Co-working May Come With Risks For Office Landlords And CMBS Investors

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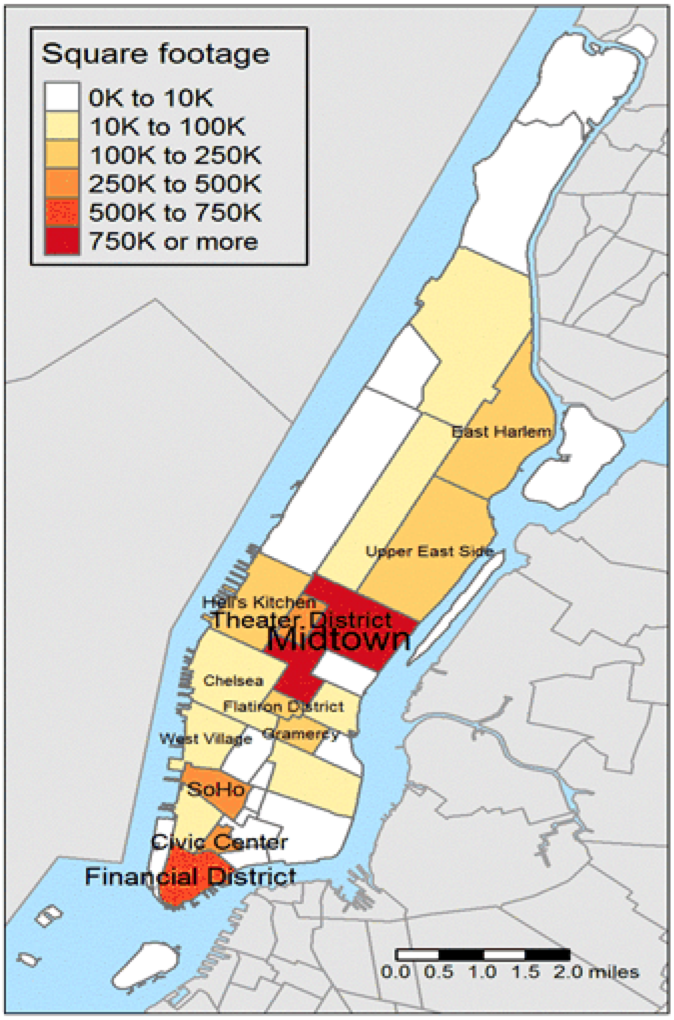
Key Takeaways

- Co-working has grown in terms of both the number of firms offering space/enterprise solutions and the amount of space occupied in recent times.
- That growth, which we've seen in many primary and secondary locations, has led to questions about how we view the risk of co-working tenants in commercial mortgage-backed securities (CMBS) loans.
- We've identified at least $3 billion in exposure within CMBS from WeWork, currently the top holder of office space amongst the growing number of co-working firms.
- Our analysis for the purpose of CMBS loans keys in on vacancy and long-term sustainable cash-flows, which align with what we believe are the main risks associated with co-working firms/tenants.
- While the office sector has mainly shown improved fundamentals (namely vacancy rate and rents) since 2011, conditions may become more challenging as the current cycle ages, exacerbating risks inherent in the co-working model.

A growing number of companies, including WeWork, Knotel, Emerge, Convene, and Regus, are offering space, or in some cases enterprise solutions, for their partners. WeWork in particular, the largest co-working space provider currently, has seen significant growth since its start in 2010. As of early 2019, the company boasted some 425 locations in 100 countries, compared with 207 locations in 65 countries in early 2018 and one location to start. In addition, in September 2018, the firm became the top occupier of office space in Manhattan based on square footage, at 5.3 million. For some perspective, that's just over 1% of total Manhattan office space, per CBRE-EA data compiled by S&P Global Ratings. In fact, based on CBRE fourth-quarter 2018 average gross rents of approximately $79 per sq.-ft. in the Midtown submarket, WeWork's annual rent obligations for this submarket alone may range upwards of $150 million, based on our estimate of 1.9 million sq. ft. leased.

Chart 1

WeWork Commercial Real Estate Exposure



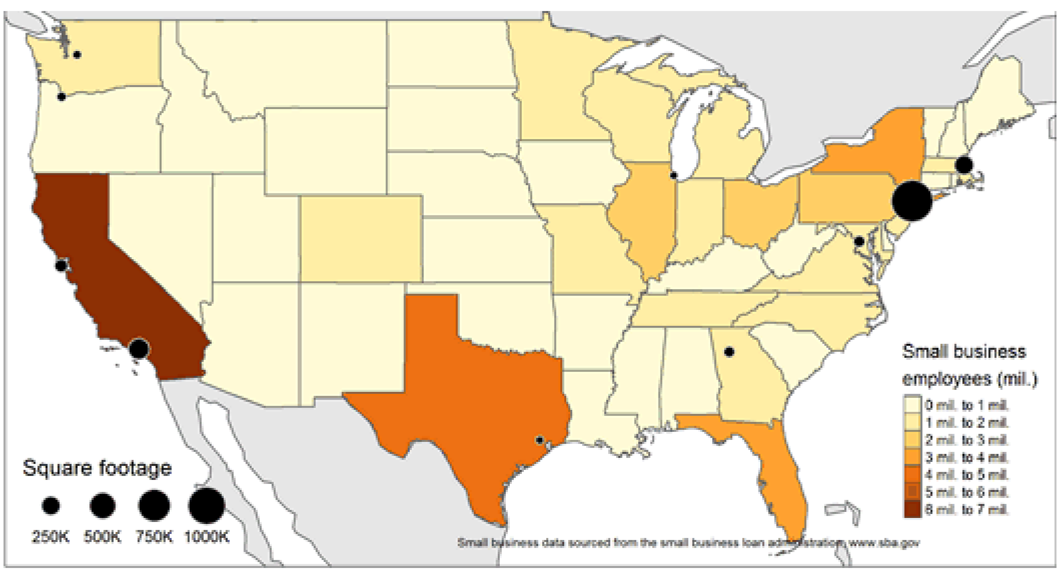
This rising footprint for co-working, especially in larger markets, has led to many questions from commercial mortgage-backed securities (CMBS) investors, issuers, and others about how we account for co-working risk when we analyze securitized loans secured by properties occupied by co-working tenants. One of the main risks, as noted in S&P Global Ratings' corporate research on WeWork and other co-working firms, is the duration mismatch between the long-term leases and the monthly member contracts. The same research noted that the natural instability of the independent workforce presents a significant risk to the company's profitability between individual members or small businesses, whose viability can be sensitive to economic swings (For more information on S&P Global Ratings' view of co-working, see our recent publication "Disruption In Real Estate: Co-Working Space Connects With An Untethered Workforce," published April 11, 2019). We are acutely aware of this nuance during our review of securitized loans, where we attempt to value the commercial property through an economic cycle.

CMBS Exposure To WeWork

Based on our query of CMBS data, we found 31 properties--an allocated loan balance of approximately $3.1 billion--with WeWork listed as a tenant (we focus on Wework because it is by far the largest of the aforementioned firms). A quick glance at these 31 properties and their locations provides some insights. First, properties located in New York (13) and California (eight) make up roughly two-thirds of the total, with the remaining properties located in Washington D.C. (three); Massachusetts (two); and Illinois, Oregon, Washington, Georgia, and Texas (each having one). Second, WeWork is the largest tenant (by sq. ft.) at 24 of these properties. Third, WeWork's average footprint at these properties is about 75,000 sq. ft., ranging from a low of about 11,000 sq. ft. to a high of 175,000 sq. ft. Fourth, WeWork occupies, on average, 43% of the property, from a low of 5% to a high of 100%. Mapping the locations of the 31 properties (chart 2), we see that they are generally in states with a higher number of small business employees.

Chart 2

U.S. CMBS Exposure By Square Footage Vs. Number Of Small Business Employees



How S&P Global Ratings Views Co-working Risk In CMBS Loans

As stated previously, co-working firms have considerably raised their profile in several primary markets and numerous secondary ones. In most cases, when we review property financials with co-working tenants, we see substantial improvement in the overall vacancy rate within a short period of time because of the sizable space co-working firms require at the property. Despite the lower vacancy and associated pick-up in overall rental income, our overall credit view of co-working tenants, all else equal, is negative relative to traditional ones. The main risks in our view are:

- A larger amount of upfront improvements are needed to customize the space while the future rental stream from the co-working tenant is subject to broader economic risks.
- A broader concern about the sustainability of the business in an economic downturn during which freelancers will likely stop their memberships; we apply this concern to the vacancy/rent assumptions.
- A potential conflict of interest between the property landlord and the co-working lessee, who is essentially another competing landlord; this also goes to the vacancy assumption.
- In recent times, a large amount of new entrants providing similar services, including some well-known real estate firms, such as the Blackstone-owned EQ Office, CBRE-owned Hana, and SL Green's Emerge212. Our concern is on the viability of a saturated co-working market as many essentially play a somewhat similar role to that of the property landlord.
- In Wework's case, the typical lessee is a subsidiary/affiliate of Wework structured as a non-recourse SPV.

How We Typically Analyze a Loan With a Co-Working Tenant

As might be expected, our typical approach to a property with a co-working tenant depends on the exposure of the tenant in terms of net rentable area and/or base rent. We consider whether the contractual rents paid by the co-working tenant are at market rates, if the term is typical of traditional long-term office leases (i.e. 10 years), and if the lease offers the co-working tenant any termination options.

As with any property, we then consider the property's vacancy rate as compared to the property's comparative set, submarket, and market. In this case, the review has an added goal of determining how the property's vacancy rate compares to those benchmarks without the co-working tenant. That is, does the property need the tenant to be in-line with market and is it above or below market with the tenant?

In general, we increase our vacancy rate assumption to a rate higher than the property's in-place figure, the degree of which depends on the amount of space occupied by the co-working tenant, to account for the aforementioned risks. If we view the relevant portion of the space as less desirable (typically lower floors with less light and/or spaces that are less contiguous), then our vacancy adjustment would generally be less punitive.

In many cases, our increase will result in a vacancy assumption that is above market. Note, this is a departure from scenarios we've come across in the past when a property (without a co-working tenant) has demonstrated a consistent track record of below-market vacancies. In those instances, we still increase our vacancy assumption, but consider a midpoint between in-place figures and market vacancy rates. Finally, we may simply increase our vacancy rate assumption to a rate that either excludes the co-working tenant or gives some credit depending on asset-specific circumstances.

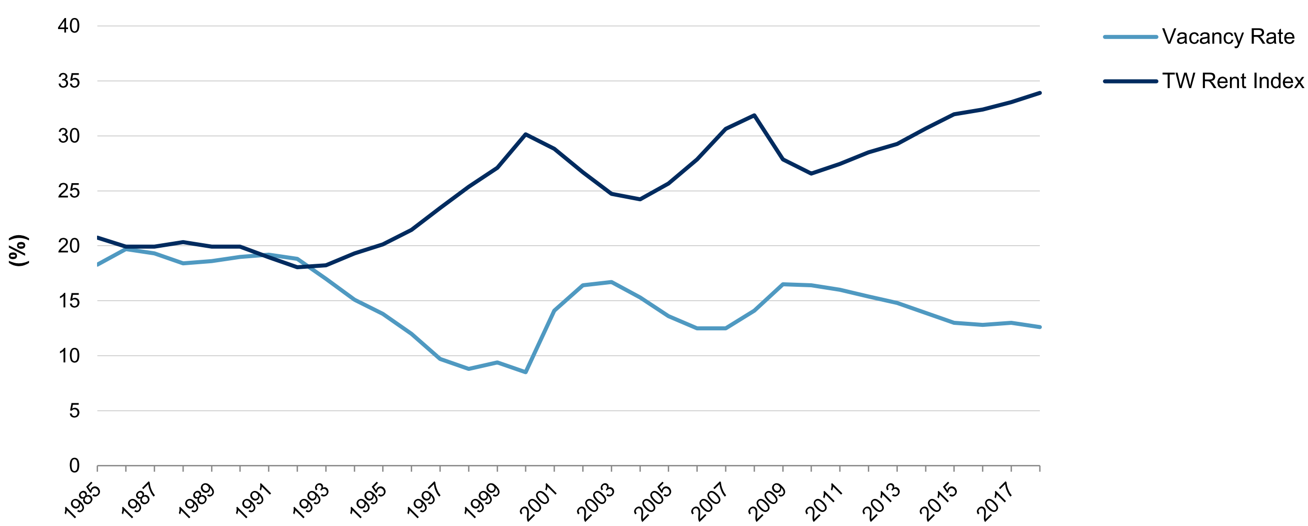
Other steps we might consider to address risks associated with co-working tenants at specific properties include, but are not limited to, increasing the cap rate by at least 25 basis points (bps) for the portion of rental income attributed to the co-working tenant and/or lowering our renewal probability for purposes of calculating tenant improvements and leasing commissions. Greater exposure to a co-working tenant results in relatively magnified adjustments and could lead us to increase the cap rate for the entire property, not just the co-working space.

The Big Picture – The Office Sector Has Performed Well, But Might be Headed for More Challenging Times

The office market regained its post-crisis positive momentum in 2018 on the back of strong net occupancy and demand, posting a 40 bps decline in the national vacancy rate to 12.6% and rent growth of 2.5% to just under $34 per sq. ft. Indeed, since peaking in 2009 at 16.5%, the national vacancy rate has steadily declined (absent a modest increase in 2017) since 2011, while rents have been growing at a decent clip.

Chart 3

National Office and Rent Vacancy (1985-2018)



Source: CBRE EA

That said, the next few years may prove more challenging for the office sector to maintain its recent rate of improvement. As the current cycle ages, moderating economic growth and growing fears of a potential recession, coupled with expected supply growth in some large markets, could potentially pressure both vacancy and rent growth rates. Taken together, we believe office properties with co-working tenants may feel these impacts more strongly, hence our more conservative view when we analyze these office loans. We recognize that it may be too early to take a long-term view of co-working firms and their concepts. However, we believe the cautious view is warranted as some firms that utilized similar concepts have run into trouble in past downturns (Regus, for example, declared bankruptcy following the dot-com era).

This report does not constitute a rating action.