Assessing the Risk of Co-working Office Space

Flex Space May Bend During the Next Downturn, but It Won’t Break

The well-publicized trials and tribulations surrounding a potential public offering of WeWork, the largest co-working company in the United States, have reignited the debate surrounding the long-term durability of the flexible office space model. The focus on co-working space intensified further following recent remarks by Boston Federal Reserve President Eric Rosengren, who cited the rise of co-working space as “creating a new type of potential financial stability risk in commercial real estate.” These worries are not unfounded. Co-working firms, which typically take on long-term leases with property owners and re-lease the space on a short-term basis, would likely be especially vulnerable to the falling occupancy and declining rents that typically occur during a downturn. As tenants fail to renew the short-term leases, the loss of lease payments would also likely lead to a higher incidence of loan defaults. The growth of co-working space, however, has also likely moderated office construction during this cycle, possibly lessening overall CRE risk.

Worries about the rise of co-working space are not unfounded.

Overall, we doubt the growing share of co-working leases presents an outsized risk for commercial real estate or the financial system more broadly. While flexible office space represents roughly one-third of all new office leases over the past 18 months and total square footage has more than doubled since 2015, occupied co-working space is estimated to be just under 2% of overall inventory (Figure 1). Co-working companies have the largest footprints in San Francisco, Manhattan and Los Angeles, but are expanding rapidly in up-and-coming secondary markets such as Austin, Denver, Charlotte and Raleigh-Durham. But even in the largest and fastest growing flex markets, which tend to have a heavy presence of creative and knowledge-based industries such as tech, media, R&D and professional services, the ratio of co-working space to total inventory remains relatively low (Figure 2). Furthermore, U.S. banks do not appear overly exposed to commercial mortgages, and thus the fallout from a potential downswing would likely be contained within the office market. Today, commercial mortgages amount to nearly 11% of total financial assets in the U.S. banking system, which is not out of line in a historical context (Figure 3).

But we doubt it presents an outsize risk to the financial system.

Source: CBRE Research, CoStar, Inc. and Wells Fargo Securities

Special Commentary

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Figure 1

Flexible Office Space Inventory
Millions of Sq Ft (Left), Percent Penetration (Right)

Figure 2

Top Flexible Office Space Markets
Percent of Total Office Inventory

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A recession would pose several challenges to the co-working model.

Even though there is less exposure than widely thought, the next recession may not be particularly kind to the co-working space model. During the prior two recessions, employment in “office-using” sectors fell relatively further than overall employment, reflecting the deep cutbacks in the tech sector following the long 1990s expansion and massive job losses in financial services following the housing collapse (Figure 4). Co-working tenants predominantly include categories of workers which tend to feel the negative impacts of a recession early, such as startups, freelancers and entrepreneurs. A downturn would also halt the vast amount of venture capital flowing into startups, which would evaporate the primary wellspring of funding on which they depend.

Still, even if the flex office model bends during the next recession, it likely will not break. While WeWork and Regus rank as two of the largest co-working companies, there are over 200 other small and mid-sized operators such as Impact Hub, Convene and Knotel. Co-working space provides just-in-time office space, which enables both new and established firms to gain efficiencies by acquiring work stations and meeting rooms on an as-needed basis. Additionally, the average space per chair in a flex office is estimated to be 60 square feet, considerably smaller than the 194 square feet in the traditional office layout. A more open and collaborative working environment with streamlined technological and business services only adds to the potential productivity gains.

By offering a suite of amenities such as beverage service and access to gyms, restaurants and retail, flex offices also provide creative ways to attract and retain younger workers, a segment growing in importance as more Baby Boomers exit the labor force. Moreover, even large organizations such as Microsoft, KPMG and IBM are beginning to see the benefits of the flex office model, which allows firms to gradually expand into new markets without making long-term commitments. This may serve to limit the downside risks of a downturn. Mitsubishi UFJ Financial Group recently leased enough WeWork space for 300 fintech employees in Charlotte, which allows it to immediately focus on hiring and more quickly ramp up its operations.

The office market currently appears balanced and should be able to withstand a run-of-the-mill downturn.

As with most real estate innovations, we expect co-working space will likely be on the front lines of the next recession. The co-working and real estate service business model, however, is unlikely to go away anytime soon. Slightly higher overall office vacancies and slower rent growth in tech-driven gateway and secondary markets, where flex operators have been rapidly expanding, would likely occur during a recession. The greater challenge for the office market would be a more pronounced slowdown in employment growth, and thus demand for office space in general. That said, new office development has been restrained, partly due to the increased use of co-working space, which has proven more efficient for both established, large users of space and new startups. The overall office vacancy rate which hit a cycle low of 9.6% in the second quarter. Even with a slowdown, the office market appears balanced and should be able to withstand a run-of-the-mill downturn.