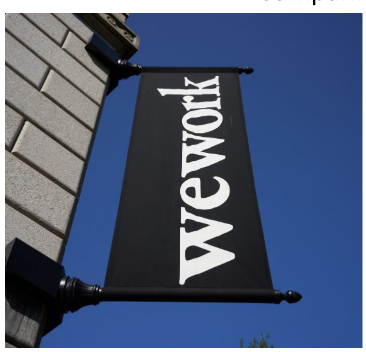
Commercial Leasing:

The Basics and the Fall of WeWork

By Kevin Chambers

We lost a unicorn in 2019. The collapse of investor darling WeWork has been one of the biggest business stories of the year. WeWork grew to a valuation of $47 billion, one of the most hyped initial public offerings coming onto the market in 2019. Now, however, the IPO is off. In a collapse that took a month or so to realize, the most recent valuation is closer to $7 or $8 billion. WeWork's CEO and co-founder Adam Neumann, who had to resign in October 2019, touted the company as a fresh new technology company. Investors bought the hype. In actuality, WeWork was a commercial real estate leasing company. We can use the story of WeWork to explore the commercial/office space leasing industry and explore how this company lost over 80% of its value in less than a year.



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Basics of Commercial Real Estate

At the base level, commercial real estate covers all workspaces for business: warehouses, office spaces, and storefronts. Although some companies own their buildings, many lease their spaces. Cities zone areas for different uses. The four main categories of commercial real estate are office, industrial, multifamily, and retail. These broad categories can be further broken down by leasing agents into quality levels.

Commercial leases come in many different forms. They can run from month-to-month agreements to 10-year long contracts. The length of the contract can affect the cost for the business. Generally, longer-term leases can give businesses a lower monthly rate, as the owner knows they won't have to spend money on finding a new tenant. Other terms of the lease can also change the price.

A gross lease is when the owner pays for all expenses, and the renter covers their rent payments. A net lease is an agreement where the tenant, or lessee, is responsible for some of the adjacent costs associated with the building. The three fundamental net lease agreements are single net lease, double net, and triple net.

In many agreements, there is a mixing of these options. Sometimes agreements specify the type of maintenance required by the tenant. For example, landscaping or regular cleaning might be the responsibility of the tenant, where the landlord would cover more significant repairs and issues. Other articles can further complicate the agreements. Requirements concerning sub-leasing, property enhancements, and other special requirements are usually discussed at signing. Landlords can also give businesses an allowance for improvements and repairs (Chen, 2019) (Hall, 2019).

Net Lease Agreements

Single net – This is a lease agreement where the tenant pays for the property tax, and the landlord pays for everything else, including insurance, repairs and maintenance. This type of net lease leaves the landlord with the most amount of liability, but also gives them more control over the property and the bills. Landlords might prefer this situation if they are worried about tenants not paying for bills on time.

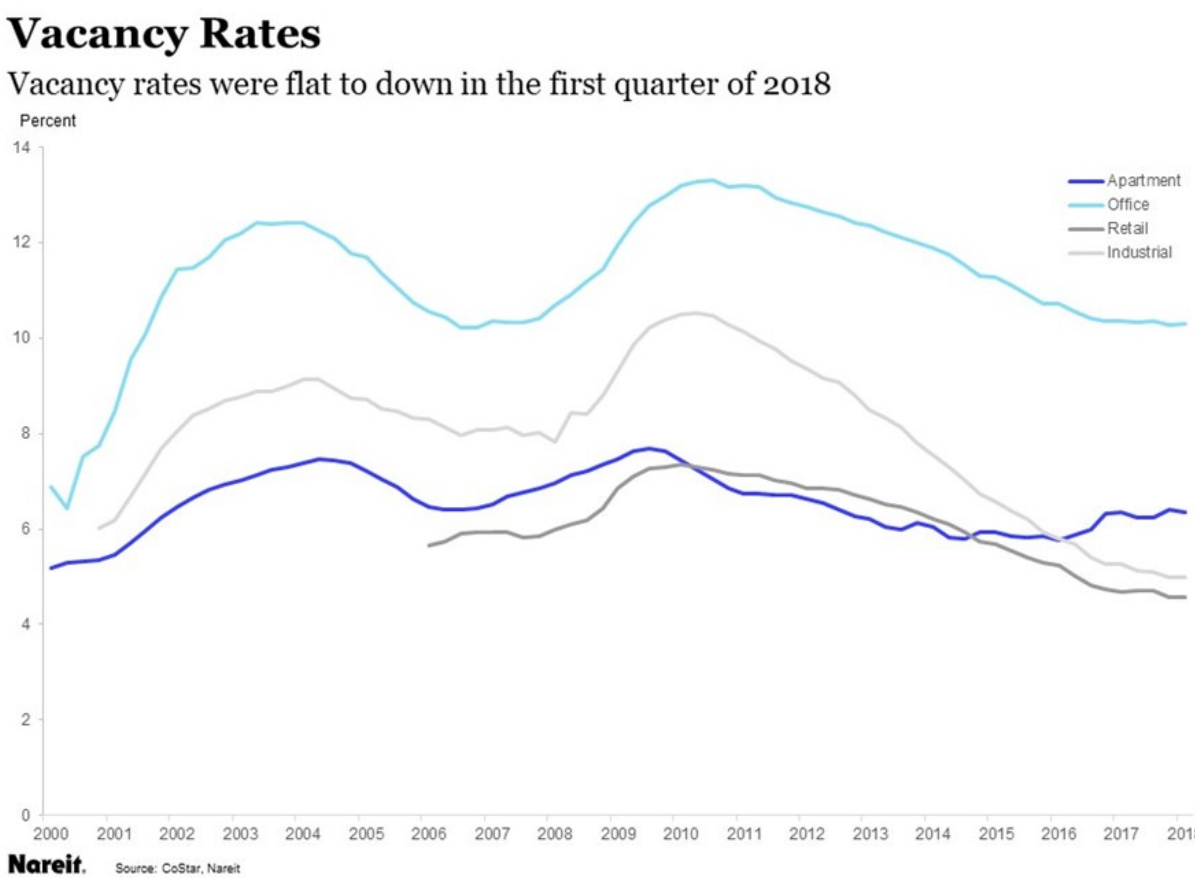
Double net – Double net leases are more common than single net. In this agreement, the tenant pays for the property tax and insurance over the property, but the landlord is still responsible for repairs and maintenance. A double net lease agreement is a fair balance of liability for landlord and renter. Both are taking some risk in the property. In comparison, usually, the rent for a double net would be a little lower than a single net lease, especially if the term is longer.

Triple net – A triple net lease is where the tenant takes on primarily all the risk from the landlord. They pay taxes, insurance, and are responsible for maintenance and repairs. These types of leases are less common and are more likely in longer-term agreements. Most renters would want to pay a significantly lower rate to take that kind of risk away from the landlord.

Commercial Real Estate Trends

According to a report by the National Association of Realtors (NAR), commercial vacancies have been trending down from highs pre-2008-crisis. The volume of commercial leases collapsed in the most recent recession, but have recovered in recent years. The average vacancy rate nationally for office buildings is 10.2% (Team, 2019). NAREIT shows that vacancy rates are now lower, or match, levels that were seen at the height of the last real estate boom (Schnure, 2018).

Mall vacancies retain the highest vacancy rate at 12.9%, with office and strip malls coming behind at 10.2% and 9.8%, respectively. Industrial vacancies are considerably better, at only 5.8%. Gross rent rates are set at between $9 and $18 per square feet, depending on the property type.



Vacancy Rates Q2	
Office	10.2%
Industrial: Warehouse	5.8%
Industrial: Flex	5.8%
Retail: Strip Center	0.1%
Retail: Mall	12.9%
Apartment	5.2%
Hoel/Hospitality	12.6%

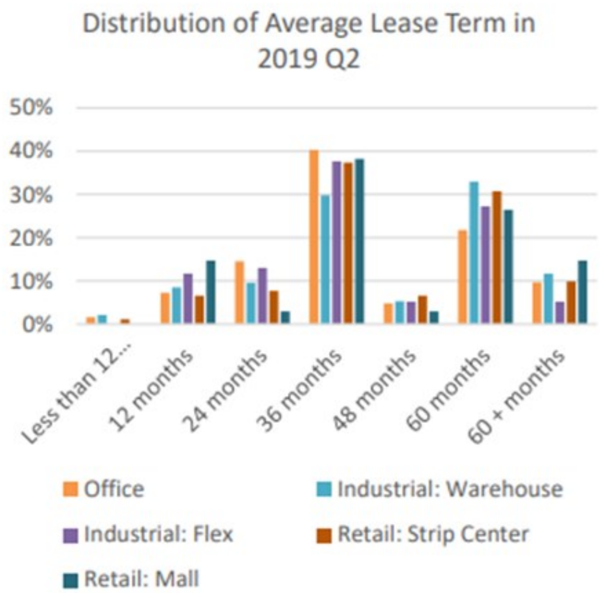
Gross Rents Q2 (per sf)		
Office	$	18
Industrial: Warehouse	$	12
Industrial: Flex	$	9
Retail: Strip Center	$	21
Retail: Mall	$	18
Apartment	$	1,358

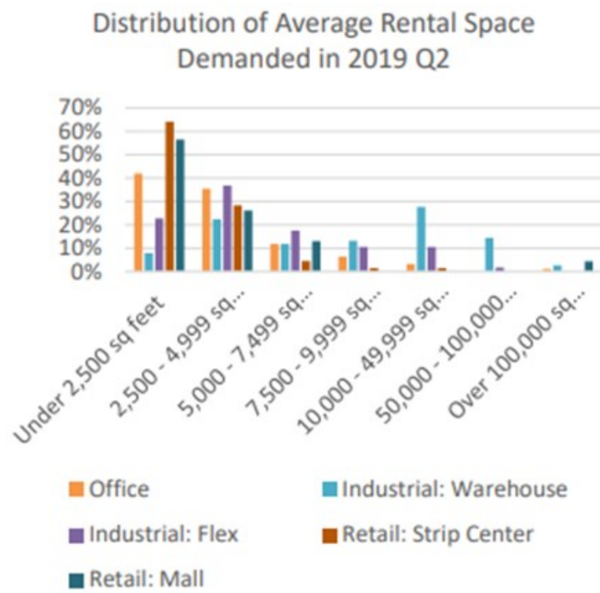
Tenant Improvements Allowance (per sf)		
Office	$	25
Industrial: Warehouse	$	12
Industrial: Flex	$	11
Retail: Strip Center	$	52
Retail: Mall	$	25

Source: 2019 Q2 NAR CRE Market Survey

Triple Net Rents (per sf)		
Office	$	21
Industrial: Warehouse	$	8
Industrial: Flex	$	9
Retail: Strip Center	$	18
Retail: Mall	$	25
Apartment	$	1,366

The NAR study also shows that most of the leases for all property types at either 36- or 60-months. Less than 10% of all lease agreements are longer than 60 months. It also shows that most renters are demanding spaces under 5,000 square feet. The exception is industrial warehouse space, which obviously demands bigger facilities. NAR's assessment on the outlook of the commercial real estate market, and mostly corroborated by NAREIT, is relatively rosy. Industrial space is targeted for inventory storage for e-commerce. Retail brick and mortar demand is driven mainly by specialized products that require more face-to-face interaction with consumers, including niche markets, with typically have higher needs of knowledgeable salespeople. Finally, office space is increasingly sought out by technology-based companies. Opportunity zones and low-interest rates will help investment in new properties. The primary factor detracting from the space is rising construction costs. There are also problems with low inventory and the unsustainability of very high rents in specific locals.





Source: 2019 Q2 NAR CRE Market Survey

The Rise of WeWork

With this basic understanding of commercial leasing, let's get back to the sweet goodness that is the WeWork story. Well, not all of it is good, but it's pretty fascinating.

WeWork was started by CEO Adam Neumann and CCO (Chief Culture Officer) Miguel McKevey. McKevey was an architect, and Neumann was a struggling entrepreneur. Their first idea together was a company called Greendesk. They leased an entire building. The concept was to bring 15 businesses together to share the workspace and resources, like receptionists and break rooms. It was initially thought as a way to promote sustainability and community in a working environment. McKelvey grew up in a commune in Oregon, and Neumann was born in Israel and had fond memories of working on a kibbutz. The collective vision of work both intrigued and inspired these men. From this first New York City building, WeWork was born in 2010.

WeWork now has 258 locations in 29 countries. They operate on the same basic business model they stared with their first attempt. They negotiate with building owners for long term leases. They get a good deal on the rent by signing a lease agreement for entire buildings at long terms and remodeling them to their atheistic. They turn around and rent spaces in their buildings for shorter terms and a higher markup. The vibe is very reminiscent of a Silicon Valley start-up. Lots of exposed brick, hardwood floors, open spaces, motivational words on the wall, comfortable yet flexible meeting spaces, beer and wine on tap... You get the picture — hip, modern, with lots of amenities (Turk, 2018).

Share Work Space Concept

WeWork offers different options for renting spaces in their buildings. The lowest-priced space is called a Hot Desk, which gives the renter access to various common areas in the building. Their website touts, “Bring your laptop, pick a spot, and get to work.” The next step up is a Dedicated Desk. Still in a shared office space, but you get a reserved area to personalize. You can set up a desktop computer and make it your own. The top of the offering is a Private Office. These vary and can accommodate businesses and teams of various sizes. All levels allow the option for the use of common conference rooms.

	Portland	Seattle	Los Angeles	New York
Hot Desk	$ 295	$ 380	$ 370	$ 470
Dedicated Desk	$ 380	$ 530	$ 450	$ 790
Private Office 4 Seats	$ 1,800	$ 2,200	$ 2,270	$ 3,100
Private Office 10 Seats	$ 4,700	$ 5,000	$ 5,000	$ 7,950

This concept is not a new business idea. There is a very successful company that has been doing this same thing since 1989. Regus, founded in Great Britain, has a much broader reach than WeWork. They have over 3,000 locations in 1,000 cities vs. 528 locations in 111 cities for WeWork. Regus also has a much larger revenue than WeWork, at $3.4 billion vs. $1.8 billion. However, WeWork has an astronomically higher valuation than Regus (whose parent company is called IWG). And guess what? Regus has a profit of about half a billion each year, where WeWork has lost money hand over fist, basically since it’s inception. In 2018, WeWork lost $1.9 billion. That is 100 million more than it’s revenue.

WeWork argues that it is different from IGW because it's a technology company. In fact, the company became somewhat famous in financial circles for using the word "tech" 123 in their public financial filings required before their now-defunct public offering. Of WeWork’s employees, about 8% are engineers. Their main argument relies on their use of technology being able to lower costs compared to competitors like IWG. They claim their cost per employee is 60% lower than their main competitors. They also were able to use technology to expand quickly. Due to their rapid expansion, they received benefits like getting lower prices on bulk ordering furniture. And like many other tech companies, including Uber and Lyft and Airbnb, they were happy to take massive losses to expand into new markets. Despite their claims, WeWork is not a tech company. They are a real estate company leveraging the advantages of modern business (Molla & Ghaffary, 2019).

The rise of WeWork is a testament to Adam Neumann’s ability to sell himself and his company, as well as an outcome of the venture capital funding model gone array. By many accounts, Neumann is very charismatic. He has convinced many landlords and investors to support his vision. His employees also bought into Neumann's schtick. He likes to say that WeWork has a single mission: to elevate the world's consciousness. His energy, enthusiasm, and plans for wild and fast growth convinced many investors to put in money (Wiedeman, 2019). WeWork has received $19 billion of funding from many of the big names in finance: Goldman, JP Morgan, SoftBank, Fidelity, T. Rowe Price, Amazon, Willington, and Harvard Management Company. As the company rapidly grew, its valuation rose with each funding cycle. Previous investors saw their stake rise in value, and new investors saw a payday on the horizon. The IPO was supposed to cash these investors out and be the biggest round of funding for the company to date.

The Fall of WeWork

So where did it all go wrong? Corporate governance and their financials. It was a perfect storm of bad news for WeWork investors. First, a rash of lawsuits issued to the company tells the story of a very unprofessional and sexist work climate. Wild office parties, alcohol served at job interviews, required company retreats with all-night parties, gender discrimination with women not being allowed to speak to executives because their wives wouldn't allow them to talk with other women, discrimination surrounding their family leave policies, and multiple allegations of sexual harassment. In other words, a general boys club atmosphere and a general lack of professionalism. Neumann openly joked about nepotism as he placed his friends and family members in positions of power. In the corporate documents, it states his wife gets to decide the next CEO in the instance of his untimely death. Some employees called Neumann's leadership style as "Game of Thrones" (Brooker, 2019). All of the leadership and culture problems, coupled with the financials required to be released, created a spook for investors.

Required by law for an IPO, WeWork had to submit a Form S-1, which details their financials for investor review. It also allows the company to argue why they deserve the valuation they are seeking. Some glaring problems started showing. First, the company was accused of burying and hiding essential information investors need. One expert analyst in the field called the company's S-1 "a masterpiece of obfuscation." "If the underlying facts were positive, why would a company go to so much trouble to prevent you from understanding them?" WeWork used many accounting tricks that make it hard to follow how they book expenses and use various cost structures at different locations (Singer, 2019). The unclear accounting practices make the acquisition cost per customer very hard to determine. This also makes it hard for investors to know if their strategy is sustainable long term or could ever be profitable in the future (Salmon, 2019). The S-1 also disclosed that WeWork is on the hook for $47 billion in future rent payments that include $10 billion in payments in the next five years (Bryant, 2019). With a revenue of just under $2 billion, that sends up a big red flag.

It also came out that Neumann owned various properties around the United States that he was leasing back to WeWork. As the IPO grew nearer, WeWork bought those properties from

Neumann. WeWork disclosed paying Neuman more than $37 million to properties at least partially owned by Neumann. This arrangement was deemed a conflict of interest and forced the sale of the properties (Brown, 2019). It also came out that Neumann would regularly take out loans from company cash, including $362 million in April 2019. In total, Neumann has cashed out almost $700 million in stock, loans, and money from the company in 2019 (Brooker, 2019).

The collapse of WeWork in the last two months has caused a myriad of problems. Most notably, the company was delaying laying off employees because they couldn't make payments on the severance (Hoffman & Farrell, 2019), which precipitated the take over by their largest investor and the ousting of Neumann as CEO. SoftBank offered a $5 billion loan to the company. They bought $3 billion worth of shares and paid Neumann $200 million in exchange for giving up his voting rights. The buyout gave Neumann one of the largest golden parachutes of all time, making him a cash billionaire. They also offered Neumann a $46 million a year for the next four years to work for SoftBank as a consultant (Scheilber, Eavis, & Yaffe-Bellnay, 2019).

A Learning Opportunity

The whole story of WeWork is interesting but will ultimately be only a footnote in financial history. It is not as catastrophic or corrupt as some of the other high profile collapses such as Enron or Theranos. It is essentially a harmless event, affecting mainly just investors who gave into Neumann's hype. The only real victims in the story are WeWorks employees, who had to endure a challenging work environment, a terrible company culture, and bad leadership. Over 600 Employees have joined together on a Slack channel and penned a letter to WeWork's new ownership demanding different treatment and requirements for future inevitable layoffs. Hopefully, the company can find a way to treat its employees humanely.

WeWork could be a harbinger for times to come. In the most recent build-up in tech stocks, we have seen massive valuations for companies who do nothing but lose money. Companies are claiming to be tech companies, but who are arguably only offering an old service presented in a new way. Hopefully, the failure of WeWork to go public is a sign that investors are getting smarter about letting companies punch above their value. A sign that, in business, making a profit is essential to running a sustainable company.

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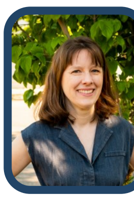

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