residential product.

The "B" Word

In the near term, the question most likely to be asked is: Will the firm file for bankruptcy? Tenants have very little recourse should the firm file for bankruptcy, largely because tenants are not tenants at all, but members. As WeWork states in the terms and conditions of its membership agreement, the membership agreement "is the commercial equivalent of an agreement for accommodation in a hotel." And to dissuade members from thinking that they're sublessees, the company adds this gentle reminder:

> "This Agreement is subject and subordinate to our lease with our landlord of the Premises and to any supplemental documentation and to any other agreements to which our lease with such landlord is subject to or subordinate. However, the foregoing does not imply any sublease or other similar relationship involving an interest in real property."

Most agreements limit legal action a member can take. Based on review of a small sample of co-working agreements in New York, suits for performance (equitable disputes) can be heard in court without a jury, but any claim for economic damages is likely headed to arbitration.

Landlords likely have begun to plan for the possibility of WeWork's bankruptcy (or bankruptcy at the entity level) and while the process will not be pleasant, landlords have many options to mitigate their losses. (For an excellent primer geared toward landlords who may be facing a tenant bankruptcy, please see this article by the CCIM Institute.)

However, some landlords are not waiting to see what happens in any bankruptcy or default; at least one landlord has filed a lawsuit[1] against the company. (Their claim: when WeWork signed its original lease several years ago using a special purpose entity, it signed a guaranty that its holding company was worth more than $150 million. With the reorganization of the firm into The We Company at the beginning of the year, there is no guaranty that the new holding company is worth this amount.) Expect other landlords to follow suit, although perhaps not as many as one might think, as the parent company has cash and cash equivalents of $2.5B as of June 30, 2019 (with roughly 20% of the cash earmarked for the firm's variable interest entities or "VIEs") and corporate guarantees that total just $4.5B of the company's $47.2B in lease obligations.

> "A majority of our leases are held by individual special purpose entities. As of June 30, 2019, we provided credit support in respect of leases in the form of corporate guarantees of $4.5 billion, outstanding standby letters of credit of $1.1 billion, cash security deposits to landlords in the amount of $268.3 million, and surety bonds issued of $183.9 million, although we may be obligated to make all required rental payments. In addition, individual property lease security obligations on any given lease typically decrease over the life of the lease, although we continually enter into new leases in the ordinary course of our business."

Translation: very little cash is on hand as recourse for landlords under a default within the individual SPEs.

There is some future funding ahead, however, even without the IPO. The company's consolidated VIEs have $400 million in unfunded commitments from investors, with $200M scheduled for receipt during each of 2019 and 2020. And potentially, WeWork will have an additional $1.5 billion available to draw from. In January 2019, the company entered into an additional warrant agreement with SoftBank Group.

[1] https://therealdeal.com/2016/09/06/neighbors-are-sick-of-construction-into-the-weework-hours/

> "***Subject to no event of default having occurred*** (emphasis mine) we have the right to receive $1.5 billion on April 3, 2020 in exchange for the issuance of [some amount of] shares of our Class A common stock at [some price] per share (subject to equitable adjustment in the event of any further stock split, stock dividend, reverse stock split or similar recapitalization event from the closing of this offering through April 3, 2020)."

While the company's uncertain future is apt to be worrisome for hundreds of landlords, the more anxious parties should be the existing investors and lenders, whose exposure is significantly greater. Who has the most to lose?

SoftBank Group, its Vision Fund and Vision Fund investors (Saudi Arabia's Public Investment Fund (PIF) and Abu Dhabi's Mubadala Investment Company)

Softbank and its $98.6B Vision Fund[2] own approximately 29% of WeWork's shares, having invested roughly $10.65B into the company, according to a statement made by one WeWork executive early in September.[3] Within the SoftBank entity, SoftBank Group holds roughly 44% of the company's total WeWork shares, while the Vision Funds holds the remaining 56%. (Assuming SoftBank makes good on the $2B it pledged earlier in the year by investing $1B in primary capital and another $1B billion by purchasing shares from investors and employees, SoftBank and the Vision Fund will ultimately have equal exposure to WeWork.) The Vision Fund has a somewhat unusual structure: roughly $40B of the capital of the Vision Fund is in the form of preferred shares, which pay a fixed return of 7% per year. (The approximately remaining $60B in the fund is equity.) Why is the Vision Fund's structure relevant? The fund must pay out roughly $2.8B in preferred returns to investors annually. As of June 30, SoftBank Group had $27.4B of cash and cash equivalents on its balance sheet, suggesting it has the ability—but perhaps not the willingness—to double-down on its WeWork bet with another cash infusion, ahead of fundraising for its second Vision Fund.

While SoftBank, with 114 million Class A shares, is the largest non-company holder of shares, other private equity firms have sizeable stakes as well, including Benchmark Capital (32.6 million Class A shares) and private equity funds associated with JP Morgan, which hold just over 18.5 million shares. (Of JPMorgan's stake, more than 98% is held on behalf of third-party clients, with "the remainder…held on behalf of certain employees involved with such funds through a co-investment vehicle.)

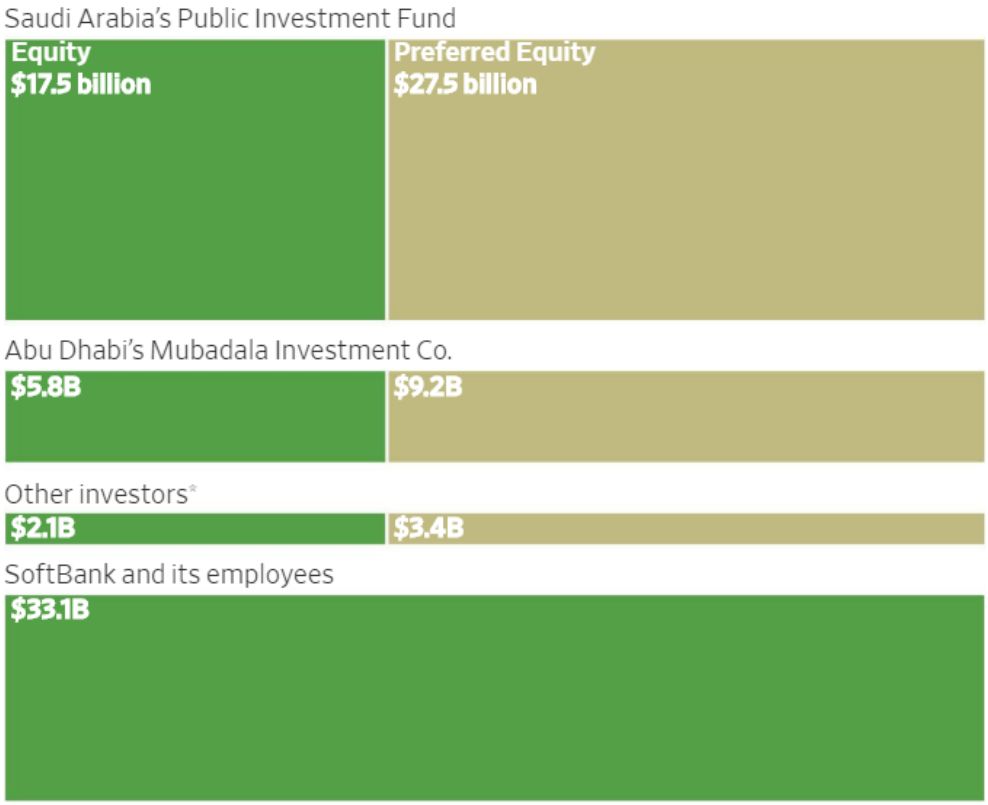
[2] https://www.sec.gov/Archives/edgar/data/1699940/000169994018000001/xslFormDX01/primary_doc.xml
[3] https://www.bloomberg.com/news/articles/2019-09-05/softbank-has-more-riding-on-wework-than-even-its-co-founder?srnd=premium

Pre-IPO Ownership Stakes of Greater than 5% Stockholders

	Beneficial ownership before this offering					
	Shares of Class A common stock beneficially owned		Shares of Class B common stock beneficially owned		Shares of Class C common stock beneficially owned†‡	
	Shares	% of Class	Shares	% of Class	Shares	% of Class
Greater than 5% stockholders						
WE Holdings LLC(1)	2,428,730		111,848,498		—	—
Benchmark entities(2)	32,645,314		—		—	—
J.P. Morgan entities(3)	18,542,307		—		—	—
Softbank entities(4)	113,988,653		—		—	—
Directors and named executive officers						
Adam Neumann(1)(5)	2,428,730		112,507,371		943,848	100
Artie Minson(6)	—	—	1,873,057		—	—
Jen Berrent(7)	109,933	*	348,792		—	—
Bruce Dunlevie(2)	32,645,314		—		—	—
Ron Fisher	—	—	—		—	—
Lew Frankfort(8)	1,247,033	*	852,309		—	—
Steven Langman(9)	27,056	*	—		—	—
Mark Schwartz	—	—	—		—	—
John Zhao	—	—	—		—	—
Frances Frei	—	—	—		—	—
All directors and executive officers, as a group (10 persons)(10)	36,431,010		114,821,543		943,848	100

Source: The We Company S-1

Vision Fund Investors



Source: The Wall Street Journal, September 23, 2019.

*Includes Apple, Qualcomm, Foxconn, Sharp, Daimler, Mizuho, MUFG, Sumitomo, Larry Ellison and Bahrain's sovereign wealth fund.

Banks and Other Lenders…But Largely JPMorgan

While a handful of loans extended to WeWork were collateralized by real property (JPMorgan, Starwood Property Trust and a third lender underwrote a loan for up to $900M for the Lord & Taylor building purchase, of which $626M has been drawn) most of the loans made to the company and/or Adam Neumann were unsecured—or secured by shares of the company's stock. And the lender who appears to have the most exposure? JPMorgan.

In November 2015, WeWork entered in a revolving loan and letter of credit facility up to $650M with a syndicate led by JPMorgan. The agreement was amended several times (November 2017, August 2018 and January 2019) with a further $500M in credit added. As of June 30, 2019, $1B in credit was outstanding, the purpose of which "is to guarantee payment under certain leases entered into by certain of our wholly owned subsidiaries." Curiously, the firm goes on to say that while "we were in compliance with all of the covenants contained in the credit agreement and the letter of credit reimbursement agreement as of June 30, 2019" that "***as of June 30, 2019, we would not have been able to borrow under our credit agreement and keep those amounts outstanding or have unreimbursed draws on letters of credit under the credit agreement, letter of credit reimbursement agreement or continuing agreement for standby letters of credit past the end of a fiscal quarter*** (other than certain foreign subsidiary borrowings up to $50.0 million) ***due to the financial covenants contained in those agreements,"*** (emphasis mine) suggesting a deterioration in the firm's financial condition. It's a good thing, then, that the firm entered into another agreement in May 2019 for an additional $200M in credit.

However, the S-1 goes on to say:

> "We expect to replace the bank facilities with the 2019 Credit Facility [the $6B letter of Credit conditional on a minimum raise of $3B in the IPO] concurrently with the closing of this offering. We expect that letters of credit outstanding under the bank facilities at the time of the closing of the 2019 Credit Facility would roll over to the Letter of Credit Facility included in the 2019 Credit Facility."

Given that the original letters of credit terminate next November (November 2020), this could spell trouble for the lending banks (although an extension would likely occur at the discretion of the lenders.) In addition, UBS, JPMorgan Chase and Credit Suisse provided a $500M personal line of credit with a scheduled maturity of September 18, 2020 to Adam Neumann, of which approximately $380M in principal amount was outstanding as of July 31, 2019. This credit line is secured by Class B common stock.

And lastly, JPMorgan Chase Bank (which apparently is on a first-name basis with Adam Neumann) "has made loans and extended credit to Adam totaling $97.5 million across a variety of lending products, including mortgages secured by personal property. None of these other lending products are secured by a pledge of any of Adam's shares of capital stock in the Company." (Approximately $11.6M of the total appears to have financed the purchase of a 60-acre estate in the suburbs of New York City.)

And the $6B credit line that was contingent on an IPO that raised a minimum of $3B? JPMorgan was to receive a $50M "structuring fee" for arranging the loan that looks unlikely to occur.

Longer-Term Impact of WeWork on Co-Working

WeWork is expected to dramatically scale back its pace of expansion. Already, the firm is the top lessee in New York City, Washington, D.C. and central London. (In Manhattan alone, including 424 Fifth Avenue, the company has space in almost 110 buildings with a total occupancy in excess of 8 MSF). In Atlanta, the company leases more than 800,000 SF and leases more than 1 MSF in Boston and Chicago and more than 1.5 MSF in Los Angeles and Seattle. In aggregate, the firm has 528 locations across 111 cities (in addition to their corporate headquarters located at 115 West 18th Street.)

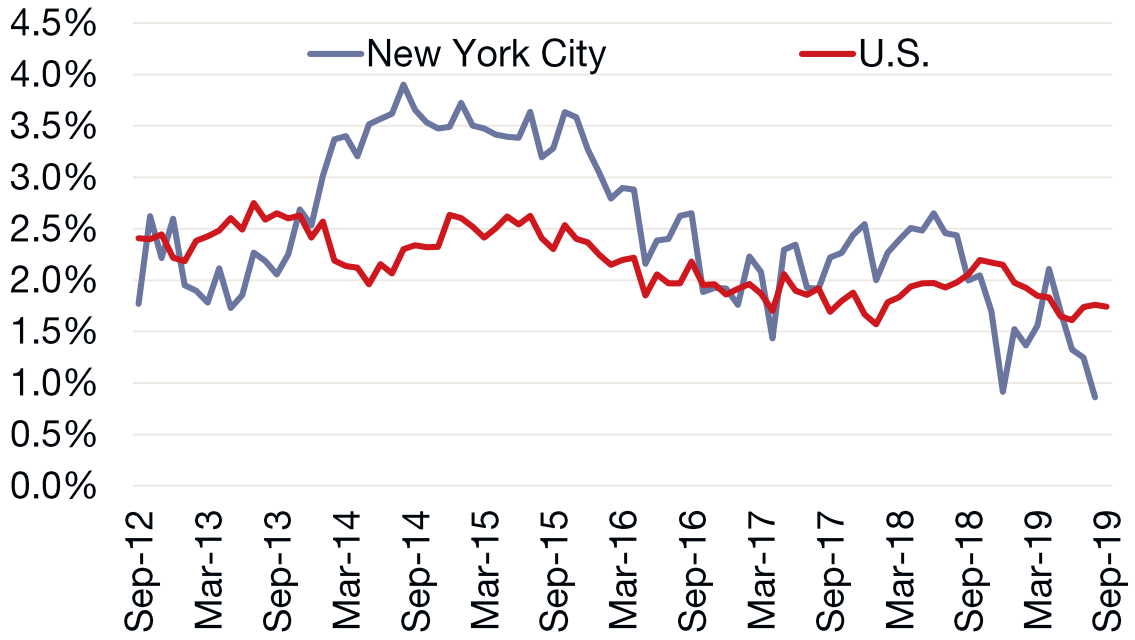
> "While we will continue to sign new lease agreements with our landlord partners, we expect the pace to slow over the next several quarters as we focus on strategic expansion and profitability."
> Matt Lawyue, WeWork spokesman

Rents Unlikely to Fall Because of WeWork

WeWork's strategy has been about building scale, assembling numerous locations within a given market. They have invested heavily in the build-out of their space, rather than paying up for space in high-end buildings with trophy addresses. As such, WeWork's pullback from the market will likely have very little impact on the upper-end of the market; the impact on the rest of the Class A/B office market is such that it removes a source of competition for space.

To the extent that landlords viewed having WeWork as a tenant as a positive for attracting other tenants to their space, some of these landlords may have offered below-market deals to the company. Moreover, some landlords may have accepted lower rent from WeWork in lieu of making tenant improvements, leaving WeWork to fund and build-out the spaces on their own. As a result, while leasing volumes may fall as WeWork pauses (or permanently halts) its expansion, it's unlikely that asking rents will fall as a result of WeWork's reduced demand for space. The view that WeWork will cause little dislocation in rental prices may be somewhat contrarian; in a note published by Fitch Ratings, they noted that "a reduction in leasing demand by [WeWork] could lead to downward pressure on rents in key gateway cities where WeWork is a major private tenant." Nonetheless, it is important to bear in mind that U.S. economic activity is decelerating broadly, with the overall labor market showing signs of slowing (which may result in a more tepid demand for space.)

Office-Using Employment, YoY % Change



Source: BLS

One forecast that Fitch made in its ratings note does seem likely: in the absence of any new sources of liquidity, WeWork has just another four to eight quarters in funding, with lay-offs at the company leading to "material restructuring cash charges" which would further harm the company's financial outlook in the near term. So how will landlords navigate going forward? Expect to see co-working providers and landlords entering into partnerships and/or service agreements, with both entities sharing in any profits. (This arrangement would echo the revenue-sharing agreement that RXR and WeWork agreed to in May 2019 at 75 Rockefeller Plaza.) Larger enterprise clients may be the signatory to any lease agreement (instead of the co-working provider), opting to pay a management fee to have someone else build out and manage their office space. And lastly, more landlords may decide to enter the co-working business directly, providing communal amenities and more flexibility with regard to lease term.

Why Co-Working?
In the olden days (the '80s), you might have gone to the library. A decade later, you might have parked yourself in a Starbucks. And today, there's co-working. But why? Co-working offers a solution to a problem that landlords have failed to address in any meaningful way: that of uncertainty. Given that most business cycles are shorter than the typical lease term, there's uncertainty around a firm's survival. And even if a firm survives, there's uncertainty around a firm's future headcount. Recent accounting changes make leasing potentially more challenging, as FASB's ASU 2016-02 requires full transparency around operating leases. Whereas a traditional lease now necessitates that the asset and liability associated with the lease be recorded on a firm's balance sheet, a short-term co-working membership avoids this requirement, as well as the out-of-pocked capital needed for an office build-out and security deposit.

Landlords realize that the appeal of co-working lies in the choices it avails tenants: flexibility in term gives way to flexibility in size, which then allows workers and firms to scale up or down as needed. And increasingly, there's flexibility in location, which is appealing to employees who travel frequently for work and freelancers alike.

Newton's first law of motion tells us that objects acted upon by an external force no longer proceed in a straight line. With the pushback from the public over WeWork's path to profitability and governance structure having derailed the firm's current course, WeWork—and co-working generally—will now head in a new, and ultimately more sustainable, direction.

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Appendix: WeWork Locations in Manhattan by SF, Midtown

Appendix: WeWork Locations in Manhattan by SF, Midtown South

Appendix: WeWork Locations in Manhattan by SF, Downtown