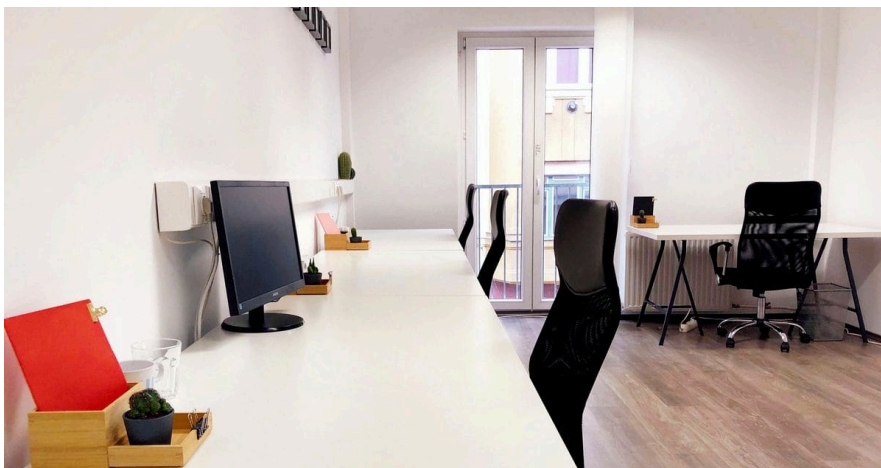


PUBLIC NOTE

How to Think About Coworking

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Are WeWork, Industrious, Knotel and other coworking startups overvalued?

I think they probably are and I'll explain why, but in some ways that's the least interesting question you can ask about them.

Whether or not these companies ever grow into their current valuations, there are hundreds of thousands of people working in their offices, and they're influencing the standard office environment for millions more. Many of these influences will persist whatever happens to the current round of startups, including second order effects that no one's discussing at all.

1. WHAT ARE THEY REALLY OFFERING LANDLORDS?

In a sense, urban office owners were the largest initial "investor" in coworking startups, in the form of below-market lease terms. But even if you believe the startups will eventually melt down, it doesn't follow that these landlords were all suckers, because they weren't making the same bet as an equity investor.

In many locations they're filling space that would be hard to lease to a standard corporate tenant — mid-block, low floors, older buildings — and in others they're looking for a "halo effect" that will help lease the rest of the property.

When you get out of the city to some more recent entrants, there are further considerations. A mall might subsidize coworking just to get more daytime foot traffic. A suburban office park may see it as an amenity for their other tenants, or an incubator for growing companies they can recruit into standard leases.

Another thing to notice is that as money pours into the startups, they're starting to accept higher rents, guarantee leases for a bit longer, and cover more of the build-out costs. Even if you took the cynical view that coworking was just a straight transfer of value from "old economy" landlords to tech investors, you've got to admit that at certain locations that subsidy may now be running in the other direction.

2. WHY CAN'T SOMEONE ELSE DO IT?

Whatever the direct rationale for landlords, there's also a research element: they're trying to understand what these startups are doing differently from Regus and all the other similar concepts that they've seen in the past. And while those differences are very real, none of them are proprietary.

So even if the bulls are right about continued rapid growth of the flex/coworking market, that doesn't mean the economics will hold up or anyone will maintain their current market share. Because whatever the network effects of being a "member" of a coworking brand, they are not strong enough to be a meaningful barrier to entry.

Now, as the model expands to higher profile locations, larger corporate tenants and more revenue-sharing arrangements rather than standard leases, you can see a different risk emerging for traditional landlords and brokerages — not "disruption" or displacement, but *disintermediation*.

The best example of disintermediation in commercial real estate is the hotel sector. First the brands and then the online travel agents have captured staggering amounts of value by positioning themselves in between owners and guests in ways that increase their leverage with both sides.

If you squint hard enough, you can see a few of the same dynamics in the office business, especially as coworking share grows and leases get shorter.

But they'll never get anywhere near the nightly "leases" of hotels, they don't have the same basic trust problem that hotel brands solved, and even the strongest proponents of the "office as hospitality" trend are not suggesting anything as management-intensive as an actual hotel.

So while the startups have jumpstarted the growth of shared and short-term office space, in the long run the operation and leasing of that space is likely to be as competitive as ever, and it's not surprising that so many real estate companies have already started their own coworking platforms.

There's room for lots of different operators to succeed, and like the hotel brands and travel websites they will certainly consolidate, but it's hard to see how anyone corners the market and extracts the kind of sustained excess returns that VCs are looking for.

3. WHAT ARE THEY REALLY OFFERING TENANTS?

This one's easier to answer. They're offering an immediate move-in, a shorter lease term and most importantly, greater density: the square footage per worker in a coworking layout can easily be half of what it is in a standard office. And while some of that is shared facilities, most of it is just less space to work in.

How about collaboration, innovation, or the motivational decor?



Work in Progress

It's hard to say. On the one hand, as I wrote above, the differences are very real between new coworking space and older temp offices, which felt like the DMV. It's no good saying "this is just Regus with a different name." Whatever you think of the slogans on the walls, these are much more appealing work environments.

On the other hand, there's really no evidence that density, open floor plans, and floating desk arrangements make employees more productive, and there's plenty of evidence that they have the exact opposite effect. I wrote about this in more detail [last year](#), and some prominent voices in tech have made related arguments about coworking, like Y Combinator's [Sam Altman](#):

"Hey, startups, we've got this really cool coworking space. There's free espresso and colorful couches. Come." You get the people you deserve when you do that...

The average level of ambition and willingness to work hard at a coworking space is incredibly low. There's this reversion to the mean that is not what you want in your life.

So when you get past the lease terms to some of these fuzzier benefits, it's hard to disentangle what companies say they're getting from coworking, what they really think they're getting, and what they're actually getting.

4. WHAT HAPPENS IN A DOWNTURN?

If you believe that individual coworking demand will be “counter-cyclical” because laid off “creatives” decide to pay \$500/month out of their own pockets to ride out the next recession in style as freelancers, then I have a bridge to sell you. If you think they’ll all found startups and raise other people’s money to pay for coworking memberships *at a faster rate than today*, that’s not much more plausible.

Now, if you want to argue that *corporate* tenants in a recession will become even more inclined towards shorter lease terms and greater density, that’s getting more reasonable. But remember that there are now lots of large corporate tenants *already* in coworking, and often that already *is* their flex space. If you’re IBM (or whoever) with most of your employees in a given market located in your permanent office with eight years left on the lease, and a few more in a coworking office with just six months left, and you start reducing headcount, guess where you’re vacating first?

And even if net demand somehow increases, there’s also more vacancy in the market competing with you, much of which can be reconfigured as coworking if that’s where the demand is.

So it’s hard to avoid the conclusion that one way or another, the spread of coworking will make the next downturn deeper for the entire office market, even for some of the landlords who never touched it. Long leases are a shock absorber for real estate cycles, and coworking is making the average effective lease term a little shorter.

What about the famous asset/liability mismatch? Will some landlords cave when the coworking operator demands a rent cut or a better revenue split?

Absolutely, but not all of them. And if that leverage with landlords is part of your bull case for current valuations, you’re still not thinking about the whole picture. Companies valued at 20x revenue need to *grow revenue*, not cut expenses. The scenario where they even have time to haggle with their current landlords is one where their valuations have collapsed; it may be a way for their late stage investors to recover 10% of their money instead of 5%, but it’s not a way to go from 2x returns to 3x.

5. WHAT ARE THE SECOND ORDER EFFECTS?

I have a theory about this that I haven’t seen anywhere else. I think coworking is a Trojan horse for working from home.

Remote work has been a recurring bogeyman for office real estate since the term “telecommuting” was coined almost fifty years ago. Many large companies have experimented with remote work policies and **changed their minds**. But maybe it’s a bank shot that needed to happen indirectly.

Many companies have slowly made their offices as cramped, noisy and distracting as possible, all in the guise of “collaboration” and “community.” Whether they believed the hype or they were just spinning the cost reductions, they’re probably not going back to lower-density layouts and more space.

But employees can solve the problem from the other direction, and I think we’re already seeing that. Everyone I know who works in a coworking space treats it as less of a full-time “home base” than they would a standard office, and spends less actual time there.

This seems to be especially true of the technical talent at startups. If you have a full day of coding ahead of you, why would you go even a few subway stops to do it in a tiny glass-walled office in a coworking space, crammed in with your non-technical colleagues who are on the phone all day, when you could open up the same MacBook Pro at home (or a coffee shop next door) and do the same work with fewer distractions?

You can see how this evolving hybrid model is where more companies will end up, with one or two “in the office” days per week. And maybe what coworking is really giving them is a way to accelerate this transition, by selling them even more density and calling it something else.

Satellite offices that reduce commute time are the first stage of remote work (this is actually what “telecommuting” originally meant) but the harder it is to be productive in those offices, the faster we’ll pass through that stage. And in a downturn when you’re trying to retain key employees without paying them more, and your marginal dollar of rent is paid on a short-term per-head basis, letting them go fully remote is an easy win-win decision.

If you don’t own any office buildings, is this even a problem? In contrast to open plan layouts, much of the research on working from home shows real benefits in productivity and well-being.

And we may have reached a tipping point in terms of technology. Here’s Stripe just [last month](#) on their new remote engineering “hub”:

...the technological substrate of collaboration has gotten shockingly good over the last decade... Google Docs, Slack, git, Zoom, and the like deliver high-bandwidth synchronous collaboration on creative work. The experience of using them is so remarkably good that we only notice it when something is broken...

While we did not initially plan to make hiring remotes a huge part of our engineering efforts, our remote employees have outperformed all expectations...

I could be wrong! It's just a theory. But the one forecast that's guaranteed to be wrong is the one I keep seeing everywhere else, which is hockey stick growth in coworking/flex market share without any offsetting changes in work patterns.

In fact, the more you believe in coworking — the more that it's really something new and different from previous temp office models — the more you should be thinking about these kinds of feedback dynamics and second order effects.

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