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How Morningstar Handles the Unique Risks WeWork Tenants Present to Office Properties

July 2019

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Hardly a week goes by without WeWork making headlines in both trade publications and mainstream news sources. While the exposure to the commercial mortgage-backed securities universe remains limited, the fact that WeWork is the largest office tenant in Manhattan (and growing) means that it is a force that cannot be ignored in the industry. At Morningstar, the risks associated with buildings that have significant coworking are reflected in our underwriting. We combine methods traditionally used when underwriting properties with significant single tenant exposure, like adjusting the capitalization rate and applying a lit/dark analysis, with adjustments that are more unique to coworking like our adjustments to occupancy and tenant improvement packages (see graphic below).

Tenant Improvements

Landlords will often pay some or all the cost of building a new tenant space in the form of tenant improvement packages. This is sometimes derisively referred to as "buying occupancy" or "buying rent" because the landlord is paying money upfront to secure occupancy or higher rent. Coworking tenants often pay high rents but often demand high TI packages to help them build out their unique spaces, complete with the free beer that seems to be mentioned in every article written about WeWork. Adding to the cost, coworking spaces often seek out class B/C offices that they plan on renovating into high-end office space.

Occupancy

A coworking tenant may be occupying a space fully on paper, but actual occupancy may vary since its users can sign monthly, daily, or even minute-by-minute rental plans. It may seem that the space may be "occupied" on a rent roll but if the coworking tenant is unable to re-lease the space to generate income, then is the space really occupied? Exacerbating the problem is the fact that the coworking companies like The We Co. are offering generous commission packages to brokers for bringing tenants to the building and offering free rent to tenants. What would occupancy look like without these generous incentives?

To account for this risk and focus on sustainable occupancy, we give special attention to the market and historic occupancy rates. When possible, we also determine the utilization rate of the coworking space and use that number to inform our vacancy assumption as well.

We will typically underwrite these high TI costs when determining sustainable cash flows. While some may argue that underwriting this is too conservative because coworking tenants have unique buildout costs that can be higher than average, we believe it captures the risk of the tenant vacating and the landlord spending again to refit the space for a more traditional tenant and factors in the full cost of a landlord achieving the rents it is receiving from the tenant.

Capitalization Rate

We divide our underwritten cash flow by a capitalization rate to determine the how much the property is worth. This means properties with a lower capitalization rate will be worth more than a property that generates identical cash flows but has a higher capitalization rate. Any property with significant exposure to a single tenant will usually be underwritten with a higher capitalization rate than a similar multitenant property because there is increased risk of cash flow disruption when a significant portion of the cash flow is coming from a single source. This is especially true when the major tenant is not investment grade or considered at higher risk of bankruptcy.

Because of this, we may apply a higher cap rate to properties with a heavy coworking concentration. Indeed, a Cushman & Wakefield Inc. study found that since 2016, properties that had 40% of their buildings occupied by WeWork sold with capitalization rates that were 50 to more than 100 basis points higher than similar properties sold over the same period.

Lit/Dark Analysis

Instead of, and sometimes in addition to, adjusting the capitalization rate, we will perform a lit/dark analysis on buildings with significant exposure to a single tenant. This analysis means in addition to the "lit" value of the building, which values the space as if it were occupied at the underwritten occupancy, we will also determine a "dark value," which assumes the space is vacant. We take a weighted average of these to determine the final value of the property. The amount of weight assigned to each component represents the likelihood that the major tenant vacates their space.

If a tenant is not rated or has a higher risk of bankruptcy, we may apply a higher weight to the dark value.

All Tenants Are Not Created Equal

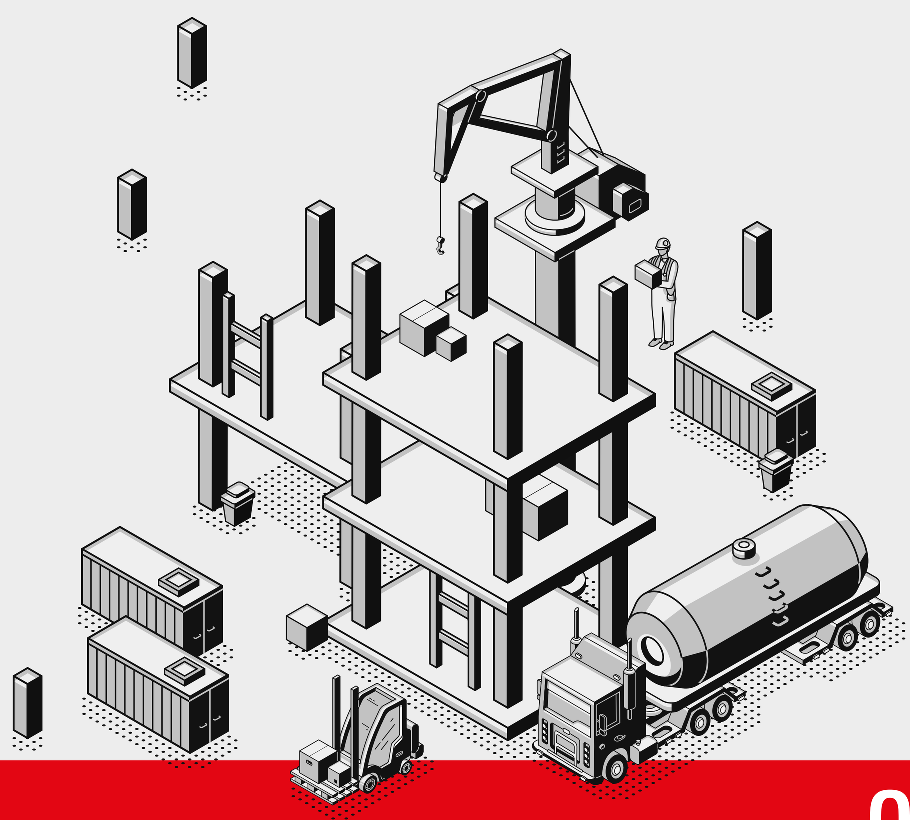
Given the growth of companies like WeWork and the increasing footprint of coworking tenants, when assessing office property loans, it's important to address the particular risks such arrangements present. Morningstar will continue to factor this into its underwriting, making further adjustments, if necessary, as more data becomes available.

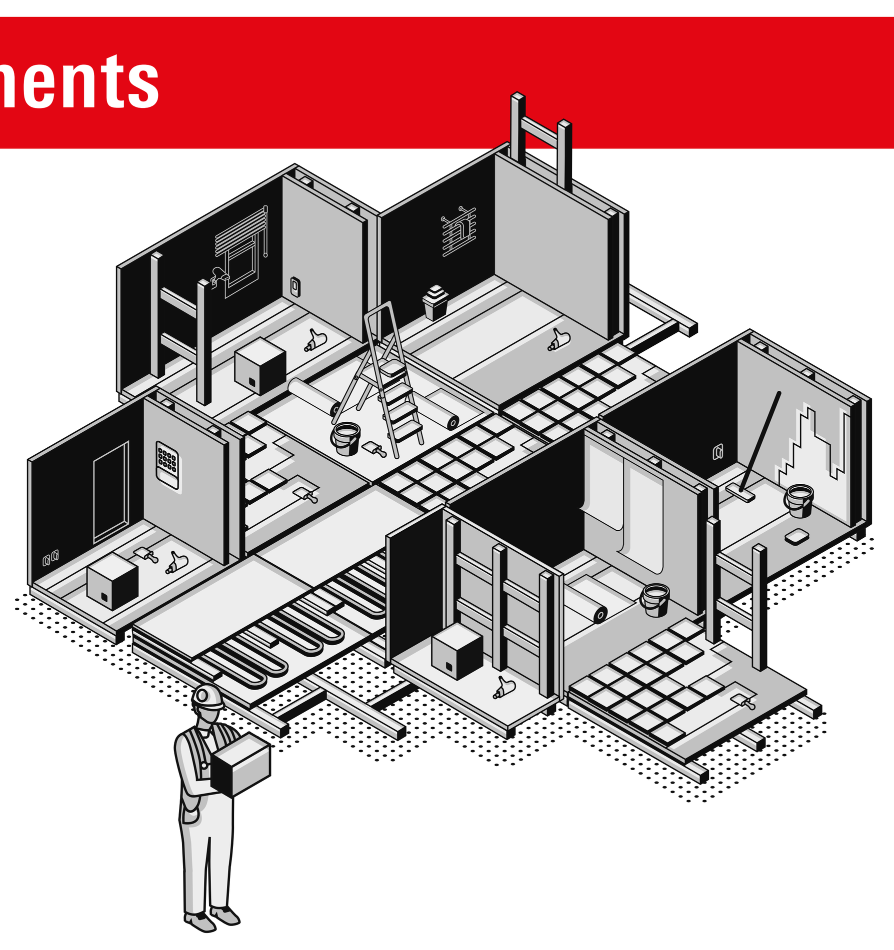
How Morningstar Handles the Unique Risks WeWork Tenants Present to Office Properties

TRADITIONAL CO.	WE CO.

Tenant Improvements

We underwrite to market rates since the next tenant will likely not require a significant buildout.

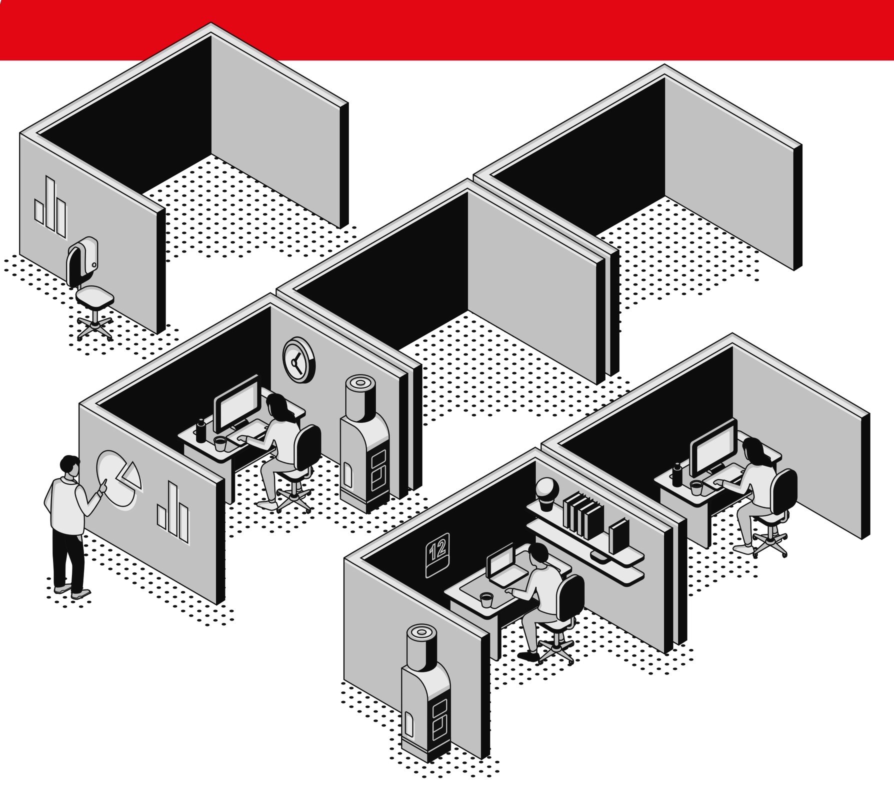




We underwrite in line with actual improvement allowance, even if it is above market.

Occupancy

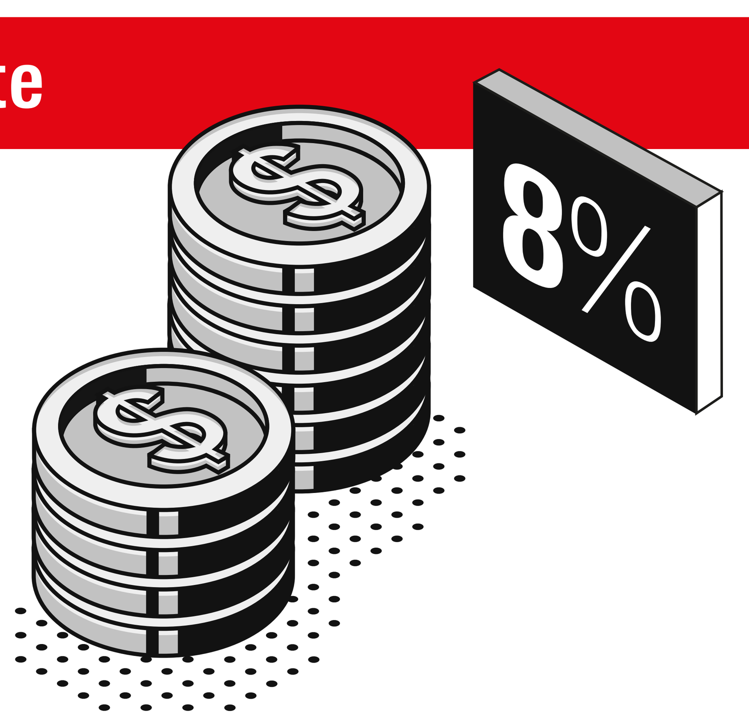
Since Traditional Co. will occupy the entire office space, **we underwrite our minimum vacancy.**



Since We Co. might sublease space to others, **we underwrite either a look-through or market vacancy.**

Capitalization Rate

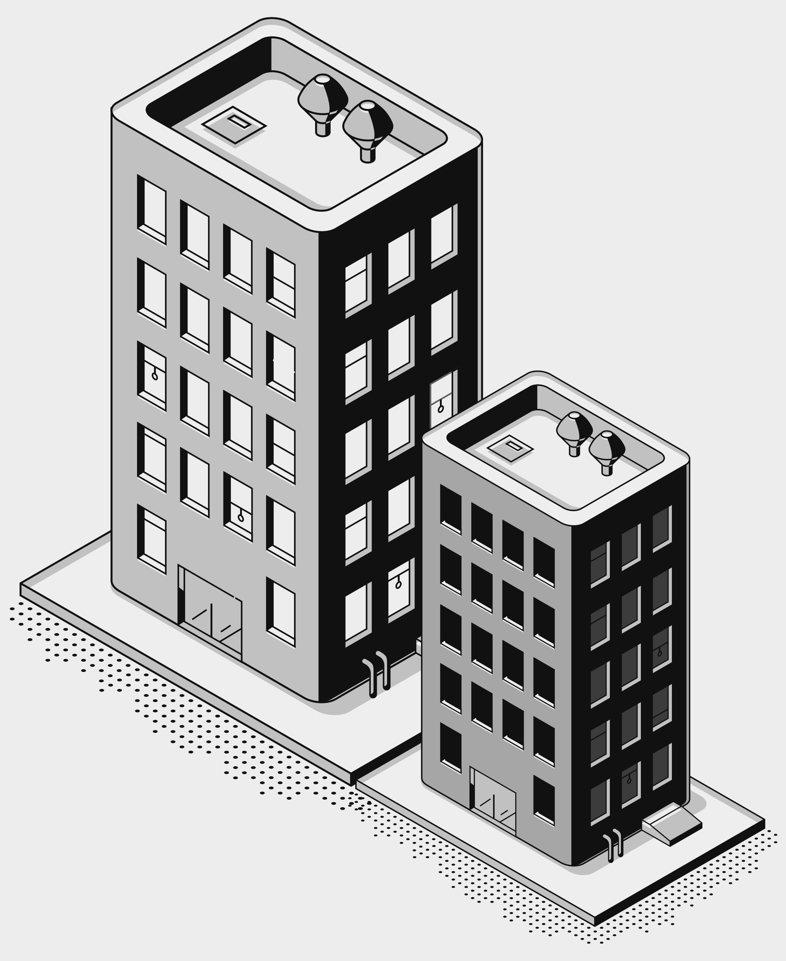
We adjust our office cap upward because Traditional Co. is the sole tenant.

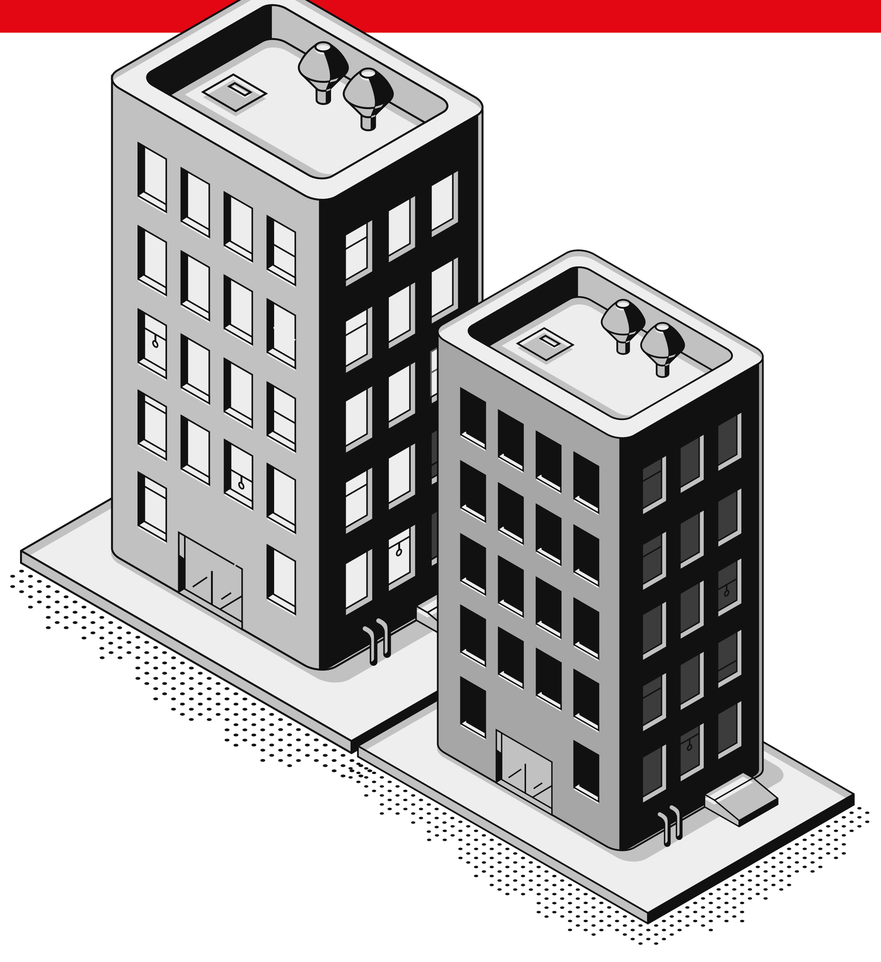


We Co. will be the sole tenant even if it sublets space. **Added uncertainty leads us to adjust our cap rate up significantly.**

Dark / Lit Analysis

Based on the long-term lease and Traditional Co.'s credit rating, **we choose not to perform a dark/lit analysis.**





Because of the greater risk of We Co. vacating, **we perform a dark/lit analysis and assign a higher weight to the "dark" portion.**

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