CASTLEFORGE PARTNERS

September 20th 2017

To: Castleforge Partners Investors

From: Castleforge Partners

Re: London Serviced Offices

Haven't We Seen This Movie Before?

History never repeats itself exactly, but we often experience echoes of history where the characters are the same, even if the actors change. It is therefore often helpful to draw parallels to previous market cycles as a way to help us understand what may be happening now. For the London office market, we think we need look no further than the run-up to 2007.

There are three major players in today's real estate world that seem to us disturbingly similar to the three major players involved in the CMBS debacle only a decade earlier. First, serviced office providers such as WeWork, cast as the part of the very highly leveraged property owner; second, the London property developer, in the supporting role as the international investment bank; and third, the yield-obsessed investor as…well…the yield-obsessed investor.

First, a spoiler alert. It is our belief that serviced office providers such as WeWork are distorting the central London office market, making it seem healthier than it really is. Although serviced office occupiers represent 4% or less of the total space in the market, its impact is significant in the context of a finely balanced London office market with structural vacancy somewhere around the 5-6% territory. Like any very highly leveraged property owner, WeWork's model, as far as we can tell, involves it contributing very little, if any, equity into each new location, yet it captures the vast majority of the upside as rents improve. This moral hazard incentivises the company to ignore rental levels on the leases it signs (its cost base) as it expands, because having only a limited amount of skin in the game leads to decision-making that disregards downside protection. At the margin, the result is that WeWork can (and often does) pay the highest amount either to lease office space, or more recently, to purchase office buildings. This behaviour artificially inflates office market demand, and supports effective office market rents at unsustainably high levels given supply and demand fundamentals.

We do not mean to pick on WeWork in isolation. Any serviced office operator that can sign leases with virtually no upfront cost is similarly impacting the market. From what we understand, this includes the likes of The Office Group, London Executive Offices and even Regus. It just so happens that WeWork has been very active in a big way over the past couple of years. Moreover, there is nothing inherently wrong with WeWork's business model, especially in an environment of increasing rents. Of course, like any carry trade, the result will be different if rents move in the opposite direction. We would not dare to contribute

36 Dover Street, 4th Floor, London W1S 4NH | +44 (0)207 637 4335 | info@castleforgepartners.com

to the litany of critiques on asset duration mismatch – much like Hemingway's quip about bankruptcy, WeWork's model will work just fine, until it suddenly doesn't.

Let us not speculate over when the WeWork specific model might cease to work or cause a market correction in rents – to paraphrase another early 20th century thinker: the market can stay irrational for even longer than one thinks possible. More interesting than "when" are the questions of "how" and "why". What might be the catalyst for a rental correction and how might it play out? For that we need to take a closer look at the incentives surrounding the serviced office model typified by WeWork, and how it is strikingly similar to the model that seriously damaged the CMBS market a decade ago.

A Shifting Paradigm?

Let us begin by reviewing the characteristics of some of the more recent serviced office leases companies like WeWork recently signed, in London at least: (1) 15-20 years or more with extension rights, (2) minimum rent increases over time, (3) fit-out costs largely if not wholly paid for by the building owner, (4) another year or two of free rent either upfront or over the course of the first five years, and (5) sometimes a guarantee over the rent from the parent company for a period of 2-3 years that burns off completely or substantially after the first five years of the lease. We've heard worse in a few cases with other serviced office providers. In a few cases no parent company guarantee was provided for the SPV signing the lease, and in a small handful of cases, a serviced office provider was even given a share of the profits earned by the developer in any onward sale to an investor in exchange for signing up to an above-market rental level.

Under this sort of structure, serviced office providers like WeWork put virtually no money into each project, apart from some management time and marginal general and administrative expenses that hit the income statement. Instead, the developer pays companies like WeWork the equivalent of about 3-4 years' rent in value across free rent and fit-out costs. This gives the serviced office providers ample time to ramp up operations to full occupancy without spending very much if anything on the building. And, before the ink on the lease is dry, the developer tries to sell the building to a longer-term investor, who has become increasingly willing to pay normal investment capitalisation rates for buildings with WeWork leases, even where WeWork represents 50-100% of the total income.

So, what's wrong with this picture, if anything? Typically, an investor purchases a new building at a market-standard capitalisation rate from another investor or developer who leased the space to one or more occupiers on long-term commercial leases. What is the difference between a lease to, say, an international law firm or a major multinational corporation, and a lease to a serviced office provider such as WeWork? The law firm or multinational corporation's employees cannot function without the building itself. There, they will produce hundreds of millions or even billions of dollars of revenue each year. Meanwhile, over at the WeWork property, WeWork will sub-lease its space to other companies so that they can operate (perhaps also producing hundreds of millions or even billions of dollars revenue each year in aggregate). Nonetheless, what if the credit of the underlying occupier were as good or even better than the law firm? After all, WeWork has spun a wonderful story for developers and investors that its tenants include blue chip companies and that a growing portion are independent operating units of much larger companies that simply value the flexibility of having short-term "project space". Therefore, as the story goes, its credit is "as good as" Fortune 500 companies' credit. Could one then argue that it is appropriate to value a building leased to WeWork on a 20-year lease at a market-standard cap rate?

In our opinion, no. Valuing a building leased to WeWork at the same capitalisation rate as one leased to commercial tenants is a mistake, because it is not the credit of the ultimate occupiers of the space that matters the most. Diversity of income means that it is very unlikely that WeWork will be unable to service its rental obligations as a direct result of mass bankruptcies among its sub-tenants alone. Even in the dark days of the financial crisis, only a minority of occupiers could not actually pay their office rent. Instead, to continue to receive the lease income at the levels in the rental agreement (remember, investors bought the building off a certain capitalisation rate), investors are not depending so much on the credit of the underlying tenants as they are on the ability of the WeWork SPV having taken the lease to cover its cost basis (i.e., rent level) throughout the ups and downs of the real estate and economic cycles.

And therein lies the rub: if serviced office providers such as WeWork are signing top of the market leases in SPV subsidiaries, then investors cannot fully rely on them to continue to pay those rents over the course of the lease. Recall that after the initial free rent period burns off, the parent company guarantee will have reduced on many WeWork leases to only 1-2 years while some serviced office operators will have no guarantees at all. Meanwhile, serviced office providers put in virtually no money at the start of the lease, since the developer gave them most, if not all, of the fit-out costs, plus a period of no rent or reduced rent so that it could ramp up its occupancy in that location. At many locations, serviced office operators might even have a negative working capital position – a nice place to be if you're growing into larger and larger spaces as time goes on. In return for these significant concessions, developers got WeWork to sign a 20-year lease at a rent that has increasingly become the prime rent or even higher than the prime rent in fast-growing markets like London. And why are developers willing to do this?

Because the end investors are increasingly comfortable buying the WeWork leases at capitalisation rates that approximate market levels, as if WeWork were any other tenant.

However, this begs the question: is there really a rent at which WeWork or the other serviced office providers would not take a 20-year lease? And, where have we seen this "heads-I-win-tails-you-lose" model before that failed so miserably in recent history?

Echoes of 2007

An ex-colleague of ours used to marvel at the fact that his previous employer (a real estate developer) purchased a piece of unentitled land in 2007 for £40 million, only to watch its value fall to about 10% of the original purchase price by 2012. Would it surprise anyone to know that the bank provided over 100% loan-to-cost financing? In fact, the owner even borrowed the amount used to pay his own management fee. If someone had convinced the bank that the value was not £40 million but, say, £50 million, would anyone hazard a guess as to what the purchase price might have been so long as the bank was providing greater than 100% loan-to-cost financing? But the bank did not care that it provided such an absurd level of leverage. The property was intended for securitisation, a process that would clear it out of the bank's "warehouse" by packaging the property up as collateral for bonds held by some unlucky pension fund. The pension fund bought the bonds on the premise that uncorrelated property values would sustain the value of the bonds. However, in a world on the verge of financial collapse, correlation went to one, and the benefits of diversification disappeared. The model that was used proved incorrect when the underlying assumptions themselves failed to hold up.

No one in the production line of leveraged 2007-era real estate buying—neither the highly leveraged property owner who took on a 100% loan-to-cost obligation as a free option, nor the international investment bank desperately in need of "product" who made a loan destined for securitisation—cared much about the underlying collateral or about the borrower's ability to service its obligation. Indeed, the higher the interest rate charged the better for the bank, and the borrower of course did not mind, provided that it had no equity in the deal. And, to close the loop, some yield-obsessed investor was willing to buy the bonds based on a model where the underlying assumptions didn't match reality. Sound familiar?

If serviced office operators are now effectively getting 100% loan-to-cost financing to "own" a building for a period of over 20 years, is it any different from the highly leveraged property owner in 2007? Does anyone think that WeWork spends sleepless nights thinking about what rent it signs up to? Does the developer that grants the lease care? And in an environment where rents are increasing, does it matter (yet)? Tellingly, we know of a shrewd developer that signed up WeWork to a single-tenant lease over its entire property a couple years ago. This developer made its ability to sell the building on to an end investor a condition of the WeWork lease; the lease would not have completed if the developer found itself unable to get rid of the "product" in its "warehouse".

As further evidence, consider the most recent WeWork deal reportedly being inked at Shoreditch Exchange for a rent well into the £60s per square foot, the same level at which one could obtain space in Blackstone's newly refurbished 20 Old Bailey in the heart of Midtown London or Brookfield's brand new 100 Bishopsgate at the heart of City of London activity, thus rendering the rental gradient virtually dead, at least on the face of it.

But, as the bulls say: the market need not worry, we have gone through a paradigm shift in working habits. And, while this paradigm shift may in fact be unfolding it is irrelevant in this context, as the yield-obsessed investors are buying these buildings based on the flawed belief that it is the underlying credit of the WeWork sub-tenant that matters.

The WeWork Singularity

That leads us to ask the larger and more important question of what effect WeWork is having on the real estate market in London. Truthfully, if it were limited, then we could all say, "good for WeWork" and the other serviced office providers for creating a 100% leveraged real estate model, and get on with our jobs. But they are increasingly becoming a larger and larger share of the total market, with potentially destabilising effects. It is estimated that WeWork has taken close to 1% of the total space in the central London market over the past few years, and year to date serviced and flexible office providers are nearly 20% of the entire leasing market. Against a vacancy rate that hovers in the 5-7% territory for a market in balance, that is a lot. Indeed, a number of market participants believe that a vacancy rate of only 2% above or below the long-term average moves headline rents up or down and even smaller variations (about 1%) start to move the dial on tenant incentives. Plus, if you consider the fact that WeWork is in the market for a very specific type of offering—large, new or like-new floorplates or entire buildings—then WeWork is an even larger share of this product type.

True to their word, WeWork is taking leases at an increasing clip. Of the five largest leasing deals in the City and the West End in 2017 (at the time we compiled data for this letter), WeWork was #2 in the City at Two Southbank Place and #1 in the West End at 125 Shaftesbury Avenue. If you believe the press and include deals reportedly in the works at The Stage and

Shoreditch Exchange, then WeWork would knock Expedia and NEX out of the #4 and #5 City spots, as well. That would put WeWork's nearly 700,000 square feet at nearly 50% of all the top five deals done in the City office leasing market year to date. Total leases signed or close to signing by WeWork for this year across the whole central London market so far represent over 10% of the entire market, and around a third of the entire market when looking at only large leases over 50,000 square feet. This huge amount of space taken up, combined with a model that includes negative working capital and almost no upfront investment cost for serviced office providers, may be playing devilish games with the central London office market.

The serviced office dynamic is already evident in smaller buildings with floors below 5,000 square feet, which is enough for a business of about 50-75 people. We are aware of a building along Cannon Street recently purchased by a foreign investor after its comprehensive refurbishment by a developer. The investor paid nearly £1,000 per square foot on the assumption that market rents of approximately £60 per square foot would provide a 6% yield on cost, much better than a comparable purchase if the building had been fully tenanted. Ten months later, and only the top two floors have been leased while six floors still remain vacant (again, at the time we compiled data for this letter). Quoted rents have dropped in buildings like this, with likely dealing levels in the £50s. All the while, WeWork is busy signing leases not on Cannon Street, but a world away on Hackney Road, in the £60s per square foot, comfortable in the fact that not a whole lot of rent is payable for a while and all the upfront fit-out costs are paid for by the developer.

Nor is WeWork simply content with signing up to obligations at ever increasing rental levels. Now, instead of giving value over to developers who would then simply sell on the investment product to end investors, WeWork has decided to consolidate downstream into the distribution game with some of its own corporate equity investors, among others. In the sequel to the movie we've all seen before, WeWork and its related entities now star as both the leveraged investor and the pension fund, with no need for the local developer to play the part of the middleman. What is ironic is that those investors who think that they're going down the risk curve by becoming asset owners (as opposed to leaseholders) are actually going up the risk curve, since at least when they were investors in WeWork the operating company, they were getting a cut of WeWork's one-way option. Now, WeWork is offloading the other side of its increasingly unachievable lease obligations on to these investors, instead of whatever yield-obsessed investor wants to get its money out the door this month. 51 Eastcheap, a building recently purchased by WeWork, was well known for nearly a year to be available for purchase off-market. Most investors and developers in the London market steered clear of what was seen to be an overpriced asset sold by an owner with unrealistic pricing expectations, but, perhaps unsurprisingly, WeWork was able to make the numbers work with its new fund.

Things Fall Apart?

So how does it all unravel? London is a huge market of nearly 250 million square feet in the city centre. It would be inconceivable to think that WeWork could continue to eat up all the new space coming on to the market over the next couple of years without hitting its table limit. Cornering the London office market would likely be far too expensive if it wants to purchase its own properties. It could continue to lease ever more space since, as we have discussed, there is not much of an upfront cost to doing so. On the other hand, there are only so many new businesses, so doubling or tripling its footprint would require it to take on a larger share of the traditional real estate owners also looking to sign on new tenants or keep their existing ones. Just how long does anyone think the owner of our

Cannon Street example will wait before he starts to feel that an actual 4-5% yield is probably better than a merely theoretical 6% yield, and lowers his asking rents or puts in place his own serviced office operation? We can only speculate about what will happen to desk rates at WeWork if the company is forced to hunt for a larger target audience as its portfolio expands over the coming years, just at the time that its free rent periods burn off and fixed increases built into its already top-of-the-market leases start to kick in (at its Aldwych location, the rent is meant to increase after five years to a minimum blended level around £70 per square foot).

Cracks in the London office market are now starting to appear. In the past 18 months, the rent-free period provided by landlords for tenants to sign new leases has increased from 15-18 months to over 24 months on a 10-year lease, which has resulted in a net 5-10% reduction in effective rental levels. Tenant-controlled space available on sub-leases has continued to climb, from approximately 10% of the market a couple years ago to over 20% of the market today, according to BNP Paribas's latest reports. Because this space is available from tenants (not owners) looking to mitigate overhead costs from space they no longer need, and not necessarily to turn a profit, it is often offered at a steep discount to market rents in order to undercut space available direct from property owners.

Furthermore, the truly large additions to office supply start to come online in late 2018 going into 2020. Even though the amount of office space under construction in the central London market today is at one of the highest levels in the last two decades, according to Deloitte Real Estate's annual crane survey, market bulls point to the amount of space that is pre-leased (about half) to explain away the potential problems down the line. However, many tenants are simply playing musical chairs. Consolidation is the order of the day. Net absorption, a figure not quoted by the market, but which can be estimated based on building stock data, has probably been negative for the past eight quarters, even as "take up" (market-speak simply for leases signed) appears steady. That means that tenants are signing leases in newer buildings that are, on the whole, smaller than the ones they are leaving. Add to the mix the fact that the millions of square feet WeWork is leasing are not necessarily "taken up" by anyone. After a fit-out, the space comes right back on to the market in the form of hundreds of sub-leases to smaller tenants. Despite this, WeWork space is being included as positive net absorption in the statistics, meaning the already-negative net absorption figures are even worse than they appear.

A noticeable gap is arguably opening between the level at which WeWork is willing to sign leases and the level at which any other typical occupier will sign, especially in non-core locations. The market-distorting effects of WeWork may indeed persist longer than the typical value investor might expect. However, the more space that is delivered by developers into the London market to serve an artificially high level of demand driven by a company with virtually no downside to signing as many leases as it can at whatever rent asked of it, the harder the comedown will be for rents when this story ultimately unwinds. So, as the saying goes, is this time really different? The answer is actually "probably yes", but certainly not in the way London office owners and developers would have hoped for: this time around, the storyline will unfold in the context of that whole "leaving the EU in March 2019" thing.