

# Research Report

## Flexible Office and Co-Working: Dynamics and Impact for Today's Real Estate Portfolio

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# Defining Flexible Workspace and Co-Working

Although a small portion of the office market, flexible workspace is rapidly becoming an important part of the overall real estate mix. Its strong recent growth is expected to continue, driven by dramatic changes in technology, workforce preferences, and the needs of small and large businesses. Flexible workspace provides fully equipped and furnished business facilities on flexible terms. A single charge covers accommodation, heating, lighting, electricity, cleaning, insurance and maintenance. Office space is made available to individuals or groups in a range of open plan or segregated formats for any chosen time period.

The concept of flexible workspace is not new. IBM invented the idea of “non-territorial office” – space with no walls or permanent workstations – in 1970. The basic premise was that people would not remain at the same work station, but would position themselves wherever they could work most effectively at a given time<sup>1</sup>. The goal was to foster collaboration and idea-sharing.

The largest portion of the flexible workspace market continues to be the traditional serviced office space that offers the privacy of a conventional leased property, with segregated offices for each firm. More recently, however, co-working space has grown in popularity. Co-working is a subset of the flexible workspace market that employs open plan office designs that are shared by different organizations. This arrangement is popular among entrepreneurs and start-ups but is also increasingly used by larger companies.

Several factors are supporting the growth of flexible workspace. First, technology, including Wi-Fi, mobile devices and cloud-based apps, allow for full connectivity irrespective of location. Second, workforce dynamics are evolving, with a surge in self-employment, freelancing, start-ups, contingent service provision, and offsite working arrangements. Third, Millennials (~ born 1982-2003), who generally prefer open and collaborative working environments, are a rapidly growing cohort within the workforce. Fourth, businesses both large and small are recognizing the benefits of flexible leasing: By scaling and configuring their space usage on a monthly basis, companies can promote greater functionality while achieving cost savings (e.g., using space in an expensive CBD for the duration of a specific project, rather than leasing space in a second-best location for a longer, fixed period).

## Key Players

Two big players, Regus and WeWork, dominate the shared workspace market. The rest of the industry is very fragmented with a number of small, local operators. We believe that less than 1% of current U.S. office inventory is controlled by flexible space providers (Chart 1), spanning all operator types, from traditional executive office suites to co-working and incubators. However, the flexible space sector has emerged as a primary growth driver within the office market, claiming 36% of the total U.S. office net absorption between 2015 and 2017 (24.1 million square feet) and reaching a total inventory of 51 million square feet in 2017<sup>2</sup>. Given industry shifts, flexible workspace and shared amenity spaces are projected to account for approximately 30% of the office market by 2030<sup>3</sup>.

The largest player in the flexible workspace market is IWG, a publically traded company also known as Regus, with almost 3,000 locations globally. Founded in 1989 in Brussels, Regus is considered the grandfather of flexible and shared workspaces. Compared to recent co-working models, Regus offers more conventional formats with the look and feel of a traditional office. Regus locations are considered less trendy and cannot be easily reconfigured. To capture market share, Regus acquired Spaces in 2015, a little-known co-working firm founded in The Netherlands. Although Spaces has the advantage of many more years' experience within the flexible workspace industry, WeWork dominates the co-working sector through its popularity and global footprint.

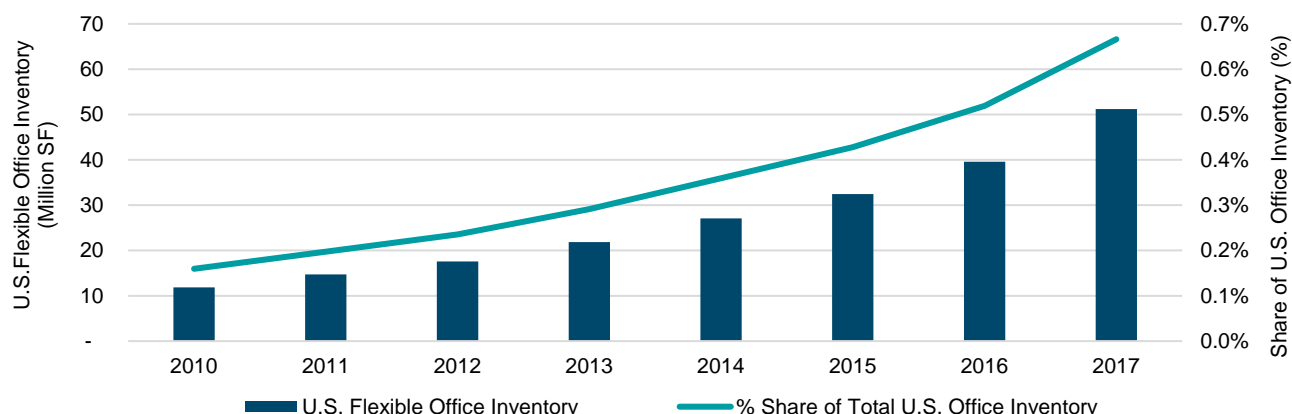
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<sup>1</sup> The Origins of New Ways of Working, Facilities. September 2010.

<sup>2</sup> JLL. Flexible Space Office Inventory. March 2018.

<sup>3</sup> JLL. Bracing Flexible Space Revolution. December 2017.

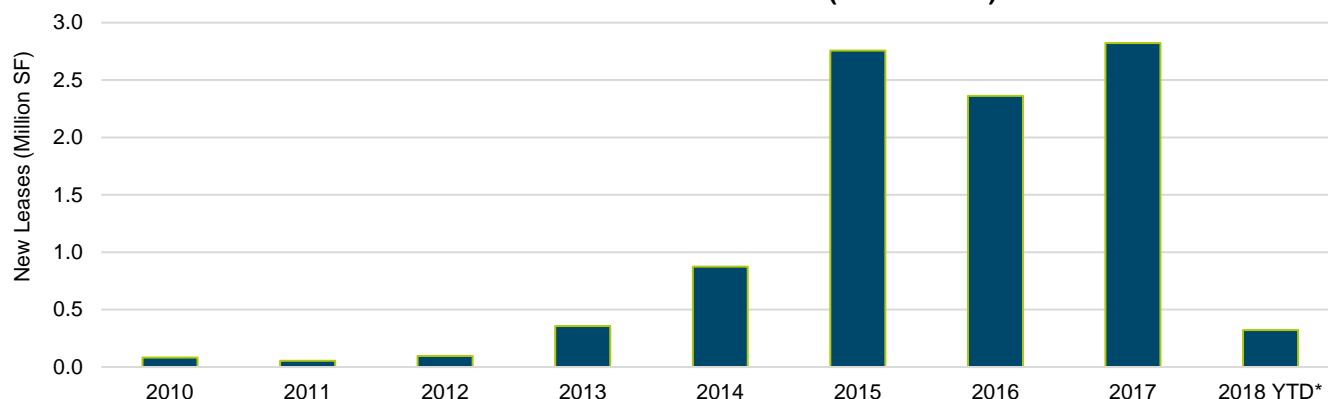
**CHART 1. U.S. FLEXIBLE OFFICE RAPID GROWTH HAS BEEN LARGELY DRIVEN BY CO-WORKING**



Sources: JLL, Costar, DWS, as of February 2018.

Much of the recent growth in flexible workspace has been driven by WeWork (Chart 2). Headquartered in New York, WeWork is a privately owned company founded in 2010 that has built a trendy global brand, becoming synonymous with the co-working term. As of February 2018, the firm had more than 200,000 members<sup>4</sup> in 315 offices spread across 21 countries. WeWork currently manages more than 20 million square feet of office space worldwide and plans to launch one million square feet of new space each month in 2018<sup>5</sup>. Top line revenue reportedly surpassed \$900 million in 2017 and is expected to reach \$2.3 billion in 2018<sup>6</sup>.

**CHART 2. WEWORK ANNUAL NEW LEASE TAKE-UP IN THE U.S. (MILLION SF)**



Sources: Costar, DWS, as of March 2018.

In the United States, WeWork locations are spread across most major cities with high concentrations in New York, San Francisco and Los Angeles (Chart 3). In New York, WeWork is one of the largest office tenants and controls more than three million square feet of office space, while Regus and all other co-working companies<sup>7</sup> account for 1.5 million square feet and 0.7 million square feet<sup>8</sup>, respectively. WeWork co-working spaces are trendy with “cool” layouts that include large common areas, individual glass offices, rentable conference rooms, upscale phone booths for private conversations, and game rooms with ping pong tables, table shuffle boards, and arcade games. A typical WeWork common area has a feel of a college hangout with people working on laptops, eating a meal, or drinking coffee.

<sup>4</sup> WeWork refers to its tenants as members.

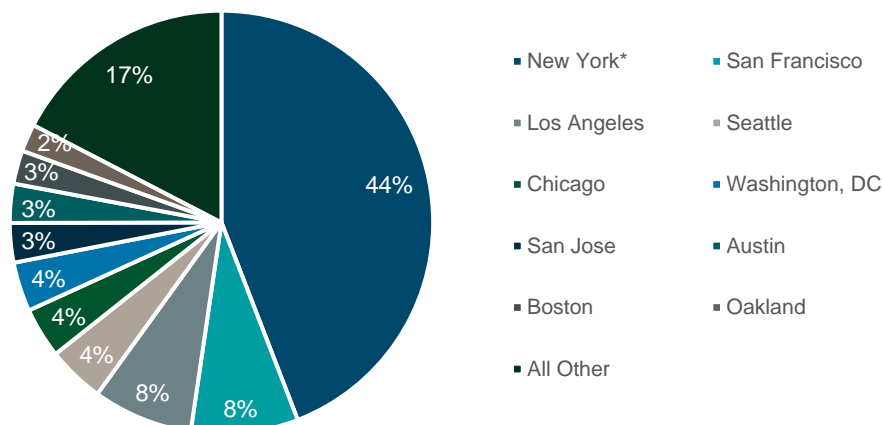
<sup>5</sup> WeWork's Powered by We Product is Central to 2018 Growth Strategy. Tech Crunch, December 2017.

<sup>6</sup> WeWork company website. March 2018.

<sup>7</sup> Other companies include: The Yard, Breather, Corp Suites, Work Better, Work House, ServCorp, Grind, Industrious, Workville

<sup>8</sup> Costar Data. March 2018.

**CHART 3. WEWORK U.S. SPACE DISTRIBUTION BY CITY (%)**



Sources: Costar, DWS, as of March 2018.

\*Includes Manhattan, Long Island City, Brooklyn and Jersey City.

To extend its appeal beyond startups and freelancers, in 2017 WeWork started building offices for large companies like Amazon, Microsoft, and IBM in cities where they have fewer employees. WeWork's enterprise membership offers flexibility and access to multiple locations. General Electric has a master agreement with the company and has employees in six locations. A "City as a Campus" partnership provides Microsoft's global marketing and sales teams access to WeWork space across New York. With access to WeWork's 30+ unique office buildings all around the city, Microsoft's sales and marketing teams can stop in, get work done, and even book private conference rooms for client meetings<sup>9</sup>. It is believed that enterprise members (companies that employ 1,000+ people) occupy about 30% of WeWork's current space, contributing 25-30% of WeWork's revenue<sup>10</sup>. Enterprise membership options are a valuable market proposition with strong growth potential, enabling WeWork to sell enterprise customers not only access to physical space, but also work space intelligence.

In an effort to diversify its revenue streams, WeWork has expanded beyond physical office space. Powered By We offers office space as a service, including helping clients find the right physical space and providing custom office décor, software to manage building operations, and back-end data on space-use efficiency. WeLive provides fully furnished micro-apartments; people can join these communities and instantly tap into amenities like free internet, maid service, and a social network. Rise by We is a spa and gym that is open to WeWork members, as well as fee-paying non-members. WeGrow is a private elementary school expected to open in late 2018. WeLabs is a partnership program with accelerators and incubators to assist small companies with space, community and programming.

## WeWork Business Model

In a nutshell, WeWork rents office space cheaply, en masse, via long-term (15-20 year) lease contracts; it transforms the space into smaller offices and common areas; and it then re-rents that space at higher prices to small companies on shorter term contracts. Because WeWork got its start in the wake of the financial crisis, when New York rents were a bargain, it has benefitted from holding advantageous lease rates as the economy has grown and rents have increased. However, the resulting asset-liability mismatch arguably exposes the company (and its landlords) to risk should its customer base dry up, whether due to recession or another industry shock. It is worth noting that Regus U.S. filed for bankruptcy in the wake of the dot-com bust as venture capital funding evaporated, forcing many of its startup customers out of business.

So far, WeWork's business model has rewarded the company with hefty margins. The company has proved effective at stimulating membership growth and maintaining high occupancy levels by providing a unique user experience, and exploiting network effects to create synergies across multiple platforms. Yet WeWork's true durability has yet to be tested in an economic downturn.

<sup>9</sup> Fortune, WeWork Will House 300 Microsoft Employees in New York City, November 2016.

<sup>10</sup> WeWork's Powered by We Product is Central to 2018 Growth Strategy. Tech Crunch, December 2017.

## Potential Impact on the Office Market

Flexible workspace and co-working are changing tenant expectations. Landlords can respond by allocating a portion of their portfolio to flexible workspace, and we expect to see more partnerships between landlords, developers and co-working operators to buy, develop, or reposition buildings. Regus is already implementing a model where landlords participate in the initial investment and later the profit of the space. In addition, because of the changes in the way workers use offices, outdated office space and industrial buildings will continue to be redeveloped. We also expect lease terms to shorten for smaller tenants as landlords contend with competition from flexible workspace providers.

Green Street Advisors estimates co-working leases are 50% more profitable than traditional office leases, but only when operated by experienced providers<sup>11</sup>. Hines and Blackstone's Equity Office have both proposed partnerships with co-working providers such as WeWork. At the same time, co-working operators have been partnering in ground-up development. Boston Properties Inc. and Rudin Management Co. recently completed the \$380 million, 675,000 square foot office building Brooklyn, NY, with WeWork as the building's anchor tenant<sup>12</sup>. Knotel, a New York based co-working platform founded in 2015, announced its first ground-up development, a 150,000 to 300,000 square foot project in Brooklyn, NY. Knotel plans to occupy the entire building<sup>13</sup>.

One of the key questions for landlords is whether co-working operators will withstand any future economic downturn. Landlords have been making heavy investments, not only into base buildings, but also into the co-working spaces themselves. While highly functional and attractive to the end user, these spaces are often quite different (i.e., denser and more heavily built-out) from what a traditional user might require. The serviced office market is innately cyclical: In theory, tougher economic times could stimulate demand for flexible leasing arrangements over longer-term fixed contracts. In practice, however, a pullback in office use more broadly could test the viability of co-working's variable revenue/fixed cost business model.

More generally, questions arise concerning the long-term impact of co-working on office space usage. In the short term, it appears that the trend has had a positive impact on office demand, attracting entrepreneurs and small businesses that were previously working from coffee shops or from home. At the same time, since co-working spaces are denser than traditional office (50 square feet per person at WeWork locations vs. 190 square feet per GSA industry standard), the expansion of co-working could modestly detract from long term office demand. This may become a larger issue as WeWork and others expand their horizons beyond flex space for smaller clients to holistic solutions for larger enterprise clients.

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<sup>11</sup> Green Street Advisors. The Co-working Impact. November 2017.

<sup>12</sup> Costar & The Architects Newspaper. March 2018.

<sup>13</sup> The Real Deal. December 2017.



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