

A photograph of a modern, multi-level coworking space. The architecture features large, curved white concrete structures and extensive glass railings. In the foreground, a group of people are seated around a long wooden table, working on laptops. In the background, another group is standing and talking near a glass wall. The space is bright and open, with a view of a city skyline through the glass. The overall atmosphere is professional and collaborative.

ROPES & GRAY

Coworking: A real estate revolution?

How coworking is driving change
in the real estate industry

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Methodology

In the first quarter of 2019, Acuris Studios, on behalf of Ropes & Gray LLP, surveyed 100 senior executives from coworking operators, equity investors who fund coworking operators and/or coworking funds, traditional landlords, lenders and brokers. Seventy-five respondents were based in the U.S., with the rest based in the U.K. and Europe.

The survey included a combination of qualitative and quantitative questions, and all interviews were conducted over the telephone by appointment. Acuris Studios analyzed and collated the results; all responses have been anonymized and are presented in aggregate. The figures included in this report also include the questions as presented to the respondents.

Introduction

What began almost 15 years ago as a grassroots movement of freelancers, start-ups and solo entrepreneurs seeking to establish collaborative coworking communities has snowballed into a global phenomenon.

Coworking has disrupted traditional occupational office markets and changed the underwriting analysis performed by lenders, operators and capital partners in office and mixed-use assets. Instead of being treated as tenants, users of coworking spaces are treated more as “members”—similar to models more typically found in hotels or gyms. They have a more limited set of rights to use and access the space, but are also entitled to have easy and immediate access to a range of services, including space booking tools, printing and document processing resources, and phone and internet capabilities, among many others.

It began with a clear rise in the demand for greater work flexibility. Technological and social changes led younger working generations to prioritize collaborative and creative working environments that offered them the freedom to work whenever and wherever, reducing the boundaries between work and social life.

At the same time, companies started looking for extra space for

short-term projects, experimental cross-company collaboration and temporary space between conventional leases.

Coworking now forms part of a broader set of workplace strategies to improve space efficiency, enabling companies to create a more efficient office footprint. Larger organizations are exploring new coworking avenues for outsourcing, through automation and crowdsourcing, and adopting new workplace technologies to increase flexibility and reduce costs.

What does this mean for the commercial real estate marketplace generally? How is the coworking sector influencing traditional real estate office strategies and the leasing and brokerage market? How is it affecting valuations and underwriting? What are the sector’s prospects for future growth and M&A consolidation, and how will it fare in an economic downturn?

In this report, we examine the coworking sector as a real estate disruptor in the United States and Europe. To investigate, we spoke with 100 senior executives from across the real estate industry, asking how they are responding to evolving workplace trends and expectations. We hope you find the results valuable to your business strategies.

Key findings

Coworking is expected to keep growing stronger

55%

of all respondents expect coworking to continue to absorb traditional office space market share in their region to a great extent over the next three years.



100%

of all respondents have seen a moderate to significant increase in the proportion of start-ups using coworking in the past three years – with **92%** and **73%** saying the same about self-employed individuals and large companies, respectively.

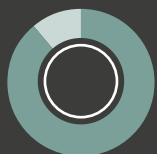


83%

of equity investors forecast membership growth among larger coworking operators in the next year, with **71%** saying the same of smaller operators.

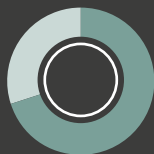


Coworking is forcing traditional commercial real estate (CRE) models to evolve



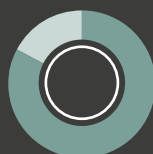
89%

of all respondents say traditional landlords have borrowed “real estate as a service” innovations from the coworking model.



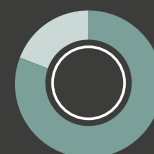
70%

of all respondents agree the trend of big coworking providers buying rather than leasing assets is set to accelerate over the next three years.



83%

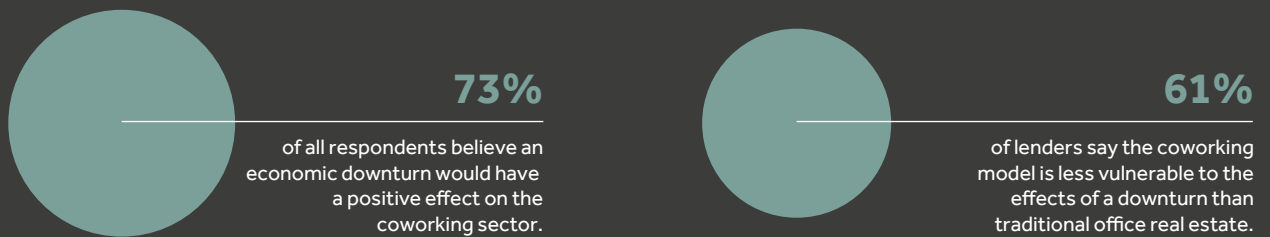
of coworking operators believe coworking has materially shortened average terms for traditional office leases, though only **50%** of traditional landlords say the same.



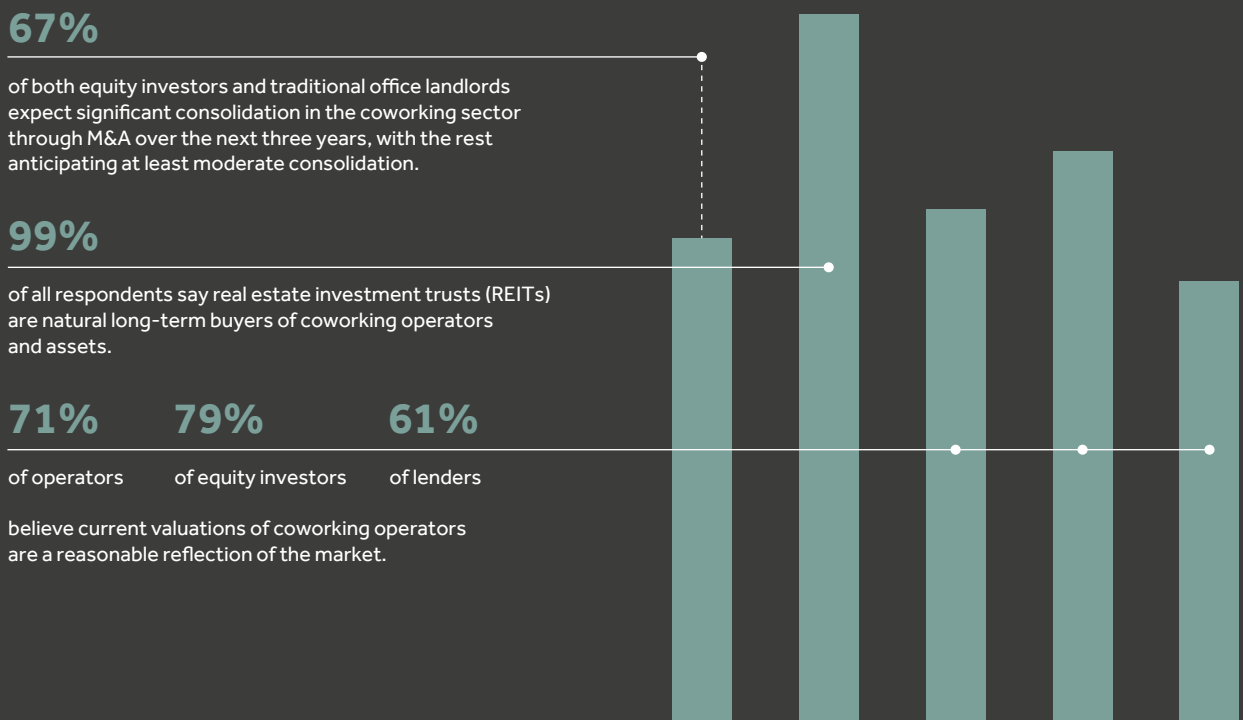
81%

of all respondents agree that coworking influences underwriting and valuation methodologies for assets, including flexible space.

An economic downturn could produce an uptick in coworking



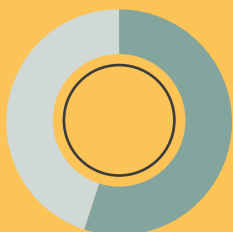
M&A, consolidation and strategic partnerships may be on the horizon for the coworking sector



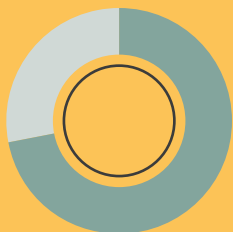
Section 1

What is driving growth in coworking?

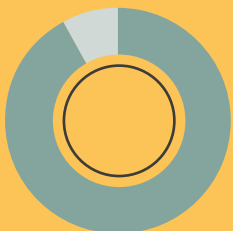
As the working landscape has evolved (along with the underlying technology) and economic growth remains relatively low, companies and individuals alike are searching for more flexible options in the workplace. As a result, many traditional office spaces are giving way to a new breed of business-building.

**55%**

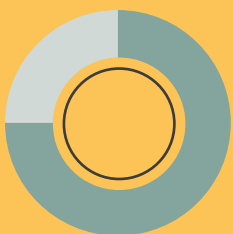
of all respondents expect coworking to continue to absorb traditional office space market share to a great extent in their region over the next three years.

**72%**

of all respondents say the rise in start-ups is one of the top drivers of demand for coworking spaces.

**92%**

of coworking operators and equity investors have seen a significant rise in the proportion of start-ups as coworking customers over the past two to three years.

**75%**

of all respondents say coworking remains most popular in the technology sector.

Start-ups and remote working, as well as self-employment, freelancing and project-based work underpinning the gig economy, are all on the rise. Technology has made off-site working both possible and practical, improving work-life balance for employees and reducing costs for companies of all sizes.

At the same time, the current low-growth economic environment is putting pressure on companies to increase productivity, as well as attract and retain talent.

All of this is driving a coworking trend that is redefining the real estate sector.

"With increased technology and internet use, and more start-ups in operation, coworking will continue to gain market share," says the chief operating officer of a coworking operator based in New York. "It is not going to surpass traditional working models, but the numbers are promising. The greater flexibility offered by coworking encourages people to take on this new model over traditional settings."

THE CHANGING NATURE OF WORK

Coworking office space is expected to continue to absorb traditional office market share over the coming years. The only question appears to be the pace of continued growth.

"The demand and supply of coworking spaces have lined up well, ensuring that spaces are well used, and that there is a suitable work environment to foster a community as well as a professional atmosphere," says the partner of a European-based

FIGURE 1: **WHAT ARE THE TOP DRIVERS OF DEMAND FOR COWORKING SPACE?**
(SELECT TOP THREE; ALL NUMBERS SHOWN ARE PERCENTAGES)

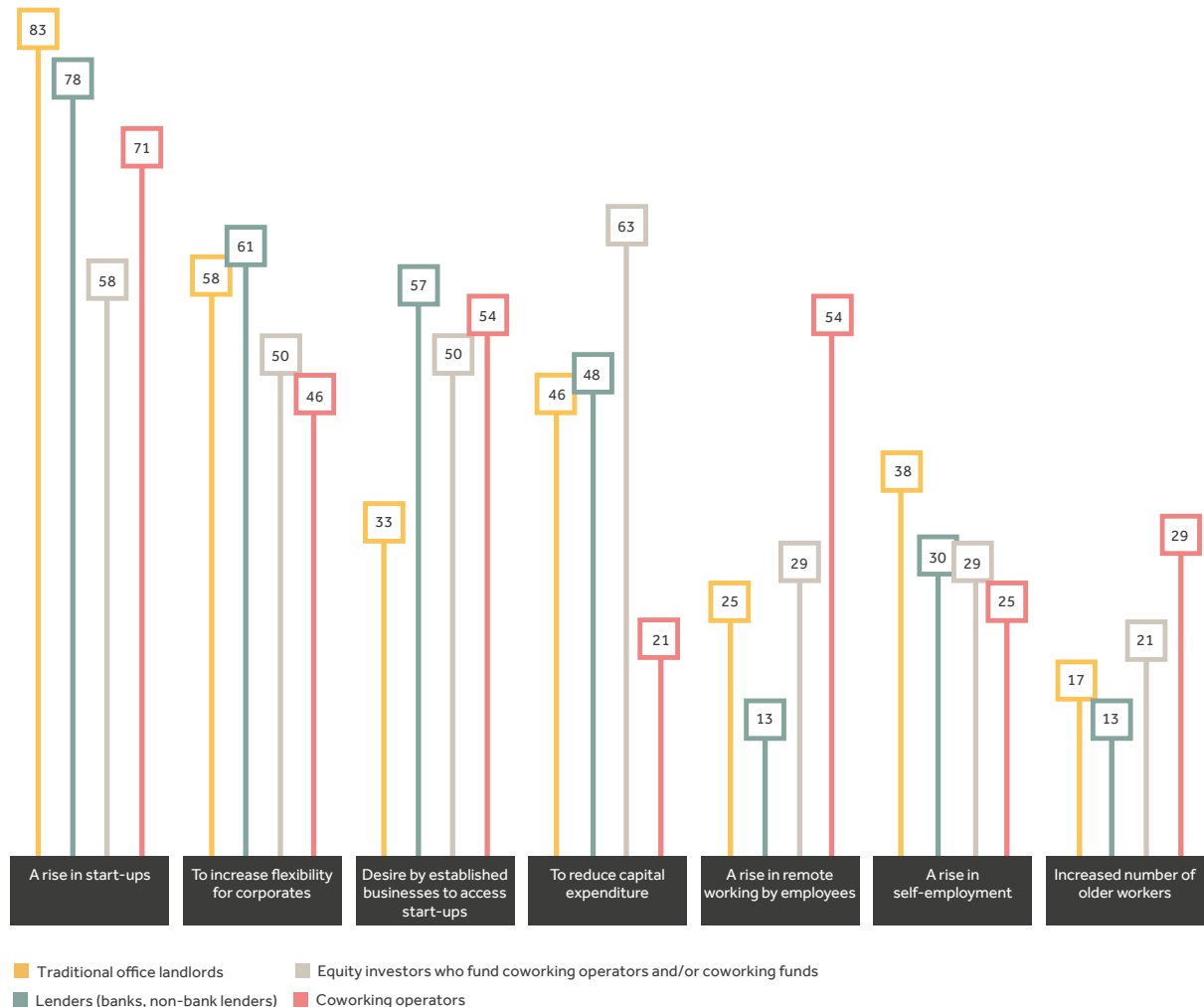


FIGURE 2: IN YOUR BUILDINGS, WHICH TYPE OF USER CURRENTLY ACCOUNTS FOR THE LARGEST SHARE OF YOUR MEMBERS? (COWORKING OPERATORS/EQUITY INVESTORS ONLY)

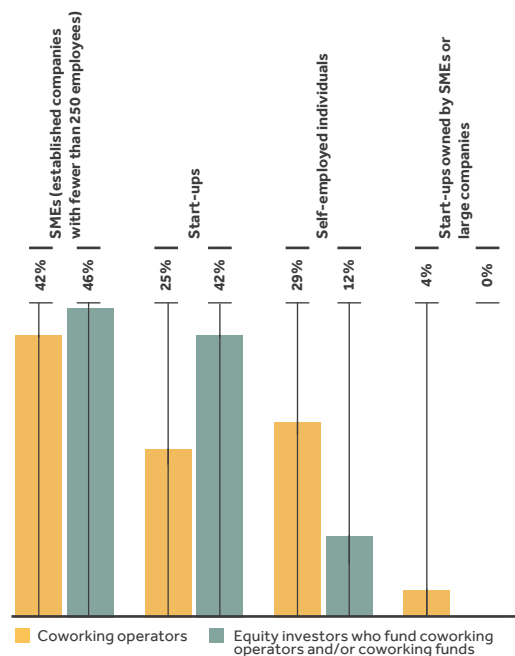
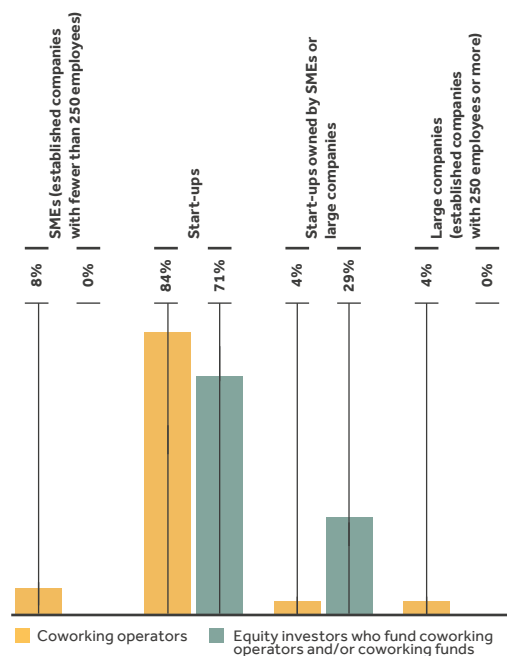


FIGURE 3: OVER THE NEXT THREE YEARS, WHICH OF THE FOLLOWING TYPE OF USER WILL ACCOUNT FOR THE LARGEST SHARE OF YOUR MEMBERS? (COWORKING OPERATORS/EQUITY INVESTORS ONLY)



lender. "The traditional office space is still predominant, no doubt, but there is a promising rate of increase in coworking spaces."

Those working in the field—from coworking operators to the equity investors funding them, as well as traditional landlords, lenders and brokers—agree the trend is only going to grow: 55% expect significant further market share penetration, while the rest expect more moderate coworking adoption.

Opinions on what is driving this demand vary. Direct operators, traditional landlords and lenders agree that the rise in start-ups drives the sector's success. Other factors contribute as well, but opinions about these factors are more nuanced. For example, while 54% of coworking operators cite remote working as a driver (tied with companies' desire for access to start-ups), just 13% of lenders think this is particularly

relevant. This discrepancy likely reflects lenders' risk assessment perspective, which gravitates to cash flow security sourced from larger, corporate clients with strong credit ratings, as opposed to the large pool of individual workers.

The desire to reduce capital expenditure is another second-tier driver of coworking demand, but the extent to which it plays a role is a matter of debate. Almost two-thirds (63%) of equity investors who invest either indirectly via a fund or directly via a joint venture or equity stake in a coworking operator cite this factor, while only 21% of coworking operators agree.

"Not only will we see continued growth and absorption in the traditional market of office towers and stand-alone office buildings, but we are also starting to see the coworking model expand into alternative areas like lab, R&D and

mixed-use developments—where coworking companies are partnering with the likes of hotel, residential and even fitness operators to provide non-traditional office space as part of a live-work-play environment," says Jack Creedon, co-chair of Ropes & Gray's global real estate practice. "The latest example is the partnership recently announced between Industrious and Equinox at Hudson Yards."

A STEADY SHIFT IN COWORKING CLIENTS

Creative industries and the technology sector were early adopters of the coworking approach. People working in these sectors are more likely to focus on the culture and value system of an organization over desks, meeting rooms, IT infrastructure, and conference and printing equipment. As coworking entered the zeitgeist,

professional services firms, including real estate advisory firms, business services companies, and broader SMEs (small-to-medium-sized companies with fewer than 250 employees), began to emulate this work style.

"Flexible working spaces are now being designed to serve as office spaces with a community spirit, which would otherwise be lost in a traditional office space," says the director of corporate development and M&A at a traditional office landlord in Chicago. "New locations and settings are being sought in prime locations so that people do not need to look far for their shared office space."

The technology sector remains the dominant natural coworking customer, according to three-quarters of those surveyed, followed by the real estate and media sectors. Financial services and broader business services are also considered substantial minority customers, reinforcing the notion that coworking is becoming a diversified office solution.

In terms of the types of companies taking advantage of coworking opportunities, coworking operators and equity investors agree

that SMEs dominate the current coworking customer base.

Over the next three years, however, 84% and 71% of coworking operators and equity investors, respectively, expect start-ups will instead dominate the member base.

Almost a third (29%) of coworking operators also say that while self-employed individuals currently dominate their member base, none of them expect this will be the case over the next three years.

"In some respects, coworking companies have provided landlords with less direct exposure to smaller tenant credit risks. They have also alleviated the operational challenges in finding multiple tenants to absorb collections of small office space by aggregating the end consumer," says Dan Stanco, co-chair of Ropes & Gray's global real estate practice. "This is a pretty good deal for a landlord. They get the coworking company's credit and operational expertise in support of the lease, along with the coworking company assuming the frontline exposure of the risks inherent in renting to start-ups and small businesses. Of course, the trade-off is that the coworking companies take the lion's share of the upside."

84%

of coworking operators and equity investors say that start-ups will account for the largest share of members in the next three years

FIGURE 4: HOW HAS THE PROPORTION OF THE FOLLOWING COWORKING CUSTOMER BASES CHANGED OVER THE LAST THREE YEARS IN YOUR EXPERIENCE? (COWORKING OPERATORS/EQUITY INVESTORS ONLY)

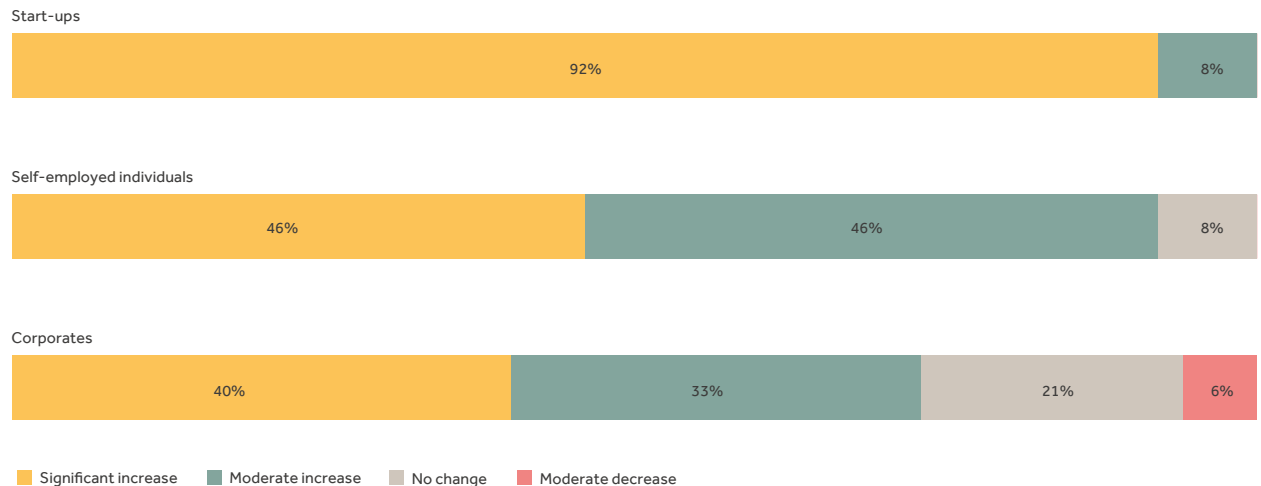
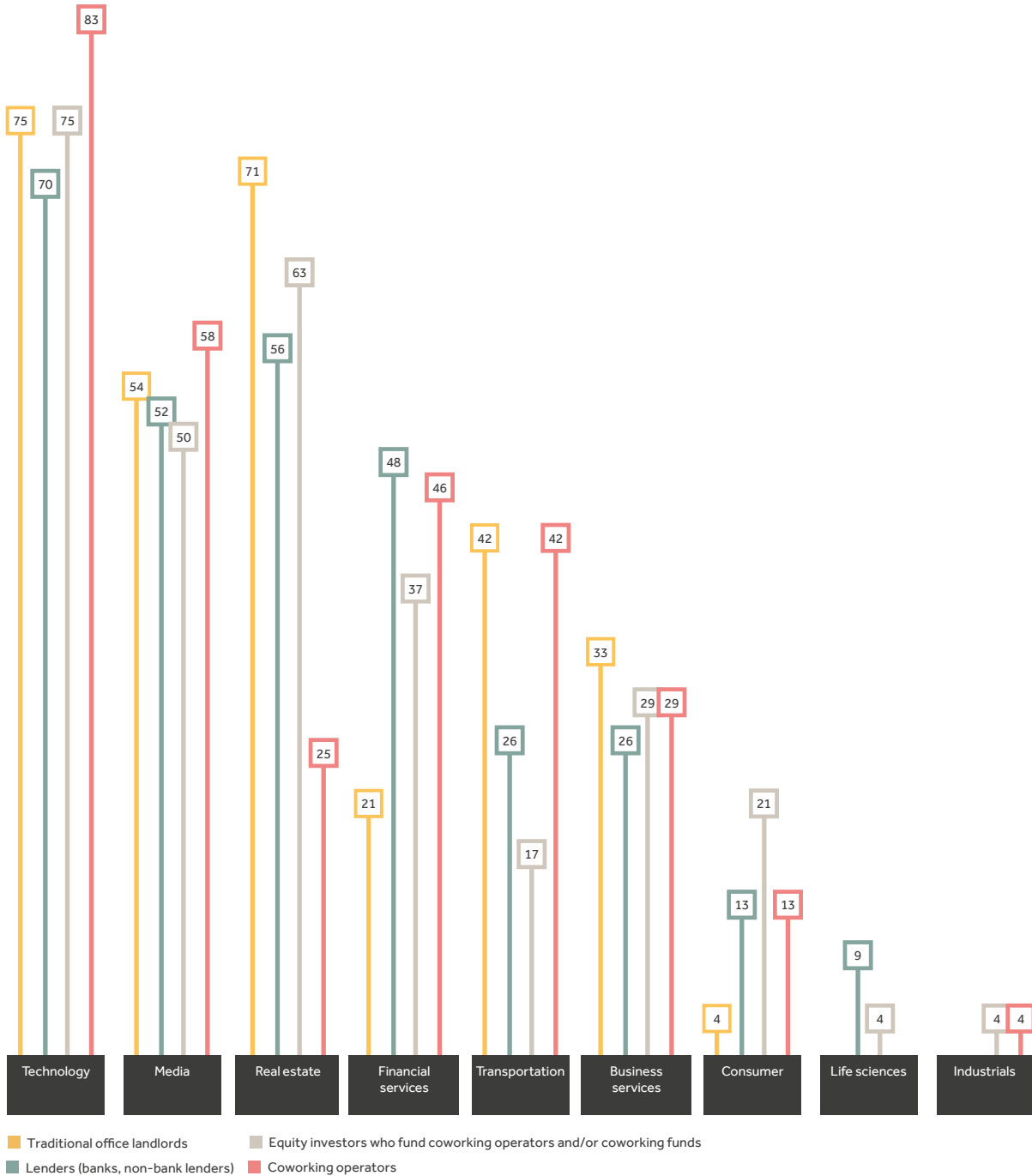


FIGURE 5: **FOR WHICH SECTORS DO YOU SEE COWORKING AS BEING MOST POPULAR?**
(SELECT TOP THREE; ALL NUMBERS SHOWN ARE PERCENTAGES)

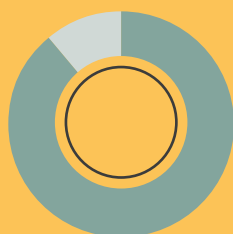




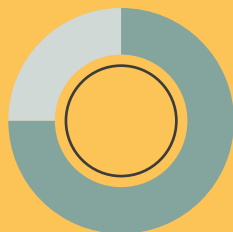
Section 2

How is coworking disrupting traditional models?

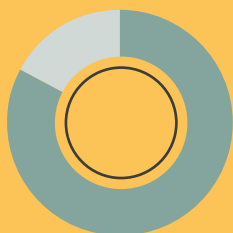
From landlords adopting more service-based strategies for their tenants to coworking operators buying their own buildings, the entire commercial real estate marketplace is undergoing dramatic change.

**89%**

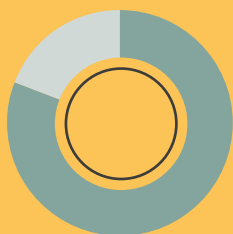
of all respondents agree that traditional office landlords have adopted service innovations and amenities inspired by the coworking sector.

**75%**

of traditional office landlords believe that those late to the party in their own investor peer group are embracing coworking as a defensive play.

**83%**

of coworking operators believe coworking has materially shortened average terms for traditional office leases, compared to only 50% of traditional landlords.

**81%**

of those working in the coworking sector agree that valuations of buildings with a coworking component are measured differently from those with traditionally leased offices.

Coworking has been the catalyst for a two-way business model extension: just as traditional office landlords have entered the coworking fray, filling vacant office space with coworking and flexible space solutions, the dominant coworking players have become direct CRE owners. A majority (70%) of respondents believe that the recent trend of big coworking companies buying rather than leasing real estate will accelerate.

For example, the We Company —parent to WeWork, the SoftBank-backed coworking market leader —recently launched a “global real estate acquisition and management platform” called Ark.

According to the launch release, “Ark will focus on acquiring, developing, and managing real estate assets in global gateway cities and high-growth secondary markets that will benefit from WeWork’s occupancy. WeWork will deploy its space-as-a-service model in Ark owned or operated properties for our member companies, including our growing Enterprise business—now representing over 40% of global memberships—in conjunction with our anchor tenant strategy.”

Ark will initially deploy US\$2.9bn in total equity capital, with “substantial capital and support” provided by Ivanhoé Cambridge, a real estate subsidiary of Caisse de dépôt et placement du Québec and one of the world’s largest institutional real estate investors.

The growing institutional capital attracted to coworking raises the prospect of future consolidation as the sector—and cycle—continues to mature.

LATE ADOPTERS: PLAYING OFFENSE OR DEFENSE?

The boundaries between operators and CRE investors, managers and owners are blurring. This is part of the evolution of office “real estate as a service,” rather than as a commodity, requiring traditional landlords and other non-coworking operators to hire operational expertise.

This is supported by our findings: 89% of all respondents

agree that traditional landlords have adopted service innovations and amenities inspired by the coworking sector.

“The big landlords are adapting through multiples strategies,” says Stanco. “We’re seeing leading landlords like Tishman Speyer launch Studio, their own coworking brand, and others are partnering with coworking companies to create prime coworking space, like RXR’s recent partnership with WeWork at 75 Rockefeller Plaza.”

While there is evidence of encroachment onto each other’s territory from all sides, our survey points to the underlying motives. Three-quarters (75%) of traditional office landlords believe that those late to the party in their own investor peer group are embracing coworking as a defensive play, while only 39% of lenders say the same of traditional office landlords.

DISRUPTING LEASE LENGTHS

There is also a clear trend toward shorter leases, particularly in major cities. Average office lease lengths have been under downward pressure in many mature markets in the United States and Europe, influenced, in part, by the growth of the coworking sector.

While the coworking operator takes a longer lease, members receive the benefits of flexible lease terms, no up-front “fit-out” capital investment and all the benefits that community and technology coworking can provide.

The majority (83%) of coworking operator respondents believe coworking has materially shortened average terms for traditional office leases, compared to 63% of equity investors and 61% of lenders. Traditional office landlords were more equivocal about the effect of coworking on office leases.

CHANGING VALUATION METHODOLOGY

The net effect of coworking components on office building valuations is nuanced. There are concurrent headwinds and tailwinds, with trends varying between markets, asset quality and coworking tenant concentration.

A recent CBRE study analyzed a dataset of asset sales going back five years that compared buildings with coworking occupancy against buildings with no coworking component. The analysis showed that, as the proportion of flexible space within a building rises, cap rates initially decrease, then plateau, and eventually increase.

Simply put, differences in cap rates reflect the degree of perceived risk. Given that a significant proportion of coworking members have low credit ratings, higher concentrations of coworking within a building are perceived as riskier.

However, this trend is not uniform. Coworking operators often cherry-pick prime assets in cities with strong demographics, and invest to modernize the space and attract members. This can offset risks associated with a high concentration of members with low credit ratings.

Overall, there remains a degree of price discovery in measuring the effect of coworking assets on building valuations. This will become clearer as more transactions take place, and as the sector weathers a full economic cycle.

Valuations typically apply either a methodology similar to that used for hotels—usually a discounted cash flow model—or a multilayered approach, which also incorporates pricing off cap rates. Again, as the market matures, insights into market-standard valuation methodologies will emerge.

From an underwriting perspective, the majority (81%) of those working in the coworking sector agree that buildings with a coworking component are valued differently from those with traditionally leased offices.

“One of the valuation challenges is that coworking company leases tend to be shorter in term than the traditional 20-year office lease, particularly in buildings where coworking takes up only a portion of the available office space,” adds Stanco. “However, the coworking companies are absorbing space that may otherwise remain unrented and providing the building with an

occupant that many other office tenants want to be associated with, all of which are factors that need to be considered when underwriting an entire building.”

Coworking spaces are more expensive to run than traditional offices, with extra services and amenities offered, such as shorter leases, inclusive business rates, equipment, catering facilities, meeting rooms, technological infrastructure, reception services, furniture and on-site managers.

As a result, coworking spaces can command a premium relative to traditional office space on a per-square-foot basis. In addition, coworking spaces also tend to benefit from improved occupancy rates due to demand for shorter leases and smaller spaces.

Indeed, our survey indicates that all segments (categorized by space size and provider) of the coworking market in the United States and Europe are expected to increase membership over the next 12 months. Equity investors are confident that they will see membership growth among both big (83%) and small (71%) coworking operators.

Among coworking operators, 75% say they are most confident that membership of coworking facilities will grow among both small operators and traditional landlords. Well-managed coworking spaces deliver a premium to conventional offices after factoring in extra costs. However, transparency among the big coworking players—predominantly private companies—remains thin.

MOVING AWAY FROM A TRADITIONAL LEASE MODEL

Players in the coworking space—on both the landlord and the coworking operator side—are moving away from a traditional lease model and starting to consider alternative “cost sharing arrangements,” which offer an opportunity for more favorable economic terms and other valuable incentives. More akin to a management agreement or joint venture agreement than a lease, these cost-sharing arrangements provide

benefits to both parties involved.

From the coworking operator's perspective, these arrangements provide an opportunity to receive more capital upfront from the building owner than would typically be offered in a traditional tenant improvement package.

These funds can be applied to renovation and build-out costs, thereby freeing up the coworking operator's cash on hand to be used on other projects at other locations.

From the building owner's perspective, the arrangement allows them to benefit from the profitability of the coworking user, with a sizable share of profits paid in exchange for funding the majority of upfront costs.

“For building owners that are REITs or rely upon REITs in their corporate structure, one question to consider is whether these distributions of profits will be considered good or bad REIT income, in which case alternative structures may need to be explored,” says Creedon.

In addition to economic terms, these arrangements may require the coworking user to provide certain regular reports to the building owner, thereby granting the latter more insights into the operations of the coworking user than the owner might otherwise be privy to under a traditional lease.

By aligning the parties' interests through cost-sharing, the building owner is incentivized to protect and maintain the coworking operator's ability to use and access the premises, thereby perhaps relinquishing the coworking operator's need to rely upon traditional tenant-like protections (e.g., a covenant of “quiet enjoyment”).

“That being said, it is unclear whether a court would interpret one of these agreements as a lease and therefore read in customary protections even if not explicitly stated,” adds Creedon. “It is also unclear whether a bankruptcy court would treat one of these agreements as a lease for bankruptcy purposes.”

70%

agree the recent trend of big coworking providers buying rather than leasing assets is set to accelerate over the next three years

FIGURE 6: **AGREE OR DISAGREE? WHEN OFFICE LANDLORDS HAVE ENTERED INTO COWORKING, IT IS A DEFENSIVE PLAY.**

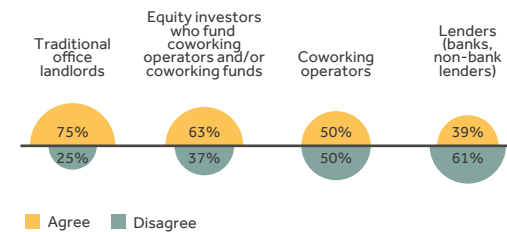


FIGURE 7: **AGREE OR DISAGREE? COWORKING HAS MATERIALLY SHORTENED AVERAGE TERMS FOR TRADITIONAL OFFICE LEASES.**

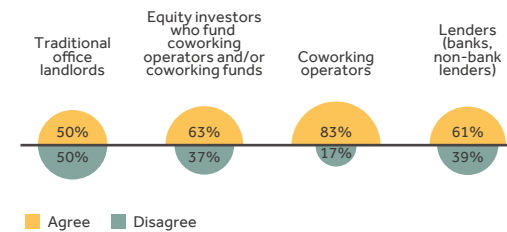


FIGURE 8: **AGREE OR DISAGREE? BUILDINGS WITH A COWORKING COMPONENT ARE VALUED DIFFERENTLY FROM BUILDINGS WITH WHOLLY TRADITIONALLY LEASED OFFICES FROM AN UNDERWRITING PERSPECTIVE.**

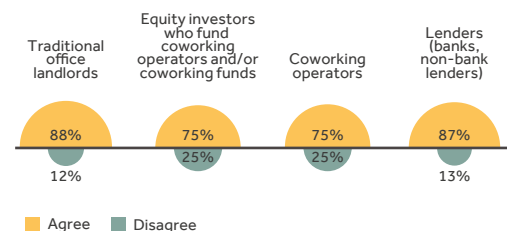
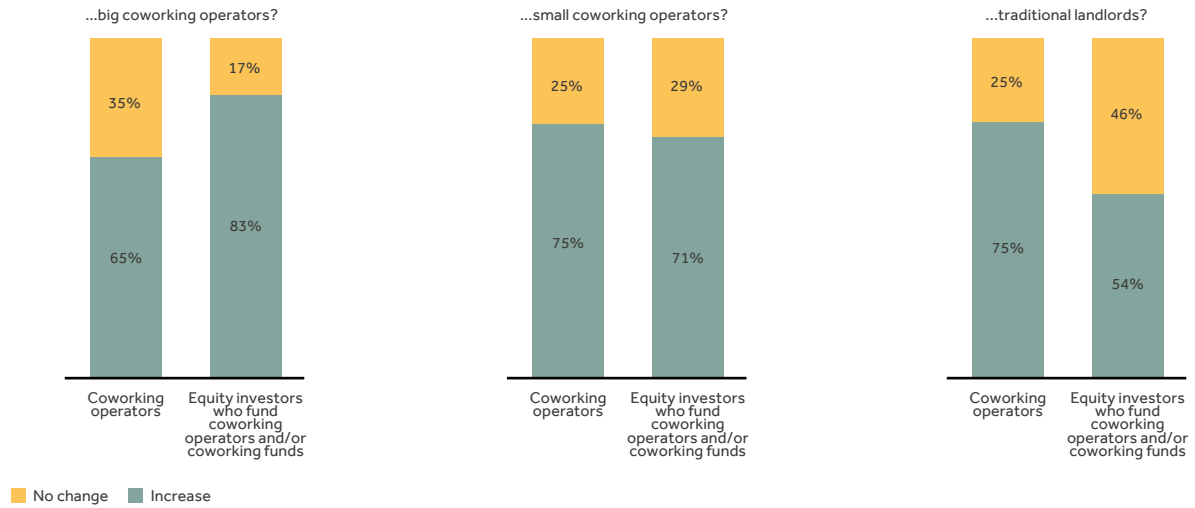


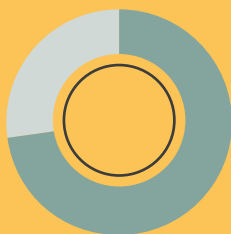
FIGURE 9: WHAT ARE YOUR EXPECTATIONS FOR THE NUMBER OF MEMBERS JOINING COWORKING FACILITIES IN YOUR REGION OVER THE NEXT 12 MONTHS PROVIDED BY.... (COWORKING OPERATORS/EQUITY INVESTORS ONLY)



Section 3

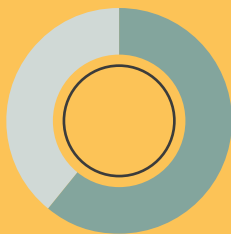
Coworking risks and challenges

What worries are keeping landlords, coworking operators, lenders and equity investors awake at night? The prospect of interest rate rises looms large, while increased leasing costs are of similar concern. But when it comes to the impact of an economic downturn, opinions are unexpectedly divided.



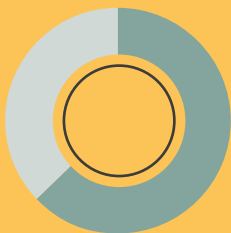
73%

of all respondents believe an economic downturn would have a positive effect on the coworking sector.



61%

of lenders say the coworking model is less vulnerable to a downturn than traditional office real estate.



63%

of office landlords cite interest rates as one of the top risks to the continued growth of coworking over the next three years.

Over the last decade, corporations have addressed economic uncertainty by increasing their focus on cost management and flexibility across labor costs, leases and occupier footprint.

Companies are turning to shared workspace and technology to support off-site and flexible staff who do not need to be in the office daily as an alternative to high-cost central business district (CBD) offices. Political uncertainty (e.g., global economic slowdown, U.S.–China trade tensions, China's economic slowdown, late-stage real estate cycle and Brexit) has also incentivized corporations to reduce costs and increase flexibility.

One of the most intriguing unknowns about the coworking sector, however, is its resilience during a market downturn. On the one hand, it is argued that coworking would thrive in a contracting economy as companies downsize and move into smaller spaces on more flexible leases. On the other hand, coworking operators (rather than office landlords who own the buildings) commit to a long lease with a landlord while securing short leases from their customers, leaving a potential mismatch if rents fall in a contracting economy and members leave in droves for cheaper, no-frills office solutions.

"Coworking companies seem to be hedging this risk by shifting away

from long-term leases in favor of management arrangements and partnerships with landlords," says Stanco. "But by making significant investments in buying buildings, it's clear that coworking companies are confident in their business model being well suited to withstand a downturn."

Our survey findings suggest that there are more bulls than bears. Almost three-quarters (73%) of respondents believe that an economic downturn would have a positive effect on the coworking sector, with 23% of respondents suggesting the effect would be net neutral.

Digging deeper into our survey, respondents most commonly cite the belief that membership would increase during an economic downturn from a diverse customer base, including a rise in self-employment as big companies slash headcounts in anticipation of lower sales.

"An economic downturn would bring out many growth prospects for coworking as a whole," says the managing partner of an equity investor that funds coworking operators and/or coworking funds based in the U.S. "It is much more affordable for smaller companies, and during a downturn, these concerns are more likely to downsize and migrate to coworking spaces until economic stability returns. Also, traditional job offerings would

be significantly fewer, giving rise to more independent contracts and short-term service requirements."

The CEO of a coworking operator in Europe adds that overall demand for coworking would increase, but with a renewed focus on cost-effective and functional offerings: "Businesses would downsize and seek out more affordable settings. Larger companies would also be inclined to pursue savings and resource preservation."

TRADITIONAL REAL ESTATE VERSUS COWORKING IN A DOWNTURN

In another surprising finding from our survey, 61% of lenders say that the coworking model is less vulnerable to an economic downturn than traditional office real estate.

"Coworking can be applied to many forms of work, without any extra processes or remodeling," adds the managing director of a lender in Europe. "In an economic downturn, a coworking model would have better responses or solutions, with higher levels of applicability, compared to traditional real estate models. Losses can be avoided by making strategic improvements to accommodate professionals and business, personalizing solutions without additional investments."

Lenders' capital is protected by an equity cushion in the event of a

FIGURE 10: IS THE COWORKING MODEL MORE OR LESS VULNERABLE TO A DOWNTURN THAN TRADITIONAL REAL ESTATE MODELS?

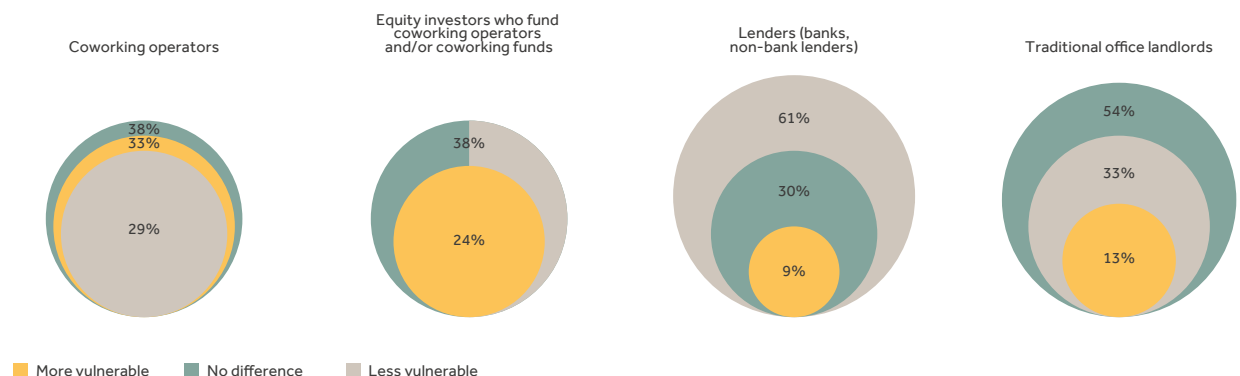
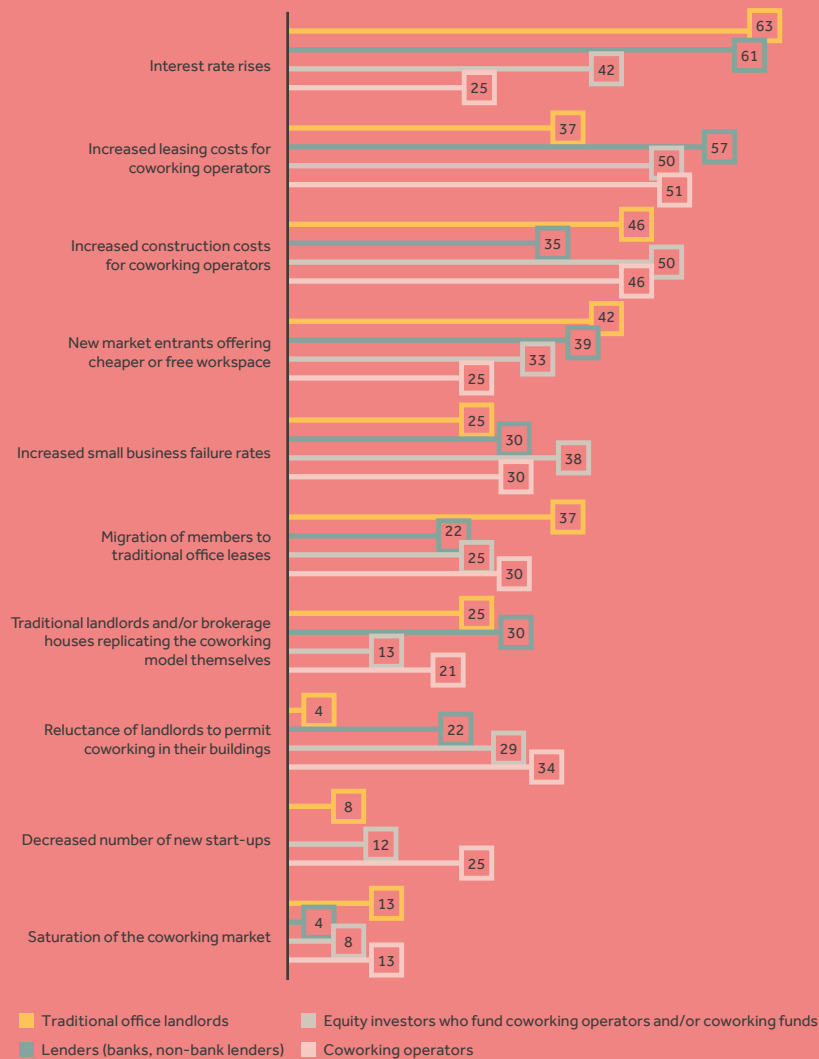


FIGURE 11: **WHAT ARE THE TOP RISKS TO THE CONTINUED GROWTH OF COWORKING OVER THE NEXT THREE YEARS?** (SELECT TOP THREE; ALL NUMBERS SHOWN ARE PERCENTAGES)



Almost two-thirds (63%) of office landlords cite interest rates as one of the top risks to the continued growth of coworking over the next three years, followed by increased leasing costs, which equity investors (50%) and coworking operators (51%) cited as the top risk.

Increased construction costs and new entrants undercutting on price to win market share are, respectively, the third and fourth top risks.

collapse in asset value driven by a fall in membership and rental income. In the early years of the coworking phenomenon, coworking operators extended guarantees at the corporate level to landlords, which supported owners' financing requirements.

However, some larger coworking operators have started to reduce these commitments and, in a few cases, offer only limited guarantees, which sometimes burn off over the duration of the lease term. Thus, from a lender's point of view, the risk of coworking occupiers can increase over the tenure of the lease.

To mitigate this, lenders often look directly to the coworking occupier tenant base. In cases where the tenants comprises SMEs, the credit rating can provide additional comfort to the lender. This adds an extra layer of due diligence, which makes financing coworking-dominant assets more time-consuming.

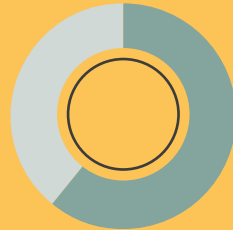
Of course, not everyone agrees that the coworking model is particularly resilient. Equity investors and coworking operators, for example, hedge their bets on its relative staying power.

"An economic downturn would naturally result in fewer job opportunities, and given the demand and supply spectrum, the coworking model would be far more vulnerable compared to more secure real estate positioning," says the managing director of an equity investor based in Washington, D.C. that funds coworking operators and coworking funds. "The effects of a downturn can no doubt be estimated by making calculated assessments of trends and complexities, and determining the actual weighting that needs to be granted. Hence, the level of vulnerability increases with time."

Section 4

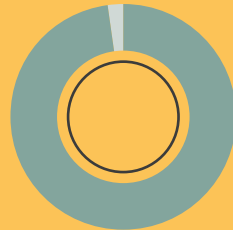
Coworking M&A and strategic partnerships

Consolidation is on the horizon for the coworking sector, with Real Estate Investment Trusts (REITs) expected to lead the pack among potential buyers. The challenge for the sector will come down to valuations: how will coworking influence how much investors are willing to pay?



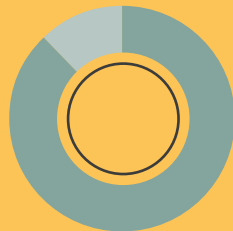
67%

of both equity investors and traditional office landlords expect significant consolidation through M&A in the coworking sector over the next three years, with the rest expecting moderate consolidation.



99%

of all respondents say REITs are natural long-term buyers of coworking operators and assets.



79%

of equity investors believe current valuations of coworking operators are a reasonable reflection of the market, followed by 71% of operators and 61% of lenders.

The fact that coworking operators function more like a hotel than an office can make relationships with traditionally leased offices challenging. But this tension between traditional office landlords and coworking operators—with some coworking providers demanding an equity “upside” share in the extra value they can create when their occupation increases building value—can also lead to strategic partnerships.

Equity investors and traditional office landlords are both fairly bullish on expected M&A activity within the coworking sector in the coming years, with two-thirds (67%) of both respondent groups confident of significant consolidation.

Current coworking operators are slightly more equivocal about the degree of M&A activity, with 54% anticipating significant consolidation. Lenders are more cautious, with 57% expecting a modest level of deals, at best.

Almost all respondents agree that REITs are natural long-term buyers and owners of coworking operators and assets, followed by private real estate companies and private equity funds.

“There seems to be some consensus around REITs becoming natural long-term buyers or ‘consolidators’ of coworking companies,” says Creedon. “However, if the recent trend of coworking operators and landlords moving away from the traditional lease model to something more akin to a management contract or joint venture arrangement—where landlords are participating in the upside profits and service-based income of the coworking operators—continues in large scale, it could present challenges for REITs to participate in that market.”

Sovereign wealth funds are cited as the least-natural owners, although several Middle Eastern funds do indirectly own a stake in WeWork through investment in the SoftBank Vision Fund.

The managing director of a U.S.-based lender says, “With the contribution of future technology and improved communication levels, big coworking providers will accelerate their buying process, more so as supply and demand in the sector breaks through. SMEs and larger corporations looking into coworking initiatives also signifies an emphasis on buying rather than leasing.”

Interestingly, few in the sector believe valuations of coworking operators themselves are overstretched. Operators, equity investors and lenders all believe valuations are accurate (71%, 79%, and 61%, respectively), while traditional landlords are most bullish, with half of respondents claiming assets are currently undervalued.

According to the senior managing director of a U.S.-based lender, however, “Many coworking operators are overvalued, based on earnings and generalized opinion of their overall standing in the market. Management positions and policies can contribute to this overvaluation, rather than it being a reasonable reflection of the market.”

FIGURE 12: TO WHAT DEGREE DO YOU EXPECT THE COWORKING SECTOR TO CONSOLIDATE OVER THE NEXT THREE YEARS THROUGH M&A ACTIVITY?

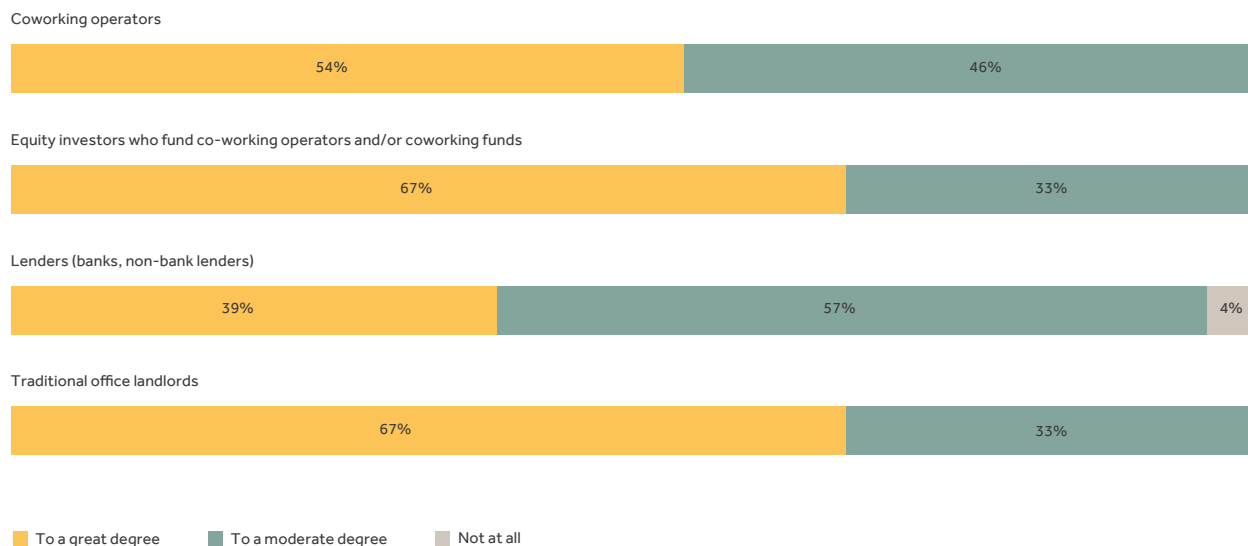


FIGURE 13: WHO DO YOU THINK ARE LIKELY BUYERS IN A COWORKING SECTOR CONSOLIDATION? (ALL RESPONDENTS)

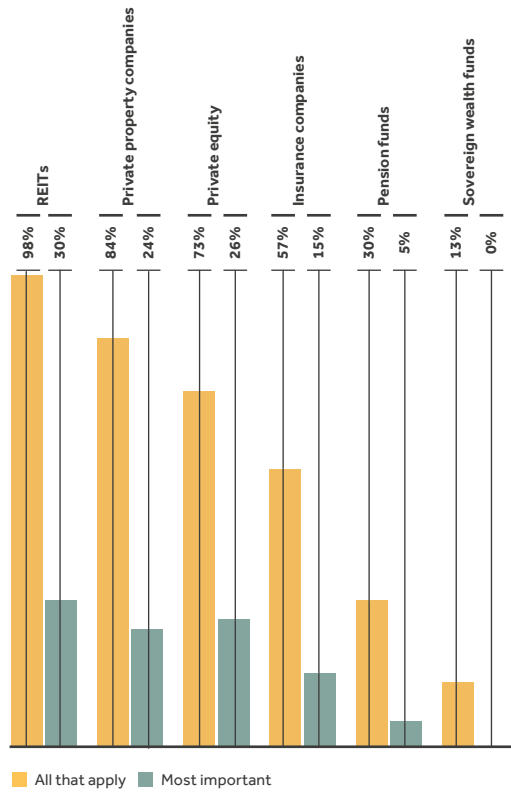


FIGURE 14: WHO DO YOU THINK ARE THE NATURAL LONG-TERM OWNERS OF COWORKING OPERATORS? (ALL RESPONDENTS)

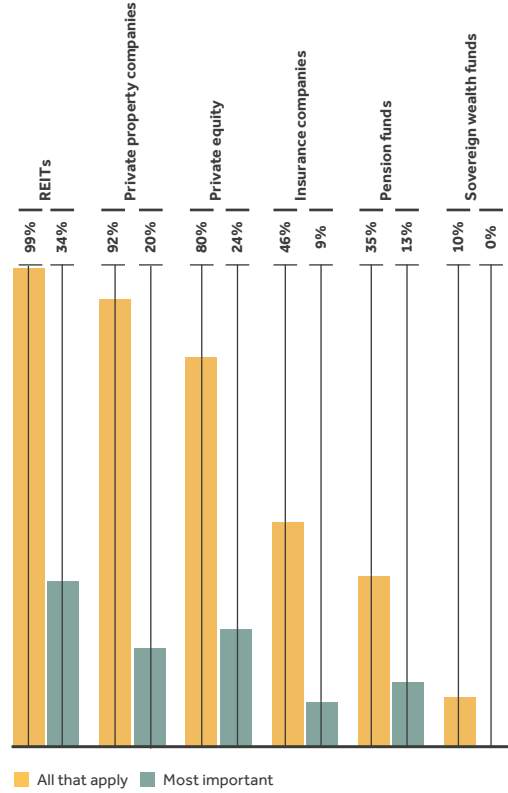
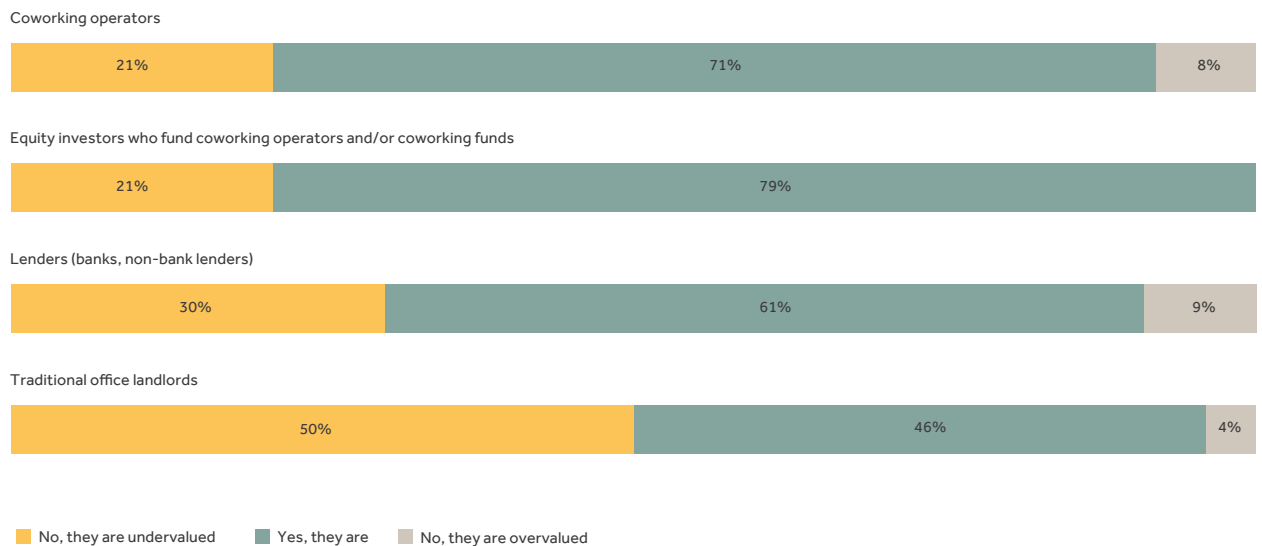


FIGURE 15: ARE VALUATIONS OF THE BIG COWORKING PLAYERS A REASONABLE REFLECTION OF THE MARKET?



Section 5

Conclusion

Coworking has only just begun to disrupt the traditional office sector. According to our findings, most respondents expect coworking to continue absorbing traditional offices as start-ups and the independent workforce grow and both small and large companies shift into community workspaces.

In addition to traditional office space disruption, we are starting to see early signs of coworking operators shifting into other asset classes, as evidenced by recent partnerships between coworking operators, hotel companies, luxury/high-end fitness operators and residential operators.

At the same time, equity investors (whether directly as shareholders in coworking operators or fund investors) anticipate membership growth among both large and small coworking operators. There are also hints that a shift is underway among those turning to coworking as a viable option. Freelancers, creatives and technology firms may soon be battling larger companies, which are looking for more flexibility in their office needs, for shared spaces.

Typical office spaces are responding in kind, with an overwhelming majority in our survey saying that landlords have begun to adopt “real estate as a service” innovations in their otherwise traditional office settings.

What does this mean for the sector? First, larger coworking providers will be buying rather than leasing assets and shifting towards management and partnership arrangements with landlords in lieu of entering into long-term leases. Second, the average length of traditional office leases will likely become shorter in response to coworking’s influence on market norms. Third, all survey respondents agree that coworking is changing underwriting and valuation methodologies for assets, including flexible space. Finally, consolidation in the sector will likely increase in the coming years as larger coworking operators look to expand their remarkable growth and traditional landlords seek to take advantage of the opportunity.

Most surprisingly, perhaps, is the consensus that an economic downturn could have a positive effect on the coworking sector, as coworking membership is likely to grow in a contracting economy due to a rise in self-employment.

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