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Coworking positioned to shift landscape post-pandemic in U.S. office markets - by Bradley Tisdahl

November 17, 2020 - Front Section

Many commercial real estate owners in primary markets turned to coworking companies over the last half decade to fill in large office vacancies under long-term, high-priced deals. The same factors that attracted owners to coworking companies are the same that are creating additional anxiety for owners of distressed coworking locations today. Amid the pandemic and subsequent lockdowns across the country, many coworking operators are now closing some locations and consolidating around their more mature centers. It seems clear that coworking operators and landlords are entering a new phase of co-existence, and what we saw pre-pandemic may no longer exist in the same form as we come out of it.

Pre-pandemic Landscape

Before the pandemic, two companies dominated among coworking operators: IWG plc (Regus and Spaces) and The We Company (WeWork). Both companies adopted an aggressive expansion strategy canvassing core commercial markets across the U.S., funded by a combination of investor money, lenders, landlords and commercial real estate owners. While the expansion slowed following WeWork’s failed initial public offering (IPO) in the third quarter of 2019, demand persisted until the pandemic descended on the U.S.

Before the pandemic, both WeWork and Regus began courting medium- and large-sized enterprise members in lieu of smaller businesses and independent contractors. Enterprise members offer higher margins to coworking companies. This is due to the lower cost of marketing and managing the space while securing cash flows for up to three years compared to twelve-month deals that are more common among small businesses and independent contractor members. TRA’s analysis of WeWork’s gross margins from November 2019 indicated that mature enterprise locations generated 20% gross margins compared with 3% gross margins catering to smaller businesses, indicating just how much cheaper it is for WeWork, and most likely other large coworking companies, to market services to enterprise users.

The COVID Gut Punch

Following the pandemic’s onset beginning in March 2020, coworking operators across the country paused new leases and aligned operations around sustaining their businesses. They worked diligently to limit membership attrition to keep occupancy as high as possible (most coworking locations need at least 65% occupancy to break even). Many operators invested their limited capital in outfitting locations to be more COVID safe, even as daily membership attendance fell sharply due to a combination of state and local capacity limitations and reduced interest from members.

As the pandemic continues, coworking operators find themselves at a crossroads. IWG plc has declared strategic bankruptcies to allow it to restructure and emerge leaner and better capitalized, largely at the expense of commercial real estate owners. WeWork paused new leases and received a $1.1 billion senior secured note from Softbank, its primary backer, giving it adequate liquidity to sustain operations through early 2021. Smaller operators like Industrious and Knotel are turning to partnerships and additional funding respectively to survive in the near term.

Coworking in the Future by Any Other Name

The coworking operators that remain following the pandemic and its effects, however long that may be, will be the ones that forged strong partnerships or raised sufficient debt and investment capital to survive. These coworking companies will likely find a cooled leasing environment with more skeptical landlords and limited funding prospects from investors and lenders. The business coworking model has always been exposed and vulnerable to recessions, so out of necessity coworking operators will need to find new ways to brand themselves and market their services.

At this point in the pandemic as we enter November 2020, coworking operators are likely to follow one of two paths: either coalesce around enterprise members or pivot toward managing existing spaces on behalf of landlords. From an accounting standpoint, many of the coworking leases currently in place are relatively new, with significant unamortized tenant improvements incentivizing landlords to work with existing coworking tenants. Owners will seek deals that guarantee cash flow to meet their debt service obligations.

On the enterprise front, many coworking operators currently occupy space in core commercial business districts where demand may recover over a prolonged period, especially for mid-sized and larger businesses. This dynamic should cultivate attractive flexible options for many commercial tenants looking to downsize their real estate footprints while offering greater flexibility for their employees. Many suburban submarkets with incumbent coworking tenants are also expected to cater to this demand for enterprise users.

With a gradual pivot toward enterprise members, however, coworking companies with existing leases could begin competing directly with their landlords for office leasing tenants. This unintended friction may require landlords to decide whether to amend non-compete clauses in existing leases with coworking tenants or restructure lease economics with them to compensate for the increased competition.

As noted earlier, some smaller coworking operators are signaling a shift toward property management. Companies like Industrious, which signed a partnership with Cushman & Wakefield earlier this year, may transition toward property and flexible space management for existing landlords. The effectiveness of this strategy would likely be predicated on a broader transition where office workers are granted more flexibility by their employers.

Coworking tenants were alluring to landlords, owners, and end-users before the pandemic, and there is a strong case for many of them to continue as viable office space options as the real estate market evolves as a whole. Landlords and owners will likely need to evolve and forge a symbiotic relationship going forward and should be considerate of the decisions being made today having a lasting impact.

Bradley Tisdahl is the CEO and principal of Tenant Risk Assessment, New York, N.Y.