WeWork goes for growth: A commercial real estate case study in late-cycle tenant risk

WeWork is trying to break the mould of the office real-estate market, but the risks of doing so need to be charged for appropriately by investors assessing the upstart property-management company as a tenant, says Scope Risks Solutions.

The company, founded just eight years ago in New York by Andrew Neumann and Miguel McKelvey, makes a good case study in real estate risk management in the late stage of the economic cycle.

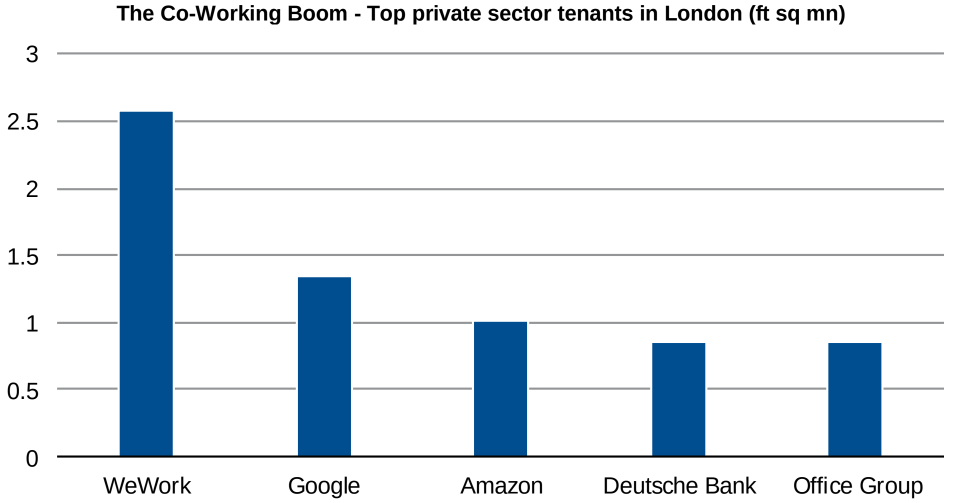
Famous for offering free beer after work for its members, WeWork has established a recognisable brand, disrupting the office-space market while profiting from changes in work practices, notably the trend toward co-working and shorter-term leases.

Two issues stand out. First, the yield premium in properties where WeWork is an anchor tenant reflect some, but not all, of the risks that are associated with the company's high-growth, branding-focused strategy, says Scope.

WeWork's costs are rising by 100% a year, growing faster than revenue, as management invests heavily in new sites and new cities using the equity support of Japan's Softbank and bond-market funding. How sustainable the strategy will prove remains to be seen, particularly as it has not been tested by a downturn.

Secondly, for a building owner assessing the contractual strength of a prospective tenant, WeWork exhibits a number of high-risk factors, such as a preponderance of short- to medium-term contracts, with a material risk of subtenants leaseholds expiring, and the danger of contract mismatches given subleases of varying durations.

Figure 1: **WeWork is leading private-sector office tenant in London**



Source: Cushman & Wakefield

WeWork – an overview

WeWork has undeniably grown fast, relying on real estate arbitrage—taking long-term leases on office space and sub-letting on a short-term basis—but positioning itself as a lifestyle technology company. Membership today exceeds 250,000, up from 7,000 in 2014, in around 460 usually prime locations. WeWork offers more 14 million square feet of office space, equivalent to all of Canary Wharf in London. The company expansion plans remain ambitious, with new cities and new countries, like Japan, in its sights.

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WeWork says it typically needs around 60% occupancy in each location to cover location costs, a threshold it has crossed comfortably for now, with around 84% occupancy this year, up from 81% in 2017.

- The company has retained some degree of operating flexibility by housing each of its locations in a separate subsidiary rather than leasing them directly, affording WeWork some protection if any individual market gets into difficulty.
- Landlords receive guarantees or credit letters from the parent which usually last for 6-12 months of an average 15-year lease, according to the company's own bond documents. WeWork, whose desks go for around USD 500 a month depending on location, offers companies considerable potential cost savings given that its offices average around 60-80 square feet compared with the US average of 200 square feet.
- Known for attracting start-up companies, WeWork is beginning to secure more established corporate clients with staff of 1,000 or more such as Amazon.com and HSBC. These 'enterprise' members now account for a quarter of WeWork membership.

WeWork justifies its premium pricing (see figure 2) in part by offering members more than just office space. The WeWork offering (see figure 3) ranges from accommodation to fitness, education, events and other business services, though they are yet to provide meaningful additional sources of revenue.

Figure 2: WeWork commands premium pricing in London

One Poultry	125 Shaftsbury Avenue	Aldwych House
▪ Bought by an Industrial Bank of Korea investment subsidiary for £182m ▪ 150k square feet, Grade II listed building, 80% leased to WeWork ▪ Initial Yield 4.7% (against typical 4.25% for the area)	▪ Bought by KB Securities for £270m ▪ Pre-let by WeWork to Facebook for two year ▪ Yield of 4.6%	▪ WeWork have 35% of the building ▪ 174k square feet, other tenants include LSE, Manche, Associated British Ports ▪ Sold in 2017 to Angela Leong for £250m with yield of 4.25%

Source: Scope Risk Solutions

Figure 3: WeWork offers more than office space

- **WeWork**
- **WeLive** – accommodation/co-living
- **Rise by We** – luxury gym concept
- **WeGrow** – education
- **We Events**
- **Meetup** – scheduling technology
- **Conductor** – marketing & SEO services company

→ At present the reality is **WeWork is a property management company** with strong branding

Source: Scope Risk Solutions

The competition is coming

WeWork's competitors have taken note and, in a validation of the US firm's approach, are increasingly focused on the mid-sized market with similar offerings, though this also implies that the competition is heating up.

- Knotel allows companies to maintain their own branding at its sites, soon to exceed WeWork's space in the city of the New York.
- HubHub, the co-working brand of Slovakia's HB Reavis, has expanded through eastern and central Europe and is targeting western Europe.
- British Land has created its own Storey brand and no longer takes WeWork or its competitors as tenants.

WeWork's finances: Growth, not margins, with a balance sheet to match

WeWork's emphasis on growth rather than profitability is clear from its finances. The company made a net loss of USD 934m in 2017 on adjusted Ebitda of USD 193.3m and so called “community adjusted Ebitda” of USD 233.1m in which marketing, design and administration costs are added back. The company has USD 5bn in rent due by 2022 and USD 13.2 billion after that.

While WeWork raised USD 4.4bn from Softbank in mid-2017, leaving cash of USD 2bn on the balance sheet at the end of year, the cash outflows are continuing, forecast at around USD 1.9bn this year and USD 2bn in 2019, hence the requirement for new funding.

WeWork sold its first bond in April 2018, raising USD 702m at 7.875%, pricing which reflected:

- Few assets on the balance sheet
- Sizeable lease obligations
- Negative cash flow
- Strategic challenges

The bond, trading at around 96.23 in October 2018, offers an average CCC+ yield, in sharp contrast with the credit ratings of its senior debt from S&P (B+) and Fitch (BB-) and an unsolicited rating from Moody’s (Caa1) which has subsequently been withdrawn. The S&P and Fitch ratings set great store by Softbank’s equity injection.

For Scope, WeWork scores as a high-risk tenant in terms of contractual strength and counterparty quality when plugged into our commercial real estate credit risk model, even though changing work practices may support the business model in the future.

Scope Risk Solutions Contractual Strength Score: High risk

- Medium- to short-term contracts represent 30-50% of debt maturity; contract price is significant above market terms
- Single net lease contract
- Rental review clauses could move rent in any direction, or none; no inflation indexing
- Break clauses potentially could squeeze cash flow
- Material risk of leasehold expiration
- Untested legal framework in the event of leases being broken
- Possibility of contract mismatches

Scope Risk Solutions Quality of Tenant Score: High Risk

- Counterparties are below investment grade OR have weak credit quality (B+ or below) but viable alternative is available in the market given attractive property qualities and price OR counterparties have weak credit quality (below B+) but non-payment of any one of them would not affect the ability of project cash flows to repay its debt (top 10 tenants/buyers account for less than 30% of revenue)
- Project provides limited economic incentives to its counterparties

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