Will Co-working Work?

The press has been all over the sale of New York's mothership store of Lord and Taylor to a new CoWork flexible workspace startup. On the surface the transaction does seem to perfectly reflect the changing times. Retail space is in duress because of competition from the internet, and everyone loves technology enabled "disruptive" ideas – which flexible workspace seems to represent.

The CoWorking Potential:

The basic business proposition of CoWorking is that companies want to forsake their larger permanent office complexes, and instead pay for their workers to move into flexible smaller spaces, at a variety of locations, with flexible hourly use. The first premise of CoWorking is that it can provide this type of space to companies at an overall lower occupancy cost to traditional 24-7 longer term leasing.

The CoWorking model effectively creates a "service provider" who operates as an intermediary between the landlord and the ultimate tenant. Potential cost savings exist as long as corporate tenants currently do not need office space full time at a constant location. Take the case where workers in one corporation (A) need space every morning, but then are on the road after lunch. In in another corporation (B) space needs are exactly orthogonal – occupancy every afternoon. Currently both companies lease space full time say for $1. Enter a "service provider" who can pair these two and "hotel" them in the same space. Doing so allows them to keep this space occupied 100% of the time. In this case they could pay the landlord the same $1 as he was originally getting from either company with a full time lease, then charge each of the part-time tenants only 75% of what they were paying for that full time space, pocket a huge 50% profit, and still save both company A and B 25% on their year around occupancy costs per worker.

This same hoteling advantage can also operate across locations. Suppose company A needs its workers on the West side of the city 3 days a week and on the East side 2 days. If CoWorking can identify a company B that needs the opposite, it again can provide "hotel offices" at lower cost to the companies, make a profit and leave the landlord equally happy. The trick of course is in both situations CoWorking keeps the space continually used while space with the traditional model has lots of empty down time.

A little economic introspection reveals that for CoWorking to be successful and replace traditional company occupancy practices, 3 equilibrium conditions must hold in the office market.

1. CoWorking service providers must be able pay at least as much for space as traditional company occupancy in order to acquire it from landlords.

2. Then CoWorking providers have to rent that space at a part time or hourly rate to (relocating) corporate tenants that is higher than the full time rent they pay landlords for it - in order to operate a viable business. This rent differential can be less only to the extent they are successful at keeping space continuously occupied through hoteling.

3). The higher rent they charge for part time occupancy must be less than the corporations were originally paying for full time space. Hence lower occupancy costs per worker.

These conditions can be true only if the CoWorking service provider can keep offices occupied at significantly higher rates than traditional corporations can.

In addition to higher effective occupancy, two additional issues have to be considered in order for CoWorking to dominate traditional office occupancy. First, the workers have to be happy enough in their new part time space so that they do not ask for higher wages. Recent experiments at the University of Chicago actually show that while workers most often prefer workplace flexibility – they are not willing to accept lower wages for it[i]. Second, it should be the case that having workers operate more independently (both spatially and temporally) will not lower (and possibly boost) overall labor productivity. Here there is very mixed empirical evidence. Breaking up a unified corporate workforce into a set of smaller remote teams, runs afoul of Nobel Prize winning arguments about the limits of contracting and the boundaries of a "firm". [ii].

It's tempting to think that Technology may have altered these traditional economic arguments for why working "together" is superior, but the recent and now rapidly fading corporate interest in working-at-home suggests perhaps otherwise[iii].

The CoWorking Business Model:

While Co Working has the potential to raise property income through greater effective occupancy, it also has the potential to impact the risk associated with that rental income. Traditional leases tend to be longer term, are quite secure, and generally can be broken only in the advent of firm closure or bankruptcy. So the first question is whether the income from a CoWorking intermediary is more or less risky than that from a traditional lease. Landlords will want higher rent from a CoWorking lease if it's perceived as having more risk and vice-versa. Currently I see two risk issues with CoWorking income in terms of its risk.

If the economic shocks received by companies A and B (above) tend to occur at different times then space that hotels both of them may well involve lower rent risk from "economic diversification" - than that from a single full time tenant. With high correlation between the business fortunes of tenants, then this diversification has less value.

The second risk issue concerns "term-mismatching" between the CoWorking–landlord lease and that between the end user and the CoWorking service provider. CoWorking companies are not just hoteling space to different end-users, but they are leasing this part time space on much shorter terms than they are leasing the space from the landlord. This strikes me as a potential problem and takes me back to S&L lending during the 1970s and 1980s. Back then, largely independent banks were lending out money at long term fixed rates (mostly mortgages) and raising that money with short term rates on deposits. With economic cyclicality, these banks continually experienced trouble: their revenue was largely fixed from mortgage lending, while their costs fluctuated considerably with short term rates. Not good.

CoWorking today seems to be playing a similar game: leasing large blocks of space under long term contract, and then re-leasing it out in much smaller parcels - with short term contracts. That means that it has a largely fixed long term liability backed by revenue which is far less certain. If any of a host of things go wrong with the office market they could be a host of trouble.

So the jury is a long way from coming in on this disruptive idea. If CoWorking service providers can successfully hotel space (obtain near to full time effective occupancy), do so with diverse tenants, and better match those lease terms with what they pay for space, then they may in fact have found a better mousetrap. On the other hand, if they fail to boost effective occupancy, rent to tenants who share mainly common risks, and using short term flexible leases I suspect they could turn into a passing fashion.

---

[i] https://scholar.harvard.edu/files/pallais/files/valuing_alternative_work_arrangements.pdf
[ii] https://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2009/williamson_lecture.pdf
[iii] https://qz.com/1032085/is-working-from-home-really-more-productive/