

GRANT'S

INTEREST RATE OBSERVER®

Vol. 38, No. 12c

233 Broadway, New York, New York 10279 • www.grantspub.com

JUNE 12, 2020

Relocation, relocation, etc.

Evan Lorenz writes:

On the collective decision of America's office workers to either return to their desks or stay at home hinges the value of swaths of commercial real estate, the myriad municipal tax bases that those values support and—it's hardly an exaggeration to say—the economic geography of the United States itself.

Now in progress is a survey of the macro dimensions of this developing post-pandemic story as well as a sharply focused analysis of IWG plc, a Luxembourg-based provider of flexible offices and co-working spaces. As to the former, it's immense, and we struggle to wrap our arms around it. Concerning the latter (IWG on the London Stock Exchange), we're bearish.

"Property taxes," observes a June 1 bulletin from Moody's Investors Service, sounding the big-picture theme, deliver "the primary revenue source of most local governments."

Office buildings furnish no small part of those revenues in such gateway cities as New York, Paris and London. Before the bug bit, the long-running trend toward urbanization—in particular, the trend toward human clustering in the biggest, most crowded, most electric cities—seemed one for the ages. But the worldwide lockdown has created a natural experiment in the alternatives of dispersal and re-suburbanization.

The ancient real-estate adage "location, location, location" might soon give way to "relocation, relocation, relocation," says Green Street Advisors in a must-read May 31 bulletin. "Even if most workers continue to work full-time in the office," the analysis says,

"plausible projections for increased remote work should put a sizable dent in long-term [office] demand. That is highly unwelcome for a sector that was already facing challenging fundamentals and lofty valuations."

The potential consequences of this still-nascent shift in American migration could upend private and public finance alike. Thus, last month, New Jersey Gov. Phil Murphy warned that his blue state may need to discharge half of its 400,000 public employees if the Trump administration fails to plug a projected \$10.1 billion deficit for the 2021 fiscal year. "I don't think there's any amount of cuts or any amount of taxes that begins to fill the hole," lamented Murphy, whose preferences in the looming national elections may be easily guessed.

Pre-lockdown, a highly-taxed New Jersey commuter perhaps saw little alternative to riding the train to and from Manhattan five days a week. Two months of enforced telecommuting have opened new vistas—with lower taxes and less aggravation—for living one's working life.

The Green Street authors—Dave Bragg, Mike Kirby and Jared Giles—cite a recent poll showing that 40% of Facebook, Inc. employees found they liked working from home and, of that cohort, "three-quarters might/will move to another place." Presumably, that place would not be in Gov. Andrew Cuomo's New York State, which has the same basic fiscal narrative as New Jersey and features winter temperatures colder than those on offer in the low-tax Sun Belt.

While New York City's taxes are al-

most certainly set to rise, the net yield on those prospective imposts is debatable. "Now, think about it," a commercial real-estate owner in New York muses, "if you can't raise your rents and you raise your property taxes, what does that do to the value of the building? And then what happens when you revalue the building for tax purposes?"

Taking one thing with another, the Green Street team sums up, the dominance of the greatest and grandest gateway cities may soon yield to accelerated growth within the humbler, lower-taxed city limits of Austin, Charlotte, Denver, Phoenix and Raleigh.

Investors in office real-estate-investment trusts seem to concur. Thus, since the start of the year, Sun Belt-heavy Cousins Properties, Inc. has fallen by 11.1%; Kilroy Realty Corp., the gem of tech-dominated West Coast markets, by 18.9%; and Boston Properties, Inc., which has broad exposure to the East Coast, by 23.5%. Meanwhile, SL Green Realty Corp., a New York City pure play, has plunged by 36.4%. (All figures include reinvested dividends.)

"The New York Office Market is Facing an Existential Hurricane" runs the headline over an analysis posted a month ago by the activist hedge fund Land & Buildings Investment Management. "WeWork and other co-working firms were the largest consumers of office space in New York City during the past several years, in some cases accounting for 100% or more of the positive leasing absorption each year," founder and CIO Jonathan Litt writes.

"In total, co-working space accounts for 4% of the office market in New York

Sun Belt tops New York



source: The Bloomberg

City, up from less than 0.5% in 2010,” Litt goes on. “WeWork alone occupies 9 million square feet in the city. In the current paradigm, the business model appears untenable. The social-distancing era is likely to dramatically diminish the popularity of co-working space, and the current recession will further reduce demand, potentially substantially. Short-term leases, high rents and poor-credit tenants make co-working businesses uniquely vulnerable to near-term stress, which could alone add 3% to the vacancy rate in Manhattan.” Overall, Litt sees New York City vacancies rising to 20% from 11.3% and rents declining by 15%–20%.

“So how big is the impending commercial real-estate bust in the U.S.?” Christopher Whalen, publisher of The Institutional Risk Analyst, asks and answers in a June 8 post: “Bigger than the residential mortgage bust of the 2000s and also bigger than the commercial real estate wipeout of the 1990s, including the aftermath of the Texas oil boom of the late 1970s and 1980s.” The ultimate cost in dollars? Whalen’s stab in the dark—a 10% loss spread across \$5 trillion in commercial real-estate assets over a half-decade—is probably as good as anyone’s.

...

In 1989, the epiphany came to Mark Dixon that there had to be something better for the traveling office worker

than the hotel business center. Following that inspiration, Dixon sold a bakery he owned in England and opened his first flexible office unit in Brussels, Belgium, under the name Regus. In 2016, Regus rebranded itself IWG plc, short for International Workplace Group.

IWG, the undisputed leader in such workspaces, oversees 63.8 million square feet of office space across 3,405 locations in more than 110 countries. For comparison, when the We Co. (aka WeWork) filed its prospectus last August, it had 40 million square feet of space spread over 528 locations. While IWG traces its origin to the heart of the European Union, its fortunes lie in the New World. The United States (accounting for 44.4% of revenues) is by far IWG’s biggest market, followed by continental Europe, the Middle East



and Africa (23.7%), the UK (15.7%) and Asia (12.2%).

Flexible-office operators like IWG sign long-term leases while their customers sign short-term ones. The risks inherent in the mismatch were front and center in the dot-com crash that followed IWG’s initial public offering in 2000. By 2003, the company’s American assets had been dumped into Chapter 11 bankruptcy protection.

As of Dec. 31, the IWG balance sheet showed £6.5 billion in lease liabilities versus a lease expense of £1.1 billion, i.e., remaining leases have around six years to run. Management, well aware of the unpleasant possibilities embedded in its own business model, has negotiated a certain amount of give and take with its landlords. Thus, today, 95% of IWG’s leases are either cancelable in six months or organized as standalone legal entities that can default on payments with no recourse to the parent.

Early in 2019, Jones Lang LaSalle, Inc., the real-estate-investment services company, predicted that flexible space would command 30% of the American office market by 2030, from less than 5% in 2018. On that heady view, IWG embarked on a stratagem to turn itself into an asset-lite franchisor, and it did manage to sell master franchise agreements in Japan and Taiwan for more than £340 million in 2019. Anticipation of the day when IWG would be clipping royalty checks for a living sent the stock up to £4.69 early this year from £2.09 at year-end 2018.

Covid-19 has canceled the royalty story, but IWG has another. To seize the work-from-home moment, the company raised £320 million in a March 28 equity offering, with Dixon himself ponying up £91.3 million. “The simple reason why [is], we see a generational opportunity... to pick up new centers, either from operators going out of business or from building owners who want to get in the business and work with us,” the boss and founder told dialers-in on a May 28 conference call. The strategic idea is that even stay-at-home office workers need a place to see clients, escape spouses and children, have meetings, etc.

So far, IWG’s results through April would seem anything but catastrophic. Revenues leapt up by 17.7% year-over-year in the first quarter, driven by a 7.6% rise in properties opened before 2019 as well as the contribution from

new centers. Occupancy for centers opened before 2019 did dip to 77.4% in April from 78.8% in March, but that was way up from the 72.2% registered in March 2019. As of April 30, net debt footed to £320.8 million. While IWG did not provide a full profit-and-loss statement in the update, last year's operating income covered interest expense by 13.5:1.

Of the nine analysts who follow the stock, five say buy, four hold and none sell. Excluding the equity offering two weeks ago, over the past 12 months insiders have purchased 4.7 million shares at an average price of £1.56 at a cost of £7.3 million; Dixon accounted for 99% of the buys.

...

The bear case begins with earnings, both their cost and quality.

The trailing p/e multiple is 34.4 times (using the pre-May share count and adjusting for the 2019 shifting of Japanese and Taiwanese assets).

A lengthening in the depreciable life of the company's assets (£14.5 million) and a reduction in allowances for slow customer payments (£8.2 million) accounted for 40.6% of last year's pretax profit. Free cash flow in 2019 weighed in at negative £126 million (£1.3 billion in cash flow from operations minus the £356 million outlay for capital spending and £1.1 billion for rent).

On the May 28 call, IWG brass cited

IWG at a glance

all figures in £ millions

	2019	2018	2017	2016	2015
revenues	£2,653.0	£2,402.1	£2,352.3	£2,233.4	£1,927.0
pretax profit	55.9	109.6	149.4	173.7	145.7
net income from cont. ops.	78.2	79.9	114.0	138.8	119.9
free cash flow	-126.2	-68.9	46.3	119.1	26.8
cash	66.6	69.0	55.0	50.1	63.9
debt	360.7	529.8	351.4	201.4	254.5
lease liabilities*	6,546.0	—	—	—	—
total assets	8,953.3	3,421.2	2,860.0	2,661.1	2,327.6

* IWG adopted IFRS 16, which recognizes lease liabilities and right-of-use assets, in 2019.

source: company reports

a deal that was about to close in Asia as an example of the transformative things to come. Last week, the *Financial Times* reported that IWG assumed a lease for 30,000 square feet at Hysan Place in Causeway Bay, Hong Kong, that WeWork had vacated in March. If this is the transaction to which management alluded (an email and a call to the London headquarters went unanswered), it isn't clear why it was worth the dilution that shareholders suffered in the March equity offering. Nor is it obvious that this was such a highly profitable unit to begin with. Presumably, if it were, WeWork would not have walked away from it.

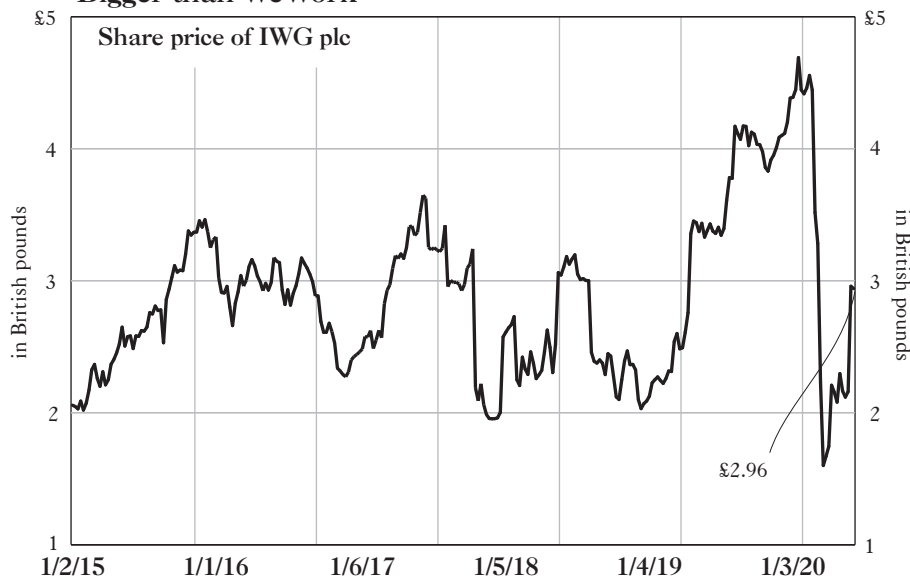
On March 23, IWG suspended share

repurchases and announced the withdrawal of payment of its final 2019 dividend. The company has furloughed an unspecified number of employees, is deferring or canceling new office-center openings and is slashing the pay of the board of directors by half. According to press reports, at least some IWG customers are irate that the company has demanded timely rent in full during lockdown while, at the same time, IWG has been asking its landlords for concessions.

It was no bullish omen when, in 2018, the pygmy flexible-workspace branch of the office-leasing industry—then commanding only a 5% market share, supposedly on its way to 30%—accounted for two-thirds of all office absorptions in the United States. Such a snapshot suggests the growth-at-any-price managerial mindset that was the undoing of WeWork. On May 21, pick-not-to-click International Business Machines Corp. (*Grant's*, Feb. 21) announced an unspecified number of job cuts. A week later, Business Insider broke news that Big Blue was leaving WeWork's 88 University Place location in Manhattan. When IBM signed a deal for that Union Square spot in 2017, the market viewed it as a validation of the flexible-office business model. Corporate downsizing may remind the flexible fan base what "flexible" literally means—customers will not only expand when profits rise but also contract when profits fall.

It will surprise no one that IWG is resorting to discounts to fill empty places in barely unlocked New York City. For instance, the daily cost of a desk at 1740 Broadway currently starts at \$24 per day, down from \$31 on Dec. 18, according to

Bigger than WeWork



source: The Bloomberg

the Internet Archive. A little more striking are the discounts on offer in Sun Belt locales, where citizens may actually leave their homes to conduct “nonessential” business. Thus, since Dec. 18, the daily cost of a desk at One Brickwell in Miami has dropped to \$13 from \$16, and that of a desk at 100 Congress Ave. in Austin to \$14 from \$19. “So far,” Dixon told shareholders on the May 28 call, “we haven’t really pulled the price trigger, so price is fairly flat.” There are apparently exceptions to the rule.

Cash collections present another managerial headache. Old-school tenants sign 6–10-year lease commitments. SL Green Realty, a U.S. REIT with gold-plated properties, announced that it had collected 91.1% of May rents and 95.1% of April rents from such tenants as of June 1. On its April 23 earnings call, Empire State Realty Trust, Inc., a New York REIT with a slightly lower quality of tenantry, reported that it had

received only 73% of April rents.

Collections appear worse for companies that provide short-term leases. On April 7, Workspace Group plc, a London owner of flexible office space, said that only around half of tenants paid rents due at the end of March.

In the May 28 trading update, IWG did not divulge what proportion of customers had paid in full and on time (nor, as mentioned, did it vouchsafe a complete set of financial statements). However, the company did state how much it had spent on growth capex (£97.1 million) and maintenance capex (£58.4 million). Through regulatory notices, we know that management laid out £44 million on share repurchases through the first four months of 2020. Because net debt increased by £26.7 million from Dec. 31, 2019, this implies that cash flow from operations was £172.8 million through April. In the first half of 2019, cash flow from operations came to

£385.1 million. If we assume that cash was generated ratably over the first half of 2019, that suggests cash flow was £256.7 million in the first four months of 2019, i.e., year-to-date cash flows appear to be down 33%. This also means that IWG has had a decline in cash collections, especially given the 17.7% year-over-year reported rise in revenues for the first three months of the year.

An IWG customer and short seller who asks to go nameless tells me that IWG set the due date for rent a week before the end of the month. In other words, April collections reflect what was going on in late March. “We are looking at something—especially in the U.S. and the UK, their two largest markets—that was a week after the lockdown or, in the UK’s case, may not even include the lockdown,” our source says.

In other words, the worst is yet to come.

●

*Grant's® and Grant's Interest Rate Observer® are registered trademarks of Grant's Financial Publishing, Inc.
PLEASE do not post this on any website, forward it to anyone else, or make copies (print or electronic) for anyone else.
Copyright ©2020 Grant's Financial Publishing Inc. All rights reserved.*