CUSHMAN & WAKEFIELD

FLEXIBLE SPACE: MISPLACED SCHADENFREUDE?

Implications for CRE

DECEMBER 2019

EXECUTIVE SUMMARY

DEMAND DRIVERS REMAIN STRONG:

Coworking memberships in the U.S. are expected to grow from approximately 750,000 today to one million by 2023.[1] More importantly, the proportion of large corporate occupiers' workforce using flexible space[2] is projected to increase four-fold by 2023. This group has deeper pockets and signs longer leases, on average, than other members.

CAPITAL IS LOOKING SLIGHTLY WOBBLY

WHICH COULD LEAD TO SUPPLY CONSTRAINTS:

In the wake of recent capital market events, we estimate that overall annual net new leasing in the U.S may be lower—by around 3% every year until 2021.[3] This is not necessarily a bad outcome particularly if it leads to a more sustainable supply-demand equation.

"FREEZE THE FOOTPRINT"

IS THE MOST LIKELY OUTCOME WITH MODEST MARKET IMPACT:

We expect vacancy in gateway markets will increase by 0-30 basis points (bps), from where they would otherwise be. Headline rental growth in these markets will be dampened by 0-110 bps, with varying impacts based on market exposure. These impacts may persist for a year or two depending on the time taken to backfill the space.

A 25% WORST-CASE SCENARIO

IS BETTER THAN IT SOUNDS:

Even if a more conservative angle is taken and a quarter of all coworking locations are vacated over three years, the vacancy and rent impacts will be constrained by the sector's relatively small footprint.

BUILDING VALUATION PREMIUMS WILL REVERT

TO MARKET LEVELS:

The 10-30 bps premiums (relative to market benchmark for buildings with coworking occupancy in the 10-30% range) will generally move back towards market levels.

SO HOW WILL THE MARKET/PARTICIPANTS REACT?

Occupiers should see coworking pricing rise while investors should see premiums revert to market levels in buildings attached to coworking. Operators should use the opportunity to stabilize properties and optimize profitability.

1 GCUC/Emergent Research (2017), Cushman & Wakefield Research
2 Flexible workplace is space as a service in which a tenant is provided with turnkey, technology-enabled and amenitized space. This includes different types of options such as coworking, managed offices or serviced offices.
3 Based on net new annual leasing levels in 2017-2018. 2019 is on pace to match those levels.

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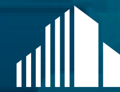

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The flexible office sector—and coworking, in particular—has been the darling of the office market since the last recession. Its meteoric 45% compound annual growth rate in U.S. gateway markets from 2010-2018 has increasingly driven new leasing activity. In 2010, coworking leasing represented just 0.5% of all net new leasing in U.S. gateway cities; by 2018, the share was 9.5%. It is tricky, however, to reconcile these statistics with recent media coverage on the sector; unsurprisingly, gloomy predictions have been on the rise. It is, therefore, worthwhile to reexamine some fundamental assumptions regarding the flexible space office sector.

Demand drivers remain strong. Coworking has redefined the relationship between landlord and tenant, and the concept of flexible space as a service is here to stay. Coworking memberships in the U.S. are expected to increase from approximately 750,000 today to one million by 2023.[4] More importantly, large corporate occupiers anticipate that about one quarter of their workforce will use coworking or flexible space in some capacity by 2023–up from just 5% in 2018. This matters since corporate occupiers or enterprise-level users are the investment-grade portion of a coworking operator's sublease cashflow. For some of the larger operators, enterprise revenue accounts for approximately 40% of sublease income. In addition, they typically sign longer term leases (18 months compared to 10 months for non-enterprise users) and are more likely to withstand an economic downturn.

Capital is looking slightly wobbly. There is, however, no denying that the ripple effects—particularly on fundraising and due diligence—will have an impact. Coworking startups may find it harder to raise both debt and equity, and existing operators may even struggle to fund expansion.

Less available capital could lead to supply constraints. The tightening funding environment is likely to dampen the sector's growth. We currently estimate that a pullback in coworking leasing will reduce overall new leasing in the U.S. by 8-10 million square feet (sf) or approximately 3% of net new leasing. This is likely to persist until 2021. In our view, this is not necessarily an undesirable outcome, particularly if it leads to a more sustainable supply-demand equation. It would give both landlords and operators the opportunity to focus on the important questions. Such as, what are the sustainable cashflows from a coworking location? What is the breakeven occupancy level? There is also likely to be greater focus on the credit strength of a coworking operator, lease guarantees and a shift towards management contracts.

"Freeze the footprint" is the most likely short term outcome. While some flexible space operators will continue to grow, others will likely refocus from expansion mode to stabilizing existing properties and possibly even close unviable locations. On an overall basis, however, we expect the coworking market footprint to remain fairly constant, especially in the short-term. The direct market impact, relative to a scenario of continued coworking expansion at recent growth rates, is likely to be very modest.

This impact is not likely to persist beyond 2021. The median lease size of major coworking operators in U.S. gateway CBDs is 15,000-25,000 sf. Over the last two years, blocks of similar sized space have typically taken 22-26 months to be backfilled, with sublease blocks typically being backfilled approximately twice as fast as direct space.

4 2018 Cushman & Wakefield CoreNet Survey of 579 corporate occupiers

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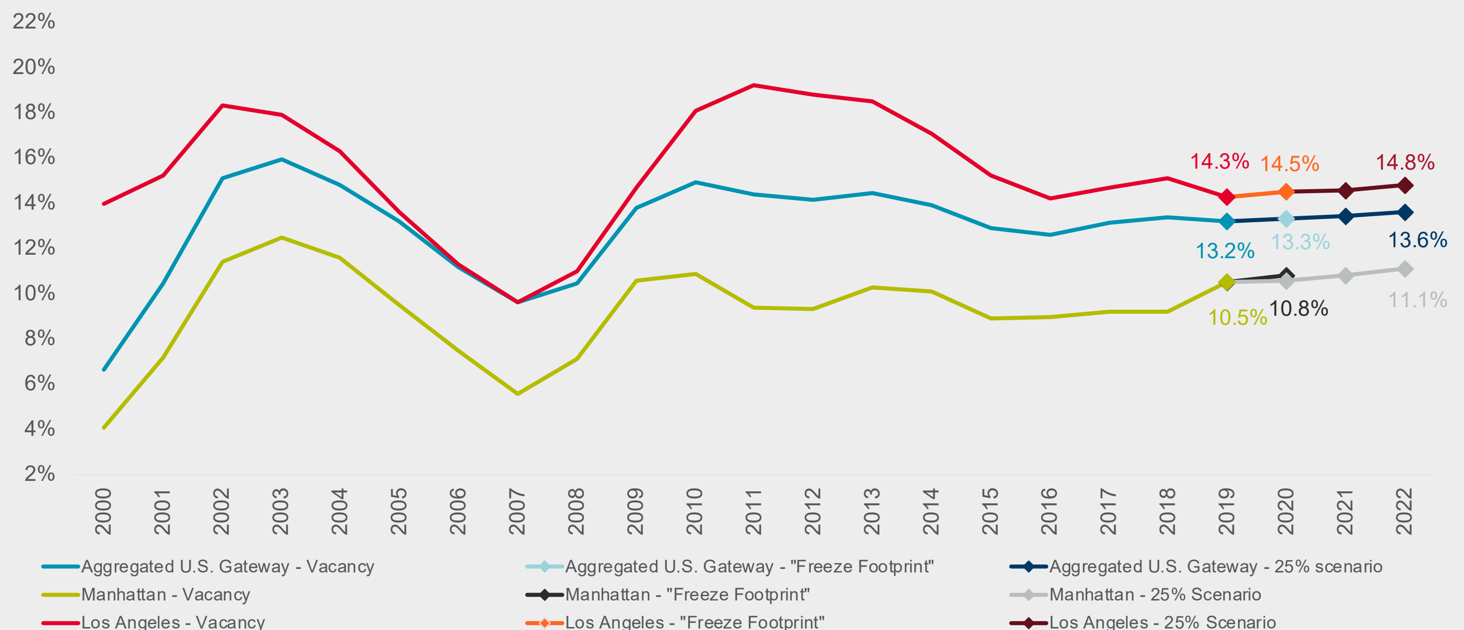
In the event of a slowdown, past performance may provide a guide for future results. It is easy to envision scenarios of large swathes of vacancies in coworking locations, but the most likely outcome is rarely as good or bad as one imagines. The experience of IWG (formerly Regus)—the only coworking operator to go through and withstand successive recessions (albeit with a bankruptcy restructuring)—is instructive. During the 2001 recession, Regus, which had embarked on an aggressive expansion program, saw its global occupancy decline from 75%-59% and then take three years to recover.[5] During the Great Recession, which impacted the CRE sector far more negatively, Regus was better prepared due to its more measured expansion strategy. As a result, Regus's memberships in the U.S. declined by 5.5% and recovered in a year. In 2009, Regus also claimed that one-fifth of its UK locations were unviable and successfully asked landlords to re-gear leases.[6]

The 25% downturn scenario. We assume that during a downturn, the coworking sector's footprint shrinks by 25%, although the range is anywhere between 20% (for IWG this was a proportion of its properties that required renegotiation) and 33%.[7] It is likely that the space would be given back to the market over three years, which is consistent with IWG's experience.

This is better than it sounds: Coworking's footprint accounts for less than 1.5% of total U.S. office inventory. Even in the most concentrated markets such as Manhattan, it only accounts for 4% of office inventory. In addition, coworking has, no doubt, allowed individuals and small businesses access to traditional office markets, i.e., 30-40% of demand for flexible office space is accretive. There is some evidence that coworking has also siphoned demand from the traditional office market by reducing leasing activity for 1,000-5,000-sf spaces. In Manhattan, the number of sub-5000-sf deals decreased by 27% from

5 IWG Annual Reports. Note: occupancy refers to the utilization rate of workstations.
6 https://www.theguardian.com/business/2010/mar/11/regus-administration-row-landlords
7 A 2019 Deskmag survey suggests that nearly a third of existing coworking locations are loss-making. This is largely attributable to the rapid expansion of the sector that has resulted in a many immature locations.

Figure 1: Aggregated U.S. Gateway Vacancy Impact



Source: Cushman & Wakefield Research, Nov 2019

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2010 to 2018.In the event coworking spaces are restricted, landlords may see a boost in the small leasing market.

Impact on building valuations. It is difficult to calculate the impact of a slowdown in the flexible space market on valuations with any degree of mathematical accuracy. For instance, valuations are driven as much by sentiment as numbers and sentiment is fickle at best. Secondly, the specific coworking operator credit will also materially affect the view taken as will credit enhancement provisions offered.

However, it is fair to assume that the 10-30 bps valuation premiums (relative to market benchmarks) that buildings with coworking occupancy in the 10% to 30% range enjoyed will move back towards market levels. We also expect the market to take a more jaundiced view of those assets in which coworking accounts for more than a 30% share of a building's occupancy.[8]

		Cumulative Impact on Headline Rental Growth	
Market	18YTD/19YTD Rent Growth	Freeze the Footprint Scenario By 2021	25% Coworking Footprint Contraction Scenario By Year 3
Boston	3.0%	-0.2%	-0.3%
Chicago	0.3%	-0.1%	-0.3%
Los Angeles	1.4%	-0.0%	-0.0%
Manhattan	1.8%	-1.1%	-2.1%
San Francisco	8.2%	-0.4%	-2.1%
Washington, DC	2.0%	-0.0%	-0.0%

Source: Cushman & Wakefield Research, Nov 2019

8 Across 64 transactions in the U.S. from 2016 onwards, there has been a 13- 30 bps premium to market for properties with coworking representing 30% or less of occupancy and a 37-bps discount to market for coworking occupancies over 30%.

Figure 2: U.S. Building Valuation Impact

Dots represent individual sales of coworking-tenanted properties.

Source: RCA, Costar, Cushman & Wakefield Research, Oct 2019

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So how will the market/participants react?

OCCUPIERS

- Pricing likely to rise, particularly for individual and SME coworking members
- Enterprise clients can explore flexible space options directly with landlord in the event of a coworking operator lease default
- Occupiers likely to move between coworking operators subject to notice periods

SME = small- and medium-sized enterprises

LANDLORD/ INVESTORS

- Determine integrity of underlying sublease cashflows: typically, enterprise cashflows (40%) are robust while individual and SME cashflows need to be discounted
- Require more credit enhancement to leases
- Any building valuation premiums attached to coworking revert to market

COWORKING OPERATORS

- Opportunity for existing operators to stabilize properties
- Overall improved industry profitability
- More due diligence from funders and overall less liquidity
- Landlords likely to require lease guarantees / profit share mechanism
- Work with landlords to take over viable flexible space locations in the event of lease default
- Consolidation; limited new entrants

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ABOUT CUSHMAN & WAKEFIELD

Cushman & Wakefield (NYSE: CWK) is a leading global real estate services firm that delivers exceptional value for real estate occupiers and owners. Cushman & Wakefield is among the largest real estate services firms with approximately 51,000 employees in 400 offices and 70 countries. In 2018, the firm had revenue of $8.2 billion across core services of property, facilities and project management, leasing, capital markets, valuation and other services.

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