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COWORKING'S IMPACT ON GLOBAL OFFICE MARKETS

Supported by demographic shifts and today's digital and experience-driven economy, coworking has emerged as a major force across global office markets. Office investors accordingly seek to understand the implications for the office space industry.

Coworking's rapid growth has made it a focal point in office investor and developer conversations. Less than a decade ago, package offices were a fringe office occupier. Today, modern coworking—under brands such as WeWork, Spaces, Industrious, and Convene—has become mainstream, occupying a significant amount of space across major office markets. In New York and San Francisco, for example, coworking now occupies more than 2.5% of the respective office markets, according to Cushman & Wakefield. In Vancouver, that figure is reaching 3.5% of the urban tenant base. Exhibit 1 shows the growth in US coworking square footage.

Many in the industry hold an outdated stereotype of coworking, viewing its spaces as dominated by skateboard-riding millennials sipping coffee or beer in open-plan offices. Coworking, however, has become more than open-plan “hot desks” for tech workers (hot desks are unassigned desks occupied by different workers on a first-come basis). Today's coworking caters to a wide range of user groups, with an even wider range of office designs and layouts. Contract workers, entrepreneurs, and increasingly major corporations all use coworking, and most work from private and semiprivate spaces rather than in open-plan arrangements. A key innovation for many coworking users is the short-term, flexible options available.

GWL Realty Advisors (GWLRA) has been monitoring the growth of coworking for several years, especially among the larger players in the industry. Understanding the long-

term potential of this sector, when coworking leases may make sense, and how to best manage a building with coworking are among the questions under investigation.

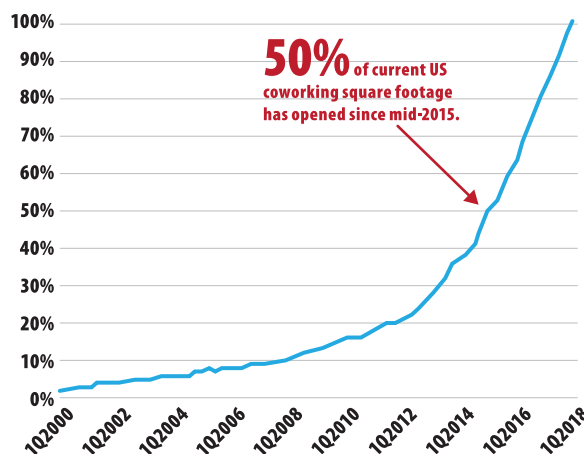
Coworking: Background and History

The concept of coworking is not a new trend; short-term, packaged offices have existed for decades. Coworking as it functions today, however, emerged nearly a decade ago when companies such as WeWork brought the practice into the 21st-century-experience economy, focusing on new generations of workers doing freelance and project-based employment, often connected to technology



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Exhibit 1: Growth in US Coworking Square Footage



Sources: CoStar Group, Cushman & Wakefield:
<http://www.cushmanwakefield.us/en/research-and-insight/2018/coworking-report>

in some way. Gourmet coffee, fruit water, and craft beer offerings created a more social and collaborative experience, while natural light, superior interior design, and seamless technology improved productivity.

Coworking has demonstrated to the traditional office sector that a sizable portion of office users will pay extra (from 30% to 100% more, depending upon the market) for a premium experience and flexible lease terms—an important lesson for landlords as they look to understand how to grow revenues or net operating income in the coming years.

Perhaps most important, coworking has evolved in terms of who uses the service. Today, coworking still aggregates some individual operators who would otherwise work from home or a coffee shop. A larger driver of demand is now coming from established businesses and especially large Fortune 500 companies that are seeking a range of month-to-month and even multiyear lease arrangements. “Coworking” in this case refers to their use of common amenities, such as meeting and video-conferencing rooms, kitchens, and office equipment.

Drivers of Coworking

GWLRA focuses on understanding drivers of real estate market trends and performance. For coworking, several longer-term structural shifts underpin the growth of this industry.

Fast-Paced, Project-Based Economy

Flexible-term office space suits the need large and small organizations have to grow and contract with their work flow. When contract employment is high, a large organization can locate a team in coworking space. Meanwhile, small companies can add team members simply by leasing an additional private desk at their coworking-based office. Closely related, flexible-term office space also suits freelancers and local representatives of outside firms when they need space close to clients.

For freelancers and micro businesses, coworking connects them to a business network where they can find help as needed or solicit contracts to expand their own businesses.

Uncertain Growth of Many Start-Ups and Small Businesses

For smaller companies that are uncertain of their growth, month-to-month lease commitments make sense. Many smaller companies have their own separate, private spaces carved out within a broader coworking operation. This quiet, distinct company area allows employees to maximize productivity while also being able to collaborate with, or learn from, other coworkers sharing the kitchen and lounge when desired. Moreover, having someone else supply reception, internet, technology support, meeting rooms, cleaning, and other office details allows businesses to focus on their core products and services.

Office Solution for Fast-Growing Companies

Flexible-term office space creates a bridge for medium-sized and large organizations expanding faster than existing premises can grow; it can also become a temporary space while another long-term office space is built or renovated.

Treatment of Office Leases in Revised Accounting Standards

Under new International Financial Reporting Standards rules, a long-term lease must be treated as a liability on the balance sheet and not a deductible expense. This encourages companies to use shorter-term and even month-to-month offerings from a coworking provider.

Demographics and Urban Living

Demographics and urban living trends are shifting how people work. The workforce in many cities is now dominated by 25- to 39-year-olds with strong views and preferences about their workplace design, whether they work independently or for a large organization. To attract this group, many companies are turning to coworking companies to supply their office space. Additionally, these millennial households in gateway cities such as New York, San Francisco, London, and Vancouver often live in smaller spaces than older generations, making working from home offices problematic. Living in 800 square feet with two kids and a dog can be distracting, and therefore a coworking membership becomes attractive.

DIFFERENT LOOKS OF COWORKING

Private and semiprivate offices are typical in coworking environments. Independent workers as well as small businesses lease these options by the month. Some coworking spaces comprise glass walls and narrow hallways separating each individual or team space.



Many coworking sites include flexible, separate, turnkey office space solutions for big and small corporations. These are often used as project spaces, unexpected growth accommodations, or swing space when office space is being renovated or built. Users share the coworking lounge (and hot-desk) space, refreshment amenities, as well as IT infrastructure and meeting rooms. These spaces can range from 1,000 sf to 100,000 sf or more. Terms can be month to month or multiyear in duration.

Company spaces designed/managed by a coworking provider (e.g., HQ by We) can be branded as the enterprise client, not the coworking provider. These spaces are often for companies that have outgrown a coworking space but still prefer the high-touch, high-service experience and prefer not to manage their own office spaces.



The percentage of open-plan, hot-desk areas has been declining in established-company coworking operations in favor of the other styles. Often, a hot-desk space is within a common refreshment area; many myths and stereotypes about coworking have emerged from this original but less-common use. Most individuals who report daily to a coworking facility use a private or semiprivate office. Hot desking is popular among members who use different locations because of business travel or for other reasons.

Prioritization of the Overall Workplace Experience

Leading coworking providers typically offer superior natural lighting, improved air quality, wellness health amenities (such as fitness), as well as free beverages and snacks. Hassle-free technology allows coworking tenants to focus on their own productivity. Wireless printing, Wi-Fi and Ethernet connections, videoconferencing rooms, and meeting rooms are all available with membership, along with experienced on-site staff to assist with technology and troubleshoot any problems. Many small and medium-sized firms cannot offer employees this high level of service and experience on their own.

Lesson for Landlords: Coworking Is Bringing the Office Sector Into the Experience Economy

WeWork, Convene, Spaces, Industrious, and other brands have brought an enhanced hospitality-like experience to the office sector, with several intriguing ideas for landlords and office developers looking to upgrade legacy assets.

- Coworking providers have demonstrated that tenants are willing to pay more for a superior office experience and flexible lease terms, as their growing client base illustrates.
- Some coworking providers track space usage carefully and have gleaned helpful insights into how people work, such as that most meetings involve two to four people and therefore a workplace needs more small rooms than large ones.
- Some coworking companies seek natural light, health and wellness features, and amenities in new spaces, which attract and retain their client base.

Challenges and Uncertainties for Landlords

Physical Buildings

Coworking tenancies can put extra strain on overall building infrastructure, such as elevators, HVAC systems, washrooms, amenities, and common spaces. This can impact capital expenditures, occupancy regulations, and daily maintenance requirements.

For instance, coworking companies that occupy multiple floors often have a single amenity space, such as a kitchen or lounge. This can lead to higher elevator

loads and frequency of use as coworking members constantly travel to the “amenity” floor. Internal stairwells may help as does locating coworking lower in a building, when possible, to facilitate stair use. Building amenities, including fitness spaces, end-of-trip facilities, and parking, can see increased use from coworking employees. Overall higher worker densities can also cause issues for landlords who must ensure fire and occupancy codes are met. Finally, coworking companies’ clients often use the space for extended hours, whether working at unusual times or hosting events in the lounge space. Some landlords need to operate HVAC at higher intensities for longer hours to accommodate this use.

Covenants

Start-up coworking companies often have weaker covenants than other types of tenants. Additionally, they typically have high tenant improvement costs owing to the design, technology facilitation, and buildout of the office-intensive nature of many coworking facilities. Bank letters of credit and surety bonds are two financial instruments that some landlords use to backstop leases to coworking companies.

Higher Cap Rates

In a 2017 study, Green Street Advisors found that in London, appraisers typically assigned higher cap rates (higher risk) to buildings with a higher percentage of coworking, offering two main reasons: coworking subleases are short term and coworking companies themselves are young, often with limited financial histories and weak covenants. One landlord response in some cases has been to secure a higher face rate, thereby maintaining values.

Uncertain Future in Uncertain Economic Times

It is not clear how the coworking sector will perform over the next five years. In some cities, coworking space is currently housing companies with leases in buildings under construction; once those buildings open, demand may be lower in five years than today. This will be especially true if the new buildings open simultaneously with an economic slowdown.

Coworking Leases in Suburban Shopping Centers

More common in the United States, coworking has become a good fit for many suburban malls.

- With large retailers downsizing or disappearing, malls often have large blocks of inexpensive, amenity-rich space.
- Suburban coworkers often arrive via car, and malls typically have abundant parking during the day, when fewer people shop.
- Many malls have added fitness centers, a feature coworking companies try to offer within their brands.
- Suburban coworking works for employers who allow their workers flexibility but may prefer employees report for work together at a suburban coworking space rather remain at home.
- For workers, whether freelance or part of a larger firm, suburban coworking offers the advantage of turnkey technology, such as quality printers and Wi-Fi, inspiring spaces, people to collaborate or talk with, plus a gym, food court, café, grocer, and other “needs-of-life” retail amenities.

Because coworking—in its current format—has not endured a globally synchronized economic downturn, it is unclear what will happen when that occurs. Leasing to coworking companies typically offers a long-term tenant who themselves survive on shorter, month-to-month contracts. This could be a recipe for challenges—or not.

The flexibility coworking offers may be appealing during a downturn, even if it costs more than doing a direct or sublease deal. The flexibility to terminate with a month’s notice gives organizations the reassurance to stay in coworking spaces or to relocate to them as their own leases expire.

On the other hand, abundance of available sublet space at cheap prices could encourage small and even larger businesses using coworking to switch to sublease arrangements, undermining coworking revenue. Layoffs could reduce the need for coworking by large, enterprise companies that currently lease as much as 50% of the space in some markets.

In conclusion, the structural drivers behind coworking suggest the concept will endure the next downturn—however, not all providers will necessarily survive. Sector consolidation is likely.

Looking Ahead: Potential Pace of Growth Is Noteworthy

Coworking is the fastest-growing occupier of office space in North America, the UK, and many other parts

of the world. Predicting whether that pace will continue is challenging. JLL put forth a scenario in which up to 30% of all office space may become flexible-term, coworking-styled space. Meanwhile, Cushman envisions coworking becoming 5% to 10% of office space in most markets by 2025 to 2030.

Office landlords are responding to coworking in different ways. Some are skeptical and to date have avoided leases in the sector. However, because of the growing interest from mainstream Fortune 500 companies in using this space type, many are adjusting. Some landlords are also experimenting with offering their own coworking environments, and others have invested in certain coworking providers or are finding other ways to partner with the sector. And all can learn from coworking about what many tenants today, especially those catering to a 25- to 45-year-old workforce, want. ■

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