Credit Benchmark

Office Property and Co-working: The COVID Effect May Persist

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"...may be the biggest disruption to real estate since the invention of the elevator."
Rob Speyer, CEO of Tishman Speyer, Wall St. Journal, September 2019, talking about Co-working.

Co-working fills an obvious but challenging gap in the office property market - offering maximum flexibility to tenants by removing the duration risk of fixed term / fixed space leases. From its inception in 2005, exponential sector growth was driven by an increasingly buoyant office property market and a steady stream of start-ups that ensured minimal voids. **With a vaccine on the horizon, the global pandemic may become a non-issue; but has there been a permanent downshift in demand for city centre office space? And if so, can the co-working model survive?**

The sector was showing signs of saturation even before COVID, when heavily indebted WeWork pulled its planned $47bn IPO in September 2019, ending the year in the hands of Softbank with a more modest valuation of $5bn. CBRE noted a huge drop (75%) in flexible leasing demand in Q4 2019, mainly due to WeWork slamming on the brakes.

WeWork's fall from grace has been blamed on the very high value assigned to its nebulous "community". But most companies in the sector have kept their focus on the basic business of offering flexible working, although many have their own legal, commercial, geographic or demographic speciality.

The co-working sector is diverse: for example, WeWork properties include many sublets, while firms like IWG (owner of Regus) use the increasingly popular "landlord partnership" model. Knotel is concentrated in the megacities – New York, Tokyo, London, while Serendipity Labs and Industrious focus on major US North Eastern cities. Traditional property companies like CBRE and Jones LaSalle have co-working investments, while some REITs have significant exposure (e.g. Capital and Commercial Trust in Singapore has 10% in co-working firms).

Co-working businesses have shared the current woes of the wider Office Property sector – reduced demand due to remote working, re-engineering and capex to meet the need for low density offices. But Office Property firms are already adapting; and Figure 1 shows some of the increasingly familiar ways that COVID challenges were due to be addressed. With a vaccine on the horizon, some of these may become irrelevant overheads; others may become sensible best practice in a virus-prone world.

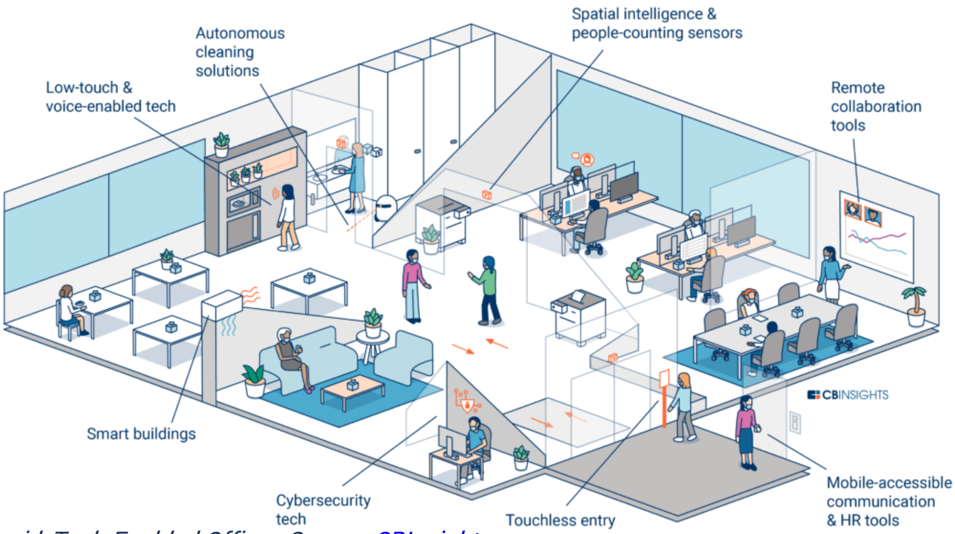

Figure 1: The Post-Covid, Tech-Enabled Office - Source, CBInsights

Consensus data shows a 30% - 40% increase in default probability over the past 6-8 months for companies with significant co-working exposure. This corresponds to single notch declines in credit quality on the traditional 21-category scale. For example, CRAs have downgraded WeWork – one of the few co-working firms assessed by agencies - from lower B to a range of CCC ratings; the credit consensus has followed a similar trend.

Figure 2 (below) shows the consensus aggregates for Global Real Estate Services (which includes co-working firms) compared with Global REITs, as well as US Industrial and Office REITs.

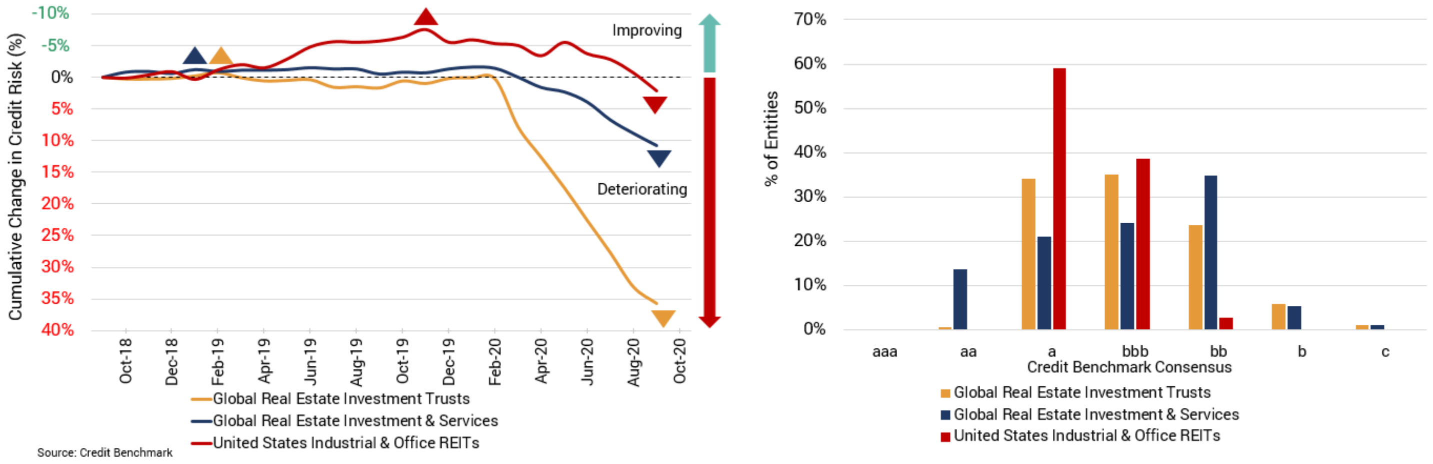

Figure 2: Credit Trend & Distribution for Global Real Estate Investment Trusts; Global Real Estate Investment & Services; United States Industrial & Office REITs

Both Global sub-sectors have declined since early 2020, but Global Real Estate Services are only down about 10% against a decline in Global REITs of 35%. As noted above, most co-working firms have followed Global REITs in the scale of their decline. However, the decline in REITs has been mainly driven by retail, while the Industrial & Office REITs aggregate is down less than 10% from its peak earlier this year. So in credit terms, co-working firms have underperformed the broadly equivalent US REITs universe.

Co-working firms see potential new growth in distributed offices and near-to-home working in suburban and rural hubs, and in a larger number of smaller urban hubs across a broader range of cities. This is a gamble; the scale and duration of the trend away from city centre offices is still largely unknown. A successful COVID vaccine could halt or even reverse that trend, favouring some of the hardest hit real estate firms. But if the move to a less urban workspace continues, then some co-working firms – those with experience and plentiful access to finance – could be major winners.

Co-working credit quality has been one of the harder hit segments in the office property space, largely through guilt by association with WeWork. But many of the nimbler companies may turn out to be in the vanguard of successful new standards for distributed working. And if the vaccines live up to expectations, then the co-working model may continue its interrupted expansion across major cities.

About Credit Benchmark

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