CASTLEFORGE PARTNERS

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INCENTIVES MATTER: A WEWORK UPDATE

"I think I've been in the top 5% of my age cohort all my life in understanding the power of incentives, and all my life I've underestimated it. And never a year passes, but I get some surprise that pushes my limit a little farther."

- Charlie Munger, on the causes of human misjudgment

Our readers will know that we have been covering the WeWork story for a number of years now and that we have been sceptical, at least to the extent that WeWork's business model was a poor bargain for landlords and likely obscured a reduction in net absorption in central London that would have otherwise led to greater rental declines than we saw. So, the company's tribulations over the past few months came as no great surprise to us. We have, however, lived in England long enough so that you won't see us standing next to a huge "Mission Accomplished" banner. But if we were being slightly truer to our country of origin, the shameless victory lap would go right here.

There was certainly one thing that came as a surprise. We did not expect the "how" and "why" to it all falling apart to have been so self-inflicted. Some journalists have used the term "Death by S-1" – hurrah, the public markets work! WeWork's senior management and founders have been exposed for the jumble of conflicts of interest, self-dealing, lack of effective oversight and potential cases of fraud that plagued the company. And while these conflicts and mismanagement alone probably didn't bring the company down, they did bring to the fore a discussion on WeWork that highlighted some real risks, such as nearly $50 billion in future lease obligations, negative EBITDA and stalling growth.

FOLLOW THE MONEY

So, surely it is over now, and we can all go back to our normal lives investing in central London office buildings, right? Maybe not just yet, although we do think we are getting there. While the broader equity and debt capital markets may now understand some of the underlying problems with WeWork's business model, we think the property market may be slow in learning the right lesson from this whole saga.

Sure, it now appears clear that Neumann ran the company with almost no rules other than his own. Sure, SoftBank provided billions of cash to a company that lost more money than it brought in. Sure, personally owning a building and then leasing it to your own company is not the kind of thing a CEO of a $47-billion-dollar public company should be doing. But, despite its questionable judgement and governance, the fact remains that WeWork is still, in effect, a super-leveraged owner of non-cross-collateralised assets. What about all the other super-leveraged owners of non-cross-collateralised assets with fair judgement and fair governance that continue to operate without the same level of scrutiny?

I'm referring to, of course, any of the flexible office operators with the business model of taking long leases over buildings with very little, if any, equity contributed into any property. And why stop at flexible office operators? Why not include the litany of "tech-enabled" hotel or hotel-like brands taking leases over residential assets with a view to operate them for a profit, but with the same "heads-I-win-tails-you-lose" return profile? Readers may be asking themselves, "Are they attacking the entire asset-light model?" Certainly not. Asset-light operators whose incentives are aligned with those of asset owners, and who have real skin in the game, can create excellent and sustainable business models that reward both them and the owners of the assets they operate. Conversely, WeWork has been at the vanguard of an entire industry created around taking advantage of a general lack of understanding as to what a "lease" even means.

This then brings us to the fundamental point of this letter: certain business models are fundamentally unsustainable because one side takes on all the risk, while the other receives all the upside. That absence of real financial downside creates an environment where the latter is willing to grow as far and as fast as the former is willing to allow it. As we told readers two years ago, incentives matter, and the above structure is one where the operator is incentivised to go for broke with very little to lose. Once the wider property market wakes up to the fact that for the last five years at least, they have been participants (often knowingly, sometimes unknowingly) in a huge one-sided trade for asset-light operators, there could be a day of reckoning that will favour those who have not only the operational capability but also the capital to pair it with.

The lease model for flexible offices and residential-apartments-turned-hotels is certainly new, and, as with anything new, there are a lot of promises made, risks taken and unknowns shrugged off. We advise readers to follow the money. If you see a deal where one side is taking on virtually all the downside risk in order to receive a fixed return with none of the upside, but the other side is putting in none (or very little) of the money and getting all of the upside, then that doesn't strike us as a fair deal. In the long run, a business model that relies on one company making its money mostly by taking advantage of its suppliers' lack of understanding that they're being taken advantage of, is one that cannot last in its existing form throughout a full cycle.

A LEASE, IS A LEASE, IS A LEASE?

To illustrate the extent to which property market participants still do not realise the absurdity of this model, a recent anecdote proves illustrative. The investment director of a large London landlord recently came to see us in our office, and he noted that an investment deal he had been watching with WeWork as the main tenant was struggling on account of "problems with their IPO." In the very next breath, he suggested that he was, however, excited about the prospect of completing a lease on a separate asset with a WeWork clone. His apparent lesson there? Nothing was wrong with the WeWork-like lease model, only that WeWork was being publicly battered. How could he possibly believe that a WeWork clone – a less-established company with less brand recognition and a lower degree of value derived from network effects – on the same no-credit lease structure could have been an acceptable tenant for his own building?

We then asked him the following. Say you walked into a bank and told them that you, personally, had a great deal for them to finance. They put in all the money to purchase the building and contribute most, if not all, of the cost to fit out the space: 100% loan-to-cost financing. You wouldn't give them any personal guarantee, though even if you did there would be no material net worth and no positive earnings to back it up. In return, you pay them a fixed rate of interest, say around 5-6%. If things work out, you are fabulously rich. If they don't, you hand back the keys and leave the bank to sort out the mess. Sound good? His response: "When you put it that way, they'd probably tell me not to let the door hit me on the way out."

The lesson here, we think, is that when you spell out the incentives explicitly, follow the money and translate many of these asset-light "leases" into something market participants are used to, then they can more easily tell you whether or not the deal makes sense for both parties. It seems that somewhere between 2009 and 2019, some investors stopped caring about what a lease fundamentally is or what credit stands behind the lease.

That brings us to the next point: where elsewhere in the real estate market are investors doing any asset-specific credit analysis over long-term leases? Are there any analogues in real estate transactions of the past that would help us to understand how to assess long-term creditworthiness of these asset-light operators?

NO SCHOOL LIKE THE OLD SCHOOL

Of course there are! The hotel industry, probably due to its history of asset-light operators working with capital-rich owners, is often years ahead of the rest of the real estate industry and has already seen this play out. We'll look here at leases taken by two asset-light operators of hotels, Premier Inn and Travelodge. We'll then look at the world of sale-leaseback transactions, where this problem has also already been considered, to help guide our thinking over today's asset-light operators.

While both Premier Inn and Travelodge are operators of hundreds of hotels across the UK, operating in the budget space on an asset-light model, their fates could not have differed more widely during the global financial crisis. On the one hand, Premier Inn was reasonably selective about the locations where it chose to sign leases. Perhaps more importantly, because most leases were guaranteed by the TopCo, Whitbread PLC, it was cautious about the rents it was willing to pay. It was wary of signing up to leases at top of the market levels, knowing that in a downturn it would have to continue to meet these lease obligations, otherwise Whitbread would be responsible for Premier Inn's losses. Landlords could take comfort that even at discounted nightly rates during periods of market weakness, Premier Inn could turn an EBITDA at individual locations that could meet the lease obligations.

On the other hand, Travelodge was purchased in 2006 by a financial investor and was given the green light to expand the portfolio. In order to secure sites, Travelodge was willing to pay much more per key for a location than was Premier Inn, taking on a higher degree of risk. Its number of locations multiplied quickly, but by 2012 Travelodge ultimately had to enter a company voluntary arrangement (a type of insolvency proceeding in the UK where a company can voluntarily restructure its debt with its creditors). In an effort to return to profitability, nearly 50 hotels were slated to be closed and rents were sharply reduced across the portfolio until the restructuring was completed. Meanwhile, cap rates on various Travelodge assets moved out by hundreds of basis points relative to those of Premier Inn. So much for the secure 25-year "leases" the owners of Travelodge assets thought they were getting.

Moving to another historical analogue, investors have been engaging in sale-leaseback transactions for years and understand the inherent conflicts as well. A sale-leaseback essentially allows a company that owns its assets to obtain 100% of the value of its assets, often making a sale-leaseback structure more appealing to owners than conventional mortgage financing.

In a hypothetical sale-leaseback, Investor A buys real estate from Company B, who in return pays Investor A a negotiated rent. Company B will continue to operate its business at a profit. Typically, the real estate is integral to its business. In considering whether to purchase a sale-leaseback, Investor A should care about the following:

- Does the Company B TopCo owe the lease payments or is the payment owed through a subsidiary or service company? Is there a corporate guarantee by a profitable entity?
- How much of Company B's profit is made at this location after allocating overheads?
- Was the rent set at prevailing market levels? Does Company B make enough to cover the rental payments with cushion for falls in profit margins across multiple cycles?
- Will Company B suffer material business risk if it no longer occupied this real estate?
- What would happen in the event of Company B going bust? Would it be possible to repurpose the real estate for another user at minimal cost or is it highly specific to Company B?

In response to almost all these questions, WeWork and many other asset-light operators (i.e., Company B) would look awful in a sale-leaseback credit analysis by Investor A. In the typical asset-light operator lease structure, for most of the lease term an SPV guarantees the lease, quite often the unit economics of customer transactions at the leased location would suggest that the unit is loss-making when taking into account high customer acquisition costs, the rents are often top of the market or beyond in order to appeal to landlords in the operator's race to put flags down, and virtually none of the real estate is individually mission-critical to the operator (consider WeWork, which has 60 locations in London, some across the street from the other).

In terms of how asset-light operators perform in response to the final question, this is where a number of the operators differ.

DIFFERENT RISKS FOR DIFFERENT ASSET CLASSES

The comedian Mitch Hedberg used to say, "I like escalators, man. You know, because an escalator can never break. It can only become stairs." Hedberg's deadpan delivery of certain simple truths can be applied to any number of other situations. The biggest question that arises from the whole WeWork implosion is what sort of position landlords are in if an asset-light operator using a lease model fails to live up to its end of the bargain...if it "breaks."

In the residential space, like escalators, leases over residential apartments leased and operated by hotel-like operators can never really break down, they can only become vacant apartments. If these hotel-like operators were to leave at any time, there is minimal cost to return a well-appointed apartment available for short-term stays back into an apartment suitable for longer-term stays. The key ingredient here is the operating capability of the landlord. If the landlord has no in-house management capability or if the block of units is too small to interest a third-party multifamily operator to take over, then the hotel-like operator holds the upper hand. Otherwise, for example, if the leased apartments are 100 units in a block of 400+ operated by the landlord, then the landlord probably does. Incidentally, we as a residential landlord through our Ocasa operating platform we founded a few years back, should have the in-house expertise to be able to navigate the changes to the residential landscape in the years to come.

For offices, however, the joke is usually on the landlord. A WeWork fit-out beyond mechanical and electrical is not entirely useable by a new incoming occupier should a landlord need to take back the space and re-lease it. Even if a London owner were to bring in a third-party operator, say IWG's Spaces or Blackstone's The Office Group, there would be a significant re-fit cost. This is not altogether different than reflagging a hotel to a new brand with its own set of brand standards and room layouts aimed at a different set of target customers. The landlord would have a stronger bargaining position if it were to have the ability to self-operate the building as a flexible office, but that would require some serious upfront investment into building operational capability, and many WeWork landlords we know are not up to it.

Ultimately, when WeWork comes asking for a rent reduction, a landlord probably will be worse off signing a new 10-year lease at a rent likely lower than the original WeWork rent (as WeWork was signing top of the market leases in order to "win" locations) and having to give away 20% or more of the lease income in tenant incentives, rather than just giving WeWork even a 30% discount. Don't think for a moment that WeWork doesn't know this. In the spirit of never letting a good crisis go to waste, watch for WeWork to blame their need to re-trade a substantial portion of their landlords on the basis of a "one-off restructuring" to help extricate themselves from "that mess Adam left us in."

IWG (formerly Regus) already showed the market how this was done. Page 21 of IWG's 2014 Annual Report (and every subsequent annual report) notes that while the single greatest risk is represented by the financial commitments deriving from the portfolio of leases, "our leases are 'flexible', meaning that they are either terminable at our option within six months and/or located in or assignable to a standalone legal entity, which is not fully cross guaranteed." But would IWG really throw back the keys? After all, this would hinder its ability to sign new leases if landlords saw it as a bad actor, right? Have a look at pages 93, 94 and 95 in IWG's 2015 Capital Markets Day presentation: "This is not theory - in the last 24 months, we have successfully concluded lease renegotiations outside of the contractual renewal cycle in: Brazil, Russia, Portugal, Italy, Greece, Spain, and many other centres across the world." In the years since, IWG has signed hundreds of thousands if not millions of square feet in the UK market.

So with no upside beyond a fixed rate of return yet with all the downside, with a knowingly rotten deal in the context of analogous structures and with a poor relative bargaining position in the event things go wrong, what's a building owner to do with asset-light operators when unwilling or unable to do sufficient tenant and credit analysis?

IN FOR A PENNY, IN FOR A POUND

As above, because of its long history dealing with conflicts arising from such operating structures, the hotel industry has probably already found a solution: management contracts (or better yet, the owner-operator model if they are willing to invest the time and resources into it).

A management contract is one in which the owner retains a manager to operate the hotel for them and pays the manager a small percentage of hotel revenue and a larger percentage of operating profit as a fee in return for good management. Sure, the income profile under this structure is theoretically more volatile, but at least under this structure the hotel owner retains both the downside risk and the upside reward after the hotel manager takes its small percentage of the revenue stream.

We would therefore suggest that a management contract model is considerably more equitable from a risk/reward perspective, and one that should be explored by landlords. With Clockwise, a flexible office company we started a few years back, this is exactly what we aim to do. We are able to offer the ease and convenience of the flexible office product, a product most certainly in high demand by occupiers all across the world, but we are also able to capture for our investors all of the upside that the asset-light operators are trying to take for themselves.

But to anyone who thinks that a move towards management contracts will somehow save WeWork's current business model, we wouldn't be so sure. Again, we can look to hotels for a reason why we believe this is not the case.

In order to grow more rapidly, WeWork (and many other flexible office operators) has given up on smaller clients in an effort to capture a larger share of what is termed the "enterprise market" or clients with over 500 full-time employees. The clear benefit that WeWork brings to these clients is that clients can move from one building to another with ease, depending on how their needs evolve. But, as soon as WeWork switches from a lease model (where it virtually "owns" the entire portfolio) to a management contract model (where it works for different owners who are competing with each other), conflicts of interest will arise, as WeWork's duty of care will no longer be just to itself but also to the landlords for which it operates.

Take, for example, WeWork's leases over 125 Shaftesbury and Southbank Place in London. Two buildings, two different owners. In the current arrangement, WeWork pays the same amount to each building owner every year regardless of occupancy levels. The owners do not care who occupies their buildings so long as WeWork continues to pay rent. Facebook currently occupies WeWork's space in 125 Shaftesbury on a short-term (2-3 year) contract. If it were in Facebook's interest to move to Southbank Place for its own business needs, then it is in WeWork's interest to cater for that. However, if we now switch to a management contract, everything changes. Because it now owes a duty to the owner of 125 Shaftesbury, WeWork would be diminishing the value of that property by allowing Facebook to move to Southbank Place. It's the reason why hotel companies like Hilton often are prohibited from operating two identical hotel brands right across the street from each other (it's also one of the major reasons hotel companies are in a race to create similar but not identical brands).

We believe that a move to a management contract model would necessarily force flexible office operators to abandon or significantly scale back their aspirations to satisfy demand from enterprise clients, thus fundamentally undermining one of their major growth strategies.

A BRAVE NEW WORLD

The business model of leasing space to asset-light operators is relatively new to the real estate industry, at least in the multifamily and office asset classes. Landlords don't quite know what to make of the current market dynamics, which haven't been tested in a downturn or across a full cycle. Most will figure it out sooner or later, although many fingers will probably be burned in the process.

Real estate is an industry that loves to use heuristics and comparables as a guide for what to do in certain situations. "London office rents are always in a band of £X to £Y," "Shopping centres on good motorway junctions with good catchments are always a good bet," "25-year leases should be valued at Z cap rates," and so on. But investors now find themselves in unfamiliar territory with the rise of asset-light operators in new asset classes. How should the leases be valued? How should they view the company behind the lease? What is likely to happen in a downturn? Who holds the bargaining power in this relationship? How can they create a structure that is fair to both parties?

No one knows the precise answer to the questions surrounding the asset-light lease model in all its forms, but, as we know, incentives matter. So, follow the money! If the incentives created by a certain business model lead operators to take risks they otherwise would not dream of were they using their own money, then landlords shouldn't be so surprised when it goes wrong. And yet, despite the spectacularly public failed IPO of the poster child of the new model, it appears that many of the flexible office and hotel-like asset light operators are still getting the classic "heads-I-win-tails-you-lose" deal at the expense of their landlord partners. It would be difficult to see that lasting.

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