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New Competition for 'Co-Working' Model

WeWork rivals pursue office-sharing setups that are more like hotel chains

By
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The business model behind the co-working craze is falling out of favor.

Until now, fast-growing co-working providers such as WeWork Cos. have generally stuck to a buy low, sell high financial model.

In short: They sign long-term leases for office space they then refurbish, divide into incubator-like smaller spaces and rent out at high rates a month at a time.

This practice carries much risk given its high fixed costs: rent to landlords. But it also can create hefty profit margins during good times. That promise has propelled WeWork to a nearly $17 billion valuation.

Now hundreds of millions of dollars in investment is flowing into WeWork competitors pursuing models more akin to hotel chains, where landlords pay co-working operators a fee and keep most of the profits. That moves the risk away from the startup co-working companies and back toward landlords.

The traditional approach "is just a fundamentally high-risk model," said Duncan Logan, chief executive of RocketSpace.

Five-year-old RocketSpace is focused on co-working for tech firms, with a home base in San Francisco and another on the way in London. In August, it announced $336 million in investment from Chinese financial giant HNA Group, an infusion that will help it expand to at least 12 locations in the next one to two years, Mr. Logan said.

Generally, the company intends to be an operator of the spaces that would take a fee, with landlords responsible for much of the cost of building out the space and collecting much of the upside as rents go up.

Mr. Logan acknowledged the large margins of the arbitrage model make the operating model "not as attractive" by comparison in the short term.

"But if you're doing the math over two cycles," he said, "it's a far better return, because you don't go bust."

The appeal of the arbitrage model is its potential for profit. But WeWork has existed only during an expanding economy, leaving many to worry how it would handle a recession, when demand for space decreases but costs remain the same.

WeWork has said its margins are generally more than 40%, not including build-out expenses, and are large enough to withstand a downturn. It is pursuing operating agreements here and there, most notably in India, and it has some profit-sharing agreements in the U.S. with landlords.

Still, it would be difficult for WeWork to pivot much away from arbitrage given that the company's weighty valuation in large part depends on its current model, with its plump margins.

The operating model also faces some headwinds. It may be harder for landlords to secure a mortgage, for instance, because banks prefer to make loans for buildings that have tenants with long-term leases.

Another co-working startup, Serendipity Labs, thinks franchises are the key to fast growth. Under its model, franchisees pay a fee to be part of the Serendipity family, then build locations in the mold espoused by the company—not unlike a franchised McDonald's restaurant.

The franchisees, who can lease space themselves or use buildings they own, pay for much of the cost of construction, allowing Serendipity the ability to grow quickly without raising hundreds of millions of dollars itself.

In all, franchisees and their investment partners have committed to putting in about $100 million based on deals struck or being negotiated right now, said John Arenas, the company's founder and a veteran of serviced office space giant Regus PLC, an early pioneer in the lease arbitrage model.

Many of the franchisees to sign up thus far come from a different corner of the real-estate world: the hotel sector, where franchising is commonplace.

"There were so many commonalities," said Scott Somerville, a hotel developer and operator who is president of Renascent Hospitality. He has signed on to set up four or five Serendipity locations in the Columbus, Ohio, area. "It's a hotel without the guest rooms."

Another co-working company vying to be a more buttoned-up alternative to WeWork, Industrious, sees operating deals as a big part of its future. Jamie Hodari, the company's co-founder, said Industrious expects to have 31 locations by the end of 2017, a third to half of which are under operating agreements and the rest traditional long-term leases.

"The era when the engine of the industry was buy by the pound, sell by the ounce," he said, "that's gone away."

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