

The Coworking Industry

Then, Now, and Tomorrow



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The Coworking Industry

In the Beginning

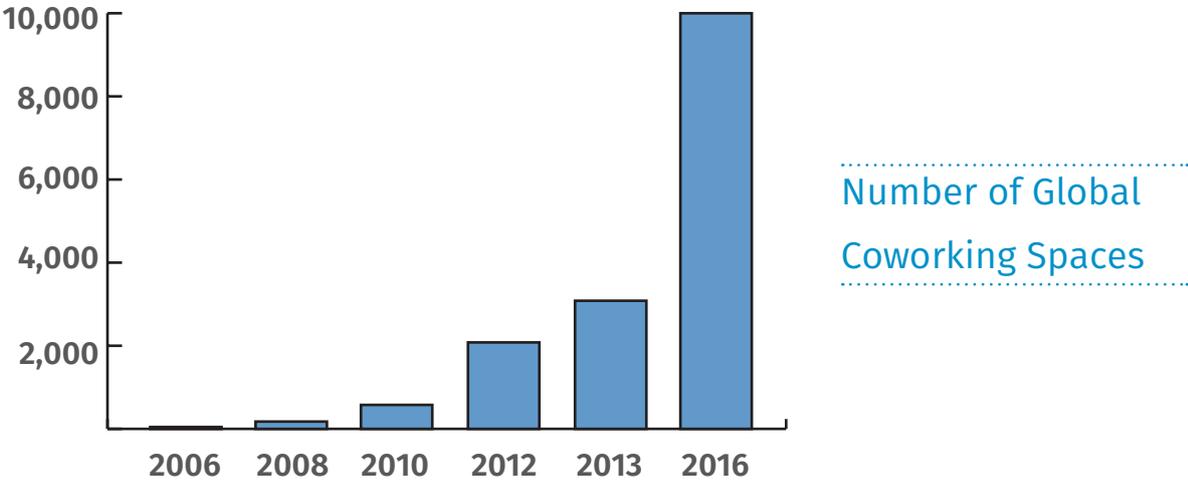
IN THE EARLY DAYS OF THE COWORKING INDUSTRY, BETWEEN 2006 AND 2009, COWORKING ENTREPRENEURS AND LANDLORDS WEREN'T THE BEST OF FRIENDS. WHEN MANY OF US PRESENTED OUR BUSINESS PLANS TO PROPERTY OWNERS AND MANAGERS, THEY LOOKED AT US WITH A MIXTURE OF DISBELIEF AND AMUSEMENT.

The whole notion of coworking, a membership based, community oriented sub-leasing model, was way too outside of the box for them. They couldn't get past the month-to-month part, or the fact that there wasn't a single-company tenant that would use the office space. It all seemed so different and uncertain that the whole industry almost didn't happen.

Of course it did happen, and we all have the Great Recession (2008-2011) to thank for that. When the property market softened significantly during the recession, property owners found themselves sitting on millions of square feet of unused space.

They were willing to make deals and take risks. When this window of opportunity opened it, I don't think anyone could have predicted how much latent demand for a new kind of working experience there was out there. Between 2006 and 2009, around seventy spaces had opened up, but by 2016 that number has reached around 10,000.

In this whitepaper, we discuss the past, present, and (possible) future of coworking, using Moore's basic framework to understand changes in the industry. We close the paper with one vision for where the industry might be heading.

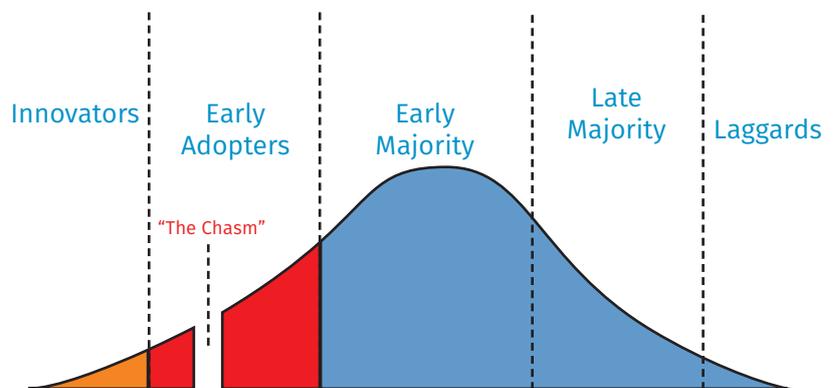


The Coworking Adoption Lifecycle

Similar to the technology adoption lifecycle discussed many years ago by Geoffrey Moore, coworking too has tracked a similar life cycle of adoption. There are five phases in the cycle: innovators, early adopters, early majority, late majority, laggards. According to our research, we are currently in the early majority phase of the cycle.

Coworking Adoption Lifecycle

The area under the curve represents the number of customers

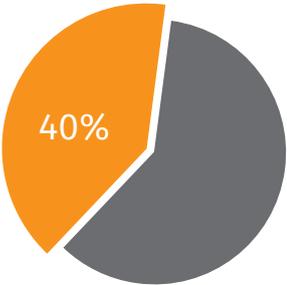


As with any heuristic that is used to make sense of a complex situation, there are exceptions to the rule. However, as more and more types of companies express interest in coworking, we feel that it is important for participants to understand some of the fundamentals of what has happened in the past, and what this might mean going forward.

Innovators

AT FIRST, the growth of coworking was as much a social movement as it was a new way of working and using office space. Freelance and small startup entrepreneurs who were seeking careers outside of corporate structures gravitated towards one another, in cities around the world, in search of more meaning and community in their working lives. The growing number of freelance professionals, predicted to be around 40% of US workers by 2020, found a new and extremely compelling environment to do their thing. There were around a dozen or two initial businesses that paved the way for the rest of the industry, places such as the Spiral Muse, Hat Factory, Citizen Space, Indy Hall, Office Nomads, Souk, Conjunctioned, and Sandbox Suites, among others. It is important to note that, qualitatively, what was happening in these early coworking spaces was very different from what we all now call coworking today.

Market Growth
 40% of US workers expected to be 'freelancers' by 2020.



Today, as I discuss shortly, coworking has become a business, a subset of the real estate industry, where the relevant metric is revenue per square foot (RPSF). Amongst the early coworking innovators, the primary focus was community, friendship, and creating a support structure to help each other succeed. As is the case with the growth and development of other industries, as well as the fate of many small companies that are acquired by larger firms, the essence of the thing sometimes gets lost when it is commercialized and driven to scale.

Early Adopters

By 2009-2010 it was clear to some that coworking wasn't a passing trend or fad. More business-minded companies, such as NextSpace and Green Desk (which would become WeWork), entered the fray and started to commercialize the industry. Of course, WeWork has become the giant of the industry, taking its place alongside other sharing economy unicorns with a \$15B valuation. This phase of the adoption cycle also demonstrated that coworking could be turned into a profitable business, even though many of those spaces that opened during this phase of the industry didn't make the final cut. Cleverly, the ones who did make the cut and managed to scale their businesses did so by bottling up many of the 'elements of cool' that were manifest by coworking innovators, and packaging them for sale to a new round of customers.

This included physical design elements such as exposed brick wall, exposed duct work, and reclaimed original hard wood

floors, and social elements such as happy hours, events, and other types of programming. Many of these spaces looked like the first generation of spaces, but the business models were changing. What had been largely open spaces, where people sat together either at open desks or dedicated desks, was slowly replaced by a proliferation of private offices that were designed to look the part but that maximized the number of people that could fit into a space. With tenants committed to longer leases, and work stations shrunk to around 50-60 sq ft. per person, the numbers began to work. As the social/community element introduced by the innovators receded as a percentage of overall businesses in the industry, the financially successful spaces were, in terms of their business models, becoming more and more like serviced office offerings like Regus. This proved to be a winning formula, which set the stage for the next wave of adoption, the early majority.



Early Majority

As mentioned earlier, according to our research, we have now moved into the Early Majority phase of the coworking adoption life cycle. Due to the WeWork Effect, building owners and property managers around the world want to get involved in the industry. We receive inquiries every week from property owners and developers who now want 'to do coworking.' It is interesting to note how far we've come from those early days when realtors wanted to have nothing to do with coworking. There are good reasons why many of these professionals have gravitated to coworking. Increasingly, the numbers are working out. Coworking chains such as WeWork and Industrious, with well-designed spaces and brand cache, fill up quickly and charge a premium for their office spaces. When you do the math you can see why they are accelerating and why others are investing in the industry.

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Annual revenue: \$150-200 psf

– Cost of Lease: \$40 psf

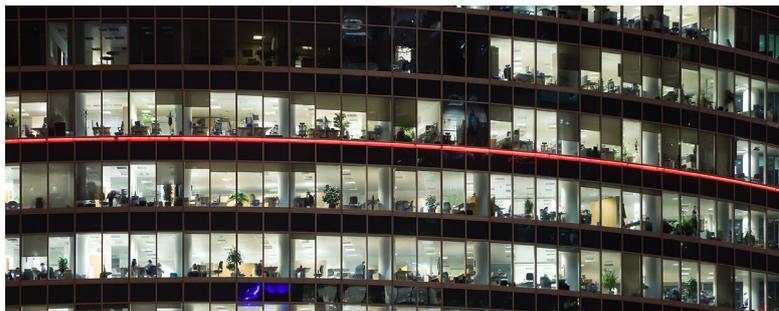
The Difference: \$110-160 psf

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Granted, not that many coworking operations can earn \$200 psf, but the very possibility that these businesses can be profitable has convinced many in the corporate real estate (CRE) industry that it is no longer a gamble. Because of this, we are seeing a proliferation of new independent operators, the growth and expansion of existing multi-location players, and now a vast interest among traditional real estate companies. Again, as was the case with the Early Adopters, some incumbents will continue to thrive while some new entrants won't. One aspect of this phase is clear. At this point in the process, brands do matter. Because it is relatively early days, there is still a significant amount of education that needs to take place before coworking is a fully mainstream phenomenon. Offerings such as WeWork will continue to have an advantage because they are frequently written about in the press and because they are...WeWork. Most interesting, though, is to ponder what comes next in the Late Majority phase of the cycle.

The Late Majority, Laggards, and the Future

Here we are speculating, but we are speculating with deep and long-standing industry knowledge. As we continue to liaise with real estate investors and property owners, we are seeing a new frontier in the industry. The opportunity, as is often the case in many industries, is for the late adopters. Sometimes, it's not the first movers or even the second movers who thrive in an industry. The WeWork Effect has proven to be both exciting and frustrating for traditional players in CRE. On the one hand, they see opportunity to



partner with coworking operators to upgrade the offerings in their portfolios. This makes sense because it is a necessary adaption, and their properties are given new life and become desirable destinations. In this they are able to lock down rents from coworking operators while increasing the value of their properties. There is, however, another and 'hidden in plain sight' dimension of the picture. Given the significant amount of revenue that the CRE industry cedes to successful coworking operators, they are leaving a significant amount of revenue on the table. Or, to put it another way, they are allowing the middleman (i.e. coworking operators) to capitalize on much of the financial scaling of the industry. This blind spot stems from a basic misunderstanding of how the world of work today relates to the world of work tomorrow.

The Unbundling Corporation:

Leases, Recurring Revenue, and (REIT) Dividends

For several generations the basic mindset/ model of the CRE industry has been to lock large organizations into long-term leases, which has made complete sense for quite some time. The default setting for leasing has been that each employee in a company is assigned to a fixed work station, so you can easily calculate a certain square foot footprint per employee and come up with the amount of space a company needs. When it enters into a lease, that recurring revenue becomes the basis on which REIT's (because of their preferred tax status) can pay such healthy dividends. In this equation, each employee's square foot footprint represents a small percentage of those dividends. Financing mechanisms for large office buildings require predictable revenues and cost structures, so the whole process becomes frozen in place. And thus, at this point in time, for the most part CRE sees coworking as coworking operators who are now capable of paying their rent. They still, for the most part, don't see, or don't want to see, the future.

What is missing from this perspective is that what we call coworking is no longer just about Millennials, freelancers, startups, and small teams. Large firms, themselves, are unbundling, and migrating to flex-work solutions,

address-less offices, Activity Based Work, and other processes that are accomplishing three powerful things simultaneously:

1. Radical reduction of real estate footprints (and costs)
2. Radical improvement in the quality of workspaces for the spaces that remain
3. Dramatic increases in choice and flexibility for knowledge workers

The implications for CRE are profound. The core demand for their products is changing. They will need to change too. Soon, gone will be the days when the old math works like clockwork. As long as real estate professionals think in terms of the past, which includes seeing coworking as a list of operators, they will remain behind the change curve. We are approaching a world of work where building owners and property managers will have to, like today's coworking spaces, present granular, modular, membership-based office solutions directly to their corporate customers. This will entail a massive shift in mindset, and quite likely many will take years and years to come around. This is why, according to Moore, they are called Laggards.

Turnkey Coworking?

When Coworking Becomes Work and Work Becomes Coworking

As we are seeing it, the next phase of the cycle looks like this. Slowly, floor by floor, building owners will, via new turnkey coworking solutions, convert their properties from being occupied by fixed, large tenants who need and want massive footprints (which they decreasingly do), to open, agnostic, membership-based, multi-company campuses that are used (and paid for) on a month to month basis. New, robust software platforms- building operating systems- will manage all of this. As we have already seen in the case of WeWork, when a place is designed in a certain way, and also has a sufficient amount of social atmosphere, a thriving 'coworking space' can actually out earn the standard lease rate of many buildings. In presenting coworking directly to their corporate clients (effectively bypassing the middlemen), certain functions and

costs arise. Buildings will need concierge and community management services, but this can be paid for out of the revenue that otherwise would go to a coworking operator. As it is anyway, property managers spend much of their time showing prospective tenants around buildings, much of which will be unnecessary activity in the future. These professionals can easily be (re)trained to run such enterprise-focused coworking spaces. Furthermore, and most importantly, not only can buildings earn more money by going direct to their customers, these are the very spaces that customers are increasingly demanding. Not only is this demand already being expressed, in a few short years Millennials will be the largest generation at work and they are clearly expressing a desire to work in a manner consistent with other aspects of the sharing economy.



The Transition

OVER TIME, THE MIXTURE OF PRIVATE OFFICES, OPEN SPACES, AND SHARED RESOURCES (KITCHENS, LOUNGE AREAS, ETC.) THAT WE NOW ASSOCIATE WITH COWORKING BUSINESSES, WILL LIKELY BE WHAT MUCH OF THE GENERAL OFFICE LANDSCAPE WILL LOOK LIKE.

This will be a massive transition- in psychology, design, financing, business model planning, management, etc. However, other than workspace/meeting space marketplaces like Liquid Space, CRE has yet to fully reckon with the enormous disruption that coworking actually represents. If one looks forward, rather than backwards, this is a huge opportunity. It will be challenging, to be sure, but also necessary, exciting, and full of new financial upsidess as well.

