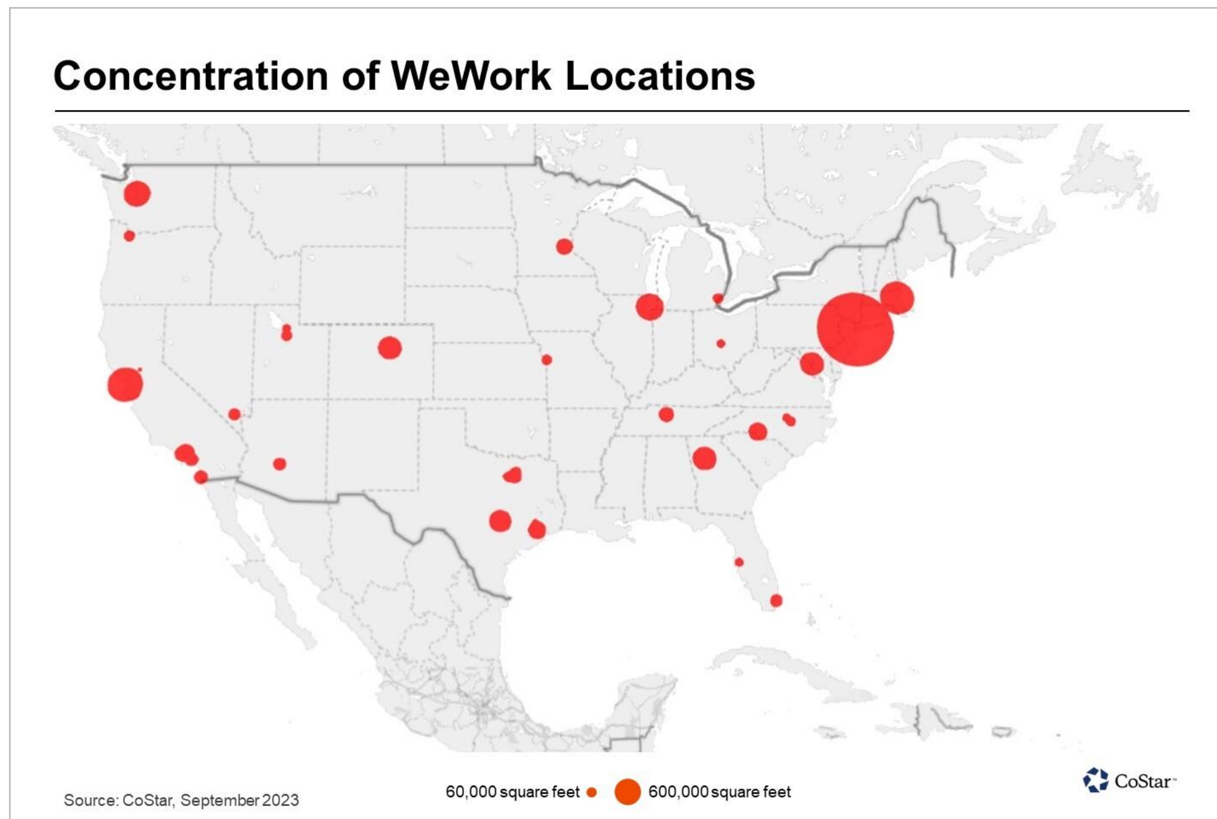
COSTAR INSIGHT

Value Losses Attributed to WeWork Could Reach $7 Billion Under Worst-Case Scenario

Office Owners Brace for Fallout if Coworking Giant Is Unable To Continue As Going Concern



By Chad Littell and Phil Mobley

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In early September, WeWork's chief executive officer grabbed the attention of office property professionals by issuing an open letter stating that the provider of coworking space was "kicking off a process of global engagement with [its] landlords to renegotiate nearly all [its] leases."

Interim CEO David Tolley's statements followed the company's second-quarter earnings call a month earlier, where he remarked that "substantial doubt exists about the company's ability to continue as a going concern."

Given recent admissions of financial diffulty by WeWork, not to mention the volatility of WeWork's valuation since it first attempted to go public in 2019, office owners who hold large coworking exposure now have a reasonable question: "What happens if WeWork actually does cease to exist?"

Based on several assumptions related to potential gross income, occupancy levels, expense ratios and capitalization rates prevalent in the market today, the total impact on property valuations could be as

much as $7 billion — though it would most likely be closer to half that, if not less.

Those assumptions are underpinned by recent conversations with office owners across the nation. In general, they affirmed the belief that coworking, as an industry, is well supported. They see most of the issues associated with WeWork as stemming from its business model rather than from a fundamental lack of demand for coworking space.

Executing with success in this niche sector, market participants note, rests in determining where in the building the space should be allocated, how large this type of space should be permitted to grow and an understanding of at what point a section of a city becomes too saturated with coworking options.

Investors underwriting office space today say that they are generally not shying away from existing coworking space altogether, but they are making coworking assessments portfolio-wide and avoiding excessive exposure to coworking tenants. They note that pricing discounts start to appear when the combined coworking space in a

building exceeds 20% of the rentable building area or RBA. When coworking space makes up less than 10% of a building's RBA, investors tend to treat this space as any other second-generation office suite.

Quantitatively, WeWork’s footprint is vast, spanning 268 U.S. properties with an aggregate size of more than 90 million square feet. WeWork leases approximately 15.5 million square feet within these office locations, with average occupancy at each site accounting for about 17% of the RBA. However, there are as many as 100 locations where WeWork accounts for at least 30% of a building's RBA. Of that total, 50 properties lease more than half of their space to the coworking behemoth, placing them at considerable risk should WeWork be unable to meet its financial obligations.

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In a total-loss scenario, which assumes that the company faces bankruptcy and is forced to vacate all its U.S. locations, the value losses attributed to WeWork's hypothetical downfall could reach as high as $7 billion. This figure represents the capitalized value of a total, permanent income loss across WeWork's entire current footprint.

To arrive at this figure, CoStar analysts use CoStar's estimates of the gross market rental rates for each WeWork location, subtracting the actual vacancy at each property, then applying a 40% operating expense ratio. This allows us to estimate the net operating income of each property, both with and without WeWork. The difference between these two capitalized values at an 8.5% yield implies the magnitude of potential losses. In the worst-case scenario, where WeWork vacates and no subsequent tenant backfills the space, the hypothetical devaluation would be $7 billion.

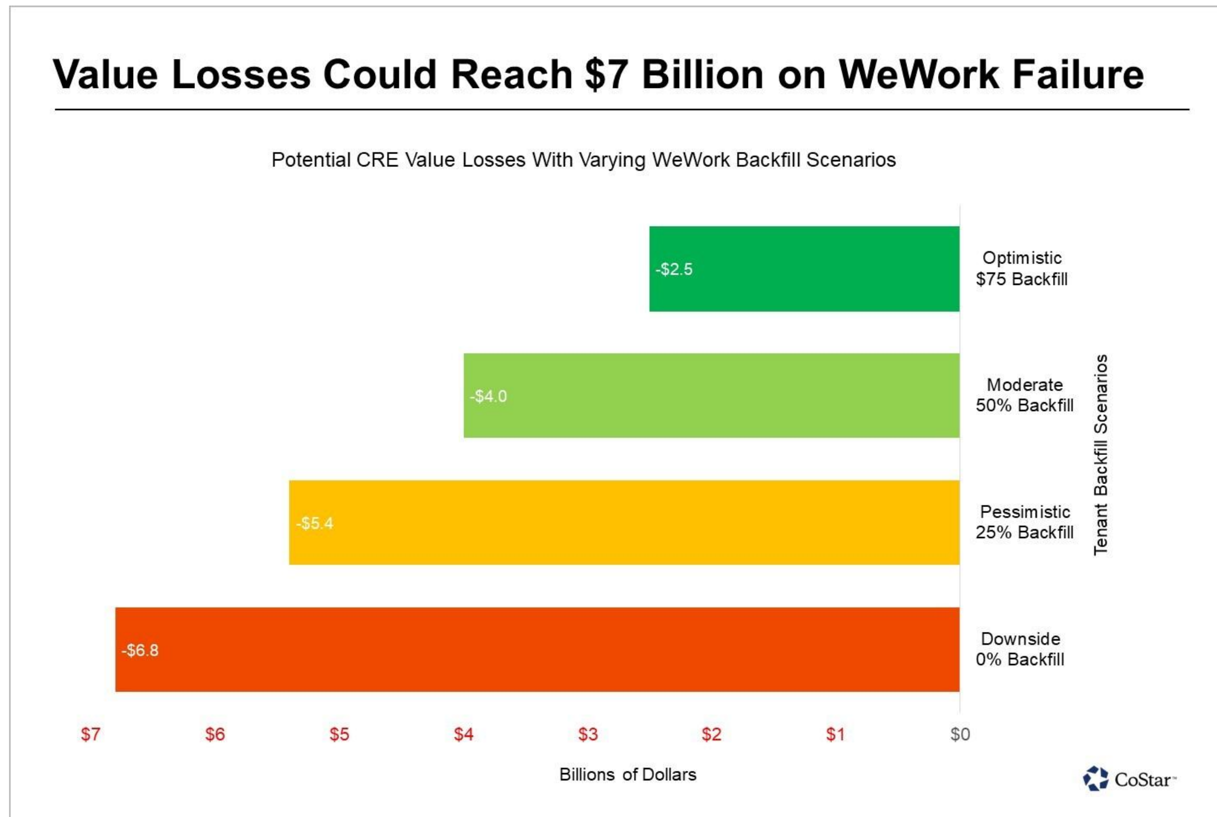
Realistically, however, much of any space vacated by WeWork would likely be backfilled and able to generate at least some future income. In practice, building owners will — and in many cases already do —

have a unique business plan for each individual asset that considers the possibility of taking this space back.

At a market level, these plans might account for coworking space in competing properties, existing and forecasted submarket vacancies and proximity to executive housing, which is viewed as a driver of future leasing demand. At the asset level, several additional variables come into play in formulating a re-leasing strategy, including the location of the coworking space within the property, its percentage of the RBA, the quality of the space's improvements and whether the WeWork space was designed for enterprise or small business clients.

Given landlords' collective proactive planning along these lines, CoStar analysts consider several hypothetical scenarios where some of the income loss from WeWork's space is backfilled. In a pessimistic scenario, property owners would maintain 25% of WeWork's current NOI with replacement tenants. In a moderate scenario, they would retain 50% of their current WeWork income. Finally, in an optimistic outlook, owners would hold onto 75% of the NOI currently attributed to WeWork. Under these scenarios, the potential value loss would range from $2.6 billion to $5.4 billion —

still substantial, but far less than the catastrophic $7 billion worst-case scenario.



While it should be noted that even the worst-case scenario represents less than one-half of one percent of the U.S. office market's estimated value of $2.6 trillion, any potential losses would be concentrated in specific markets and within a particular class of buildings. The implications of WeWork's restructuring plans at the

market level will vary according to the unique coworking ecosystems within major U.S. markets.

No doubt there will be winners and losers as WeWork initiates its comprehensive lease renegotiation plan in the latter half of 2023. Those office properties offering the best locations and flexible tenant improvements should continue to hold favor in the market. On the other hand, sites with tepid leasing interest might be too large or need better connectivity to the property's common areas to attract other tenants.

In a larger sense, WeWork is only one of numerous headwinds pressuring the office market today. Difficulties in securing financing, negative net absorption, elevated new supply and economic uncertainty all pose unique challenges to the owners of office property. The consequences of WeWork's potential value impacts under similar scenarios to those we have applied at the national level could magnify the impact of the other challenges facing the sector.

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