

September 27, 2019

## Dear Clients and colleagues:

The saga at WeWork continued this week. Rather than being a negative indicator of the coworking concept as a whole, we believe the problems are more internal issues at WeWork, and the recent rash of unprofitable unicorn initial public offerings (IPOs) that subsequently traded below their IPO price isn't helping matters.

Coworking, or flexible working, can be beneficial for individuals, start-ups, small and medium enterprises and large corporations alike. Using national or global networks of office and meeting spaces enables large multinationals to operate in markets as needed, allowing them to be closer to customers and suppliers without spending capital on a permanent location. An added bonus is the ability to add or subtract locations as needed. Smaller enterprises, start-ups and even freelancers leverage the same coworking networks as large corporations but they benefit even more from (1) flexible leases with short lead times and no set-up costs, and (2) access to support staff and equipment, which alleviates the need to employ extra staff or make capital-consuming equipment purchases. It is estimated that up to 30% of corporate real estate portfolios could be flexible workspaces by 2030. According to CBRE research, flexible office markets are growing at 13% per year, while Forbes estimates that the coworking market is growing at 24% per year.

With that in mind, and despite WeWork's difficulties, we continue to believe that coworking can thrive, and as such we feel comfortable holding IWG plc in our portfolios. IWG was founded in 1989 (at odds with WeWork's claims of having a significant first move advantage) and has a global presence with workspace locations in 110 countries at 3,300 locations across 1,000 towns and cities. This is in contrast to WeWork's geographic concentration in 111 cities in 29 countries, with a focus on New York, San Francisco, Los Angeles, Seattle, Washington D.C., Boston and London. These are all expensive markets, which means WeWork pays a lot more per square foot for locations than IWG.

As well as geographic concentration, WeWork has been taking on longer lease obligations than IWG, with an average lease term of 15 years. The idea is that WeWork, like all coworking and flexible working space operators, pays less for longer-term leases and then sublets the space to companies willing to pay higher rents for the flexibility of short-term leases. However, the longer duration has an increased risk profile during an economic downturn because companies are typically looking to shed office space, and this makes it hard for coworking and flexible working operators to cover the long-term lease payments.

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IWG was in this situation after the dotcom bubble burst, and its US operations filed for bankruptcy as companies moved out of its locations on a massive scale. Part of the problem was that IWG rented entire locations to single companies, something that it now makes an effort to avoid. Also, IWG now inserts clauses into many of the leases it signs regarding early termination, reduced rates and similar provisions to minimize losses in the event of a recession. It is unclear if WeWork has used the same prudence in its lease obligations. In addition, it has been reported that WeWork has put a hold on any new lease deals in the US in an effort to cut costs, which could in turn put the brakes on future growth.

IWG is best known for its Regus brand and has a similar amount of workstations as WeWork at slightly over 600,000. The main difference is that Regus has office suites whereas WeWork has communal offices. This means that WeWork can fit more workstations into each location and therefore generate higher revenue per location. However, IWG also has a coworking subsidiary, Spaces, which is expanding rapidly and operates locations very much like WeWork.

WeWork has been growing more quickly than IWG and generates almost the same in revenues. Yet this growth has come at a hefty price. IWG made an operating profit of £148.3 million on revenues of £1.3 billion in the first half of 2019 whereas WeWork declared an operating loss of \$1.37 billion on revenues of \$1.54 billion in its IPO filing.

This year IWG has shifted its focus to a franchising model that it believes could create significant value for shareholders and enable the company to continue to grow without having to invest as much capital.

In April IWG sold its Japanese operations for £320 million and entered into a franchise arrangement whereby the 130 flexible working centres will be operated under the IWG brand. In August its Taiwanese operations were sold to the same company. While the deal was much smaller, it confirmed the validity of the strategy and interest shown by potential partners.

IWG hopes to expand to 30,000 locations, and the franchise model will help it achieve this target more quickly. The company expects that eventually all operations will be sold to franchise partners. The multiple paid for the Japanese operations should not be taken as a target for the remaining operations. IWG wants to ensure it has the right franchise partners that will help the company grow, not just run the existing locations. The focus is on accelerating growth to build out full, multi-brand coverage across all markets.

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The WeWork IPO also highlighted governance shortfalls at the company that are too numerous to go into in detail in this commentary, but they have left WeWork scrambling for solutions to appease investors. On the other hand, IWG can point to solid and established ESG practices.

Despite WeWork's failings, the talk around its IPO did bring the concept of coworking and flexible working into the public eye. With more sales to franchise partners expected, we believe IWG will continue to create shareholder value and a potential multiple rerating.

Have a great weekend.

The Global Alpha team

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