INSIGHT

VIEWPOINT

Commercial Real Estate Disruptors

SAGAR PARIKH | MAY 30, 2018

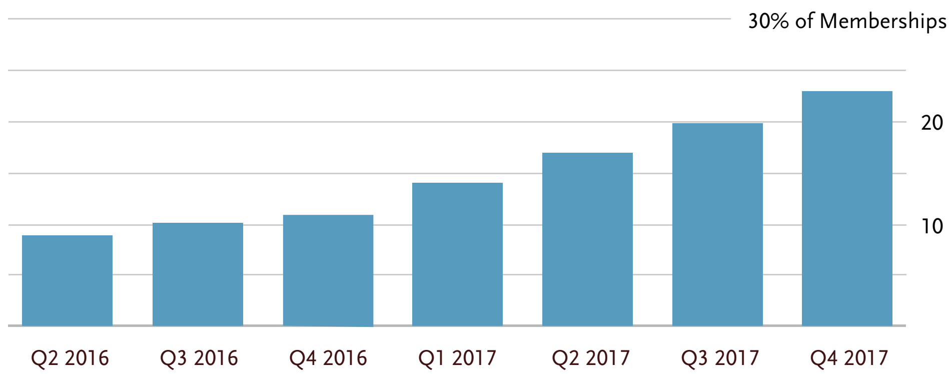
Changing demographics, consumer preferences, and technology mean that real estate investors who aren't rapidly evolving risk being left behind. Two companies at the forefront of these changes are Airbnb and WeWork. Airbnb now offers more rooms than the three largest hospitality providers in the U.S. combined. Meanwhile, WeWork has become the second largest private sector office tenant in New York City and will likely soon be the largest office tenant in London.

In the last several years these two companies have only accelerated the need for sponsors to reinvest in their assets and adjust to a quickly changing commercial real estate landscape. Companies that initially ignored co-working spaces and short-term rentals have since reconsidered.

Large office sponsors such as Brookfield and Blackstone have responded by investing in co-working providers (Convene and The Office Group, respectively). Meanwhile, large equity residential REITs like Equity Residential, Camden Property Trust, and Avalon Bay have explored partnership agreements with Airbnb. Airbnb still represents less than 7% of the total hospitality supply in the U.S.; WeWork's office space is still less than 2% of available office supply. However, the rate at which both firms have been growing (WeWork's revenue grew 88% in 2017 and Airbnb is profitable with over $2.6BN in revenue) is very hard to ignore. WeWork has gone from a small company that primarily worked with startups when it began operations in 2010 to one that has leased out entire office buildings in New York and San Francisco (over 30% of WeWork members work for companies with over 1,000 employees). The absorption rate among its larger properties clearly points to a business model that is more suitable to office tenants today.

Is Bigger Better?

WeWork's Corporate Customers Sign Longer Membership Agreements



Source: WeWork
Shows "enterprise" customers as percentage of total memberships. Enterprise members are defined as companies with more than 1,000 employees. WeWork doesn't specify a minimum number of desks they must rent to qualify.

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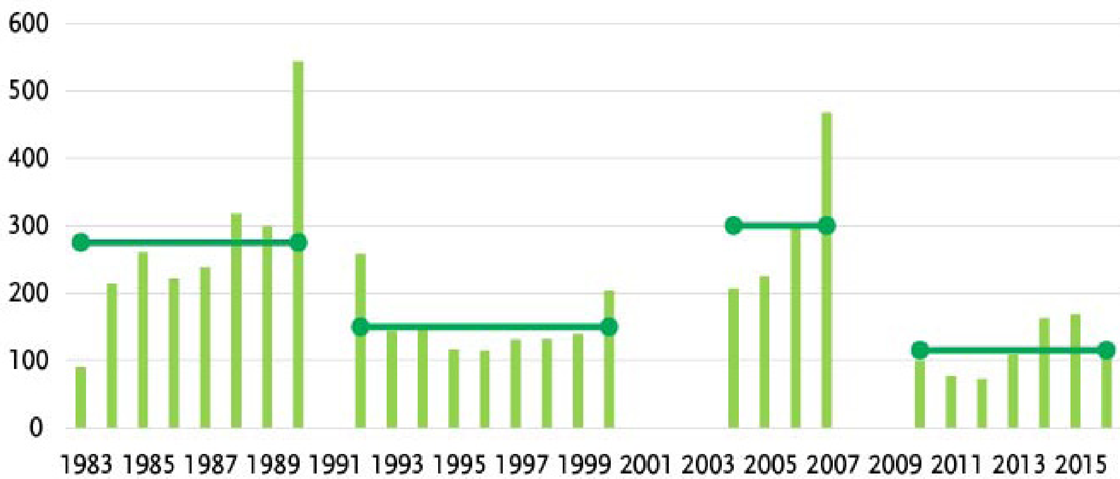
The common concern with WeWork is that its business model remains untested by a recession, and there is a natural mismatch between the company's long-term leases and the flexibility it provides users. WeWork's main business model historically has been signing long-term leases (10-15 years) in established office buildings while leasing out user space for as short as one day or one month. WeWork has been trying to address this by partnering with landlords in co-management agreements similar to what has become popular in the hospitality space (one example is landlords paying for a portion of the buildout and sharing the membership revenue). This would allow them to limit their capital investment while continuing to expand quickly. They've also created a real estate investment arm used to acquire outright ownership of some properties (Lord & Taylor's headquarters in New York City) and to co-develop others (such as the Brooklyn Navy Yard project).

Critics of WeWork point to the historical experience of Regus, a co-working provider that grew rapidly in the 1990s but was forced to file for Ch. 11 bankruptcy in 2003 after the 2002 recession. Regus offices, however, were largely located in the suburbs and technological changes (like the ability to work remotely) have significantly changed the demand for co-working space since that time. Another difference is optimization - WeWork's spaces typically allocate 50 sq ft/employee versus 250 sq ft/employee for a traditional office building. As the chart below shows, companies continue to focus on office space optimization (Throughout the years, WeWork has been able decrease the cost of adding additional desks by nearly 50%).

Held Back By a Work Revolution

Office space absorption per job added (sf per new job)



Source: CBRE Econometric Advisors and Macrobond, CBRE Research

In contrast to WeWork, Airbnb's biggest threats come from municipal governments. Large cities around the U.S. such as New York, Boston, and Los Angeles claim the company has reduced affordable housing stock and have enacted restrictions on the number of nights that a residence can be rented on Airbnb. Airbnb has been forced to limit the number of rentals of non-owner occupied residences and has since partnered with large-scale apartment landlords to rent out portions of their buildings on Airbnb in exchange for shouldering some of the marketing and property management costs. The chart below shows the effect of regulation in one specific market: Santa Monica. (You can see that the number of available rooms dropped dramatically in 2015 once Santa Monica enacted legislation on the number of short-term rentals.)

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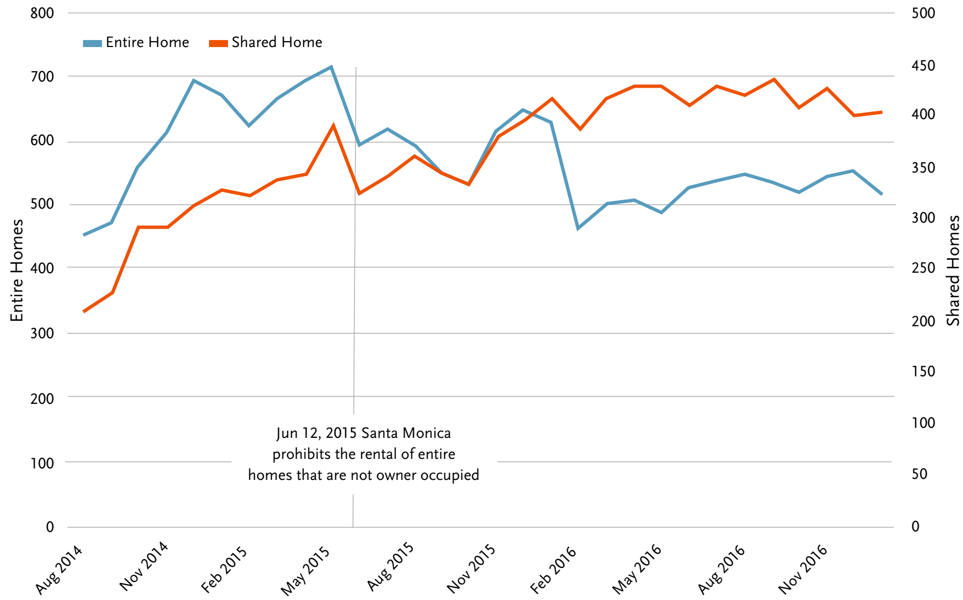
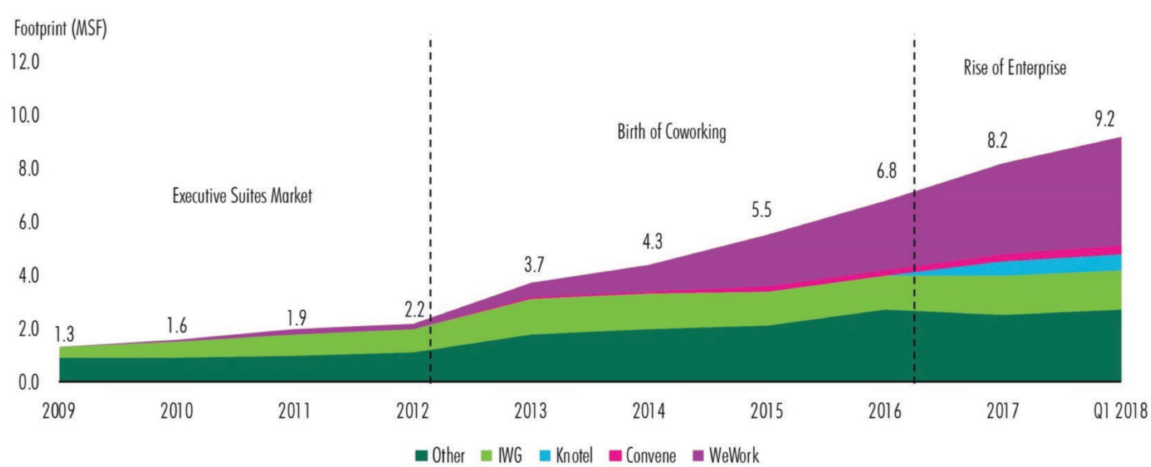
Santa Monica Room Supply on Airbnb



Source: AirDNA

Even with enhanced regulation, large hospitality companies such as Hyatt, Accor, and Marriott have responded to Airbnb's overall growing market share by investing in companies that specialize in short-term rentals. Marriott, in fact, recently announced that its co-working pilot 'Tribute Portfolio Homes' will be connected to their loyalty program. If these traditional hospitality companies are able to scale their new investments, it could pose significant competition to Airbnb over time. The next round of growth for Airbnb and WeWork is to ensure they remain the provider of choice for their evolving markets. WeWork has tried to sell a 'user experience' by providing cross-location benefits to its users via networking events, specific member forums, and expanding into the multifamily/ recreational (WeLive/ WeFit) space. Airbnb has created loyalty programs similar to ones provided by the largest hospitality companies and has created a brand called 'Airbnb Plus', which caters only to highly rated hosts and is expected to compete with the experience provided by a hotel. As you can see below, other brands such as Knotel and Convene have begun to grow marketshare within the co-working space. Knotel, mainly focused on New York City, has signed over 50 locations in the city and was recently valued at $500MM.

As Co-Working Continues to Grow, Other Participants Have Entered the Space

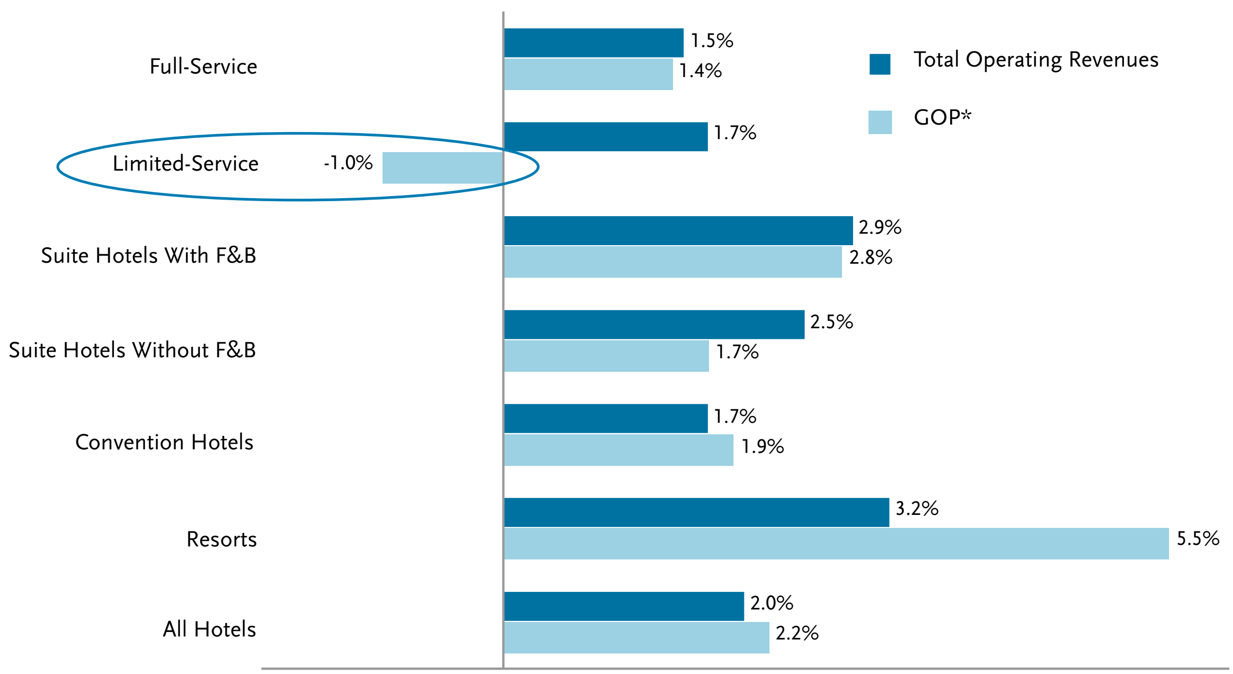


Source: CBRE Research

What has investors in both companies worried is their slowing growth profile over the last six to nine months. WeWork's stabilized occupancy (locations open longer than 18 months) has dropped to 89% versus 97% just 12 months earlier. Leasing brokers have claimed that WeWork has been trying to minimize turnover and build up occupancy by offering double the standard commission to incentivize tenants to sign one year leases . WeWork recently sourced financing via the high yield debt market and initially increased its anticipated debt raise, but its debt has traded down as the cash burn for the company has significantly increased in the last year. Meanwhile, Airbnb's battle with city regulators has continued to escalate as New York's city controller argued that Airbnb itself was responsible for 9% higher rents over the last seven years. That backlash, along with Los Angeles (its second largest market) recently restricting the number of days a host can rent their property (120 days per year), has Airbnb looking to diversify its revenue streams.

Regardless of whether WeWork and Airbnb continue to enjoy spectacular growth rates, both companies have significantly disrupted portions of the CRE market that have historically been slow to change. The global membership of co-working spaces is now over 2M (WeWork has over 200k members) and has represented an increasing portion of new leases. WeWork and Knotel have consistently been among the top three companies in signed office leases in New York City over the last year, while Airbnb continues to experience significant growth in its secondary markets. Co-working spaces have pushed office landlords throughout the U.S. to offer higher tenant allowances , whereas capital investments per key have significantly increased in the limited service segment of the hospitality market (as owners have had to invest in common spaces and more 'residential' type units to compete with Airbnb). Large office landlords such as Boston Properties and SL Green have noted on conference calls that co-working spaces have been one of the few leasing bright spots in the sluggish office rental market in certain parts of New York City, while limited service operators have seen struggling revpar growth due to increased competition from short-term rentals.

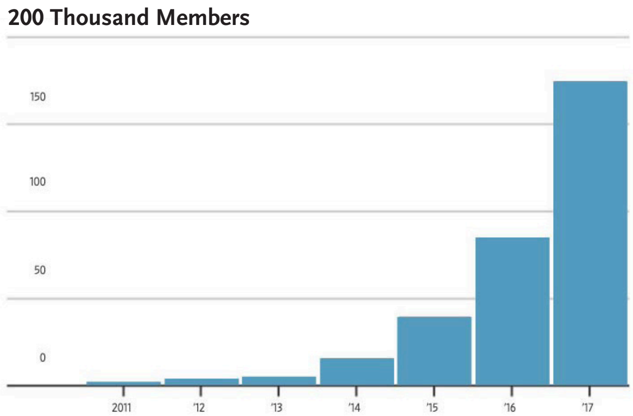
2018 Trends® in the Hotel Industry
Percent change 2016 to 2017



Note: *Before deduction of Management Fees and Non-Operating Income and Expenses
Source: CBRE 2018 Trends® in the Hotel Industry

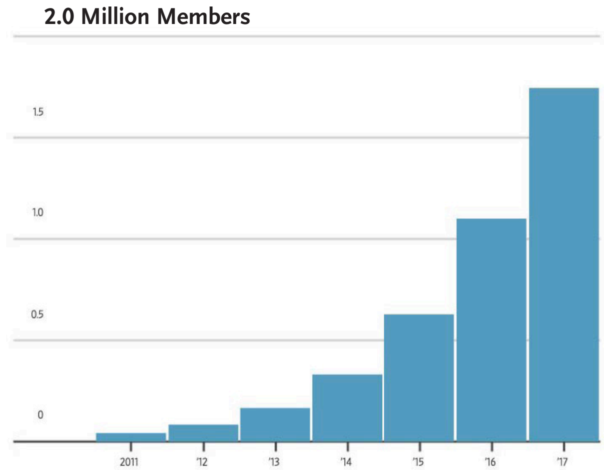
WeWork Users

The number of people working in a shared offices has surged in recent years



Sources: WeWork (WeWork members); Emergent Research/GCUC (global members)

Global Membership of Co-Working Spaces



Sources: WeWork (WeWork members); Emergent Research/GCUC (global members)

As large office owners like Blackstone and Brookfield (investors in the Office Group and Convene, respectively) continue to invest in co-working spaces while companies like Marriott diversify into short-term rentals (Tribute Portfolio Homes), the line between institutional and upstart players will continue to blur. The disrupters in the space have shown that customers are requiring a wider variety of services than what was offered in the past and companies that don't have the financial wherewithal to evolve or are slow to do so will continue to underperform. We at TCW are constantly monitoring these changes and highly value sponsors who are re-investing into their commercial real estate assets. ■

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