A LEVERED BET ON FLEX DEMAND: VALUING THE WE(WORKS) IPO!

Is there a we in WeWorks?

The WeWork IPO

- A Big Deal: In a year full of high-profile IPOs, WeWork takes center stage as it moves towards its offering date, offering a fascinating insight into corporate narratives, how and why they acquire credibility (and value) and how quickly all of that can be lost, if markets lose faith.
- Slip, sliding away: When the WeWork IPO was first rumored, there was talk of the company being priced at $60 billion or more, but a news story today reporting that the company was looking at a drastically discounted value of $20 billion, which would make Softbank, the most recent VC investor in WeWork, an big loser on the IPO.
- My personal bias: I have never liked the company, partly because I don't trust CEOs who seem more intent delivering life lessons for the rest of us than about the businesses they run and partly because of the trail it has left of obfuscation and opaqueness.

The WeWork Model: Set Up

- An old model? Unlike many other tech disruptors, the WeWork business model is neither new, nor particularly unique in its basic form, though access to capital and scaling ambitions have put that model on steroids.
- Which has not worked: That said, most traditional real estate companies that have tried the WeWork business model historically have abandoned it, for micro and macro reasons
- The Test: of the WeWork model is whether the advantages it brings to the table, and it does bring some, can help it succeed, where others have not.

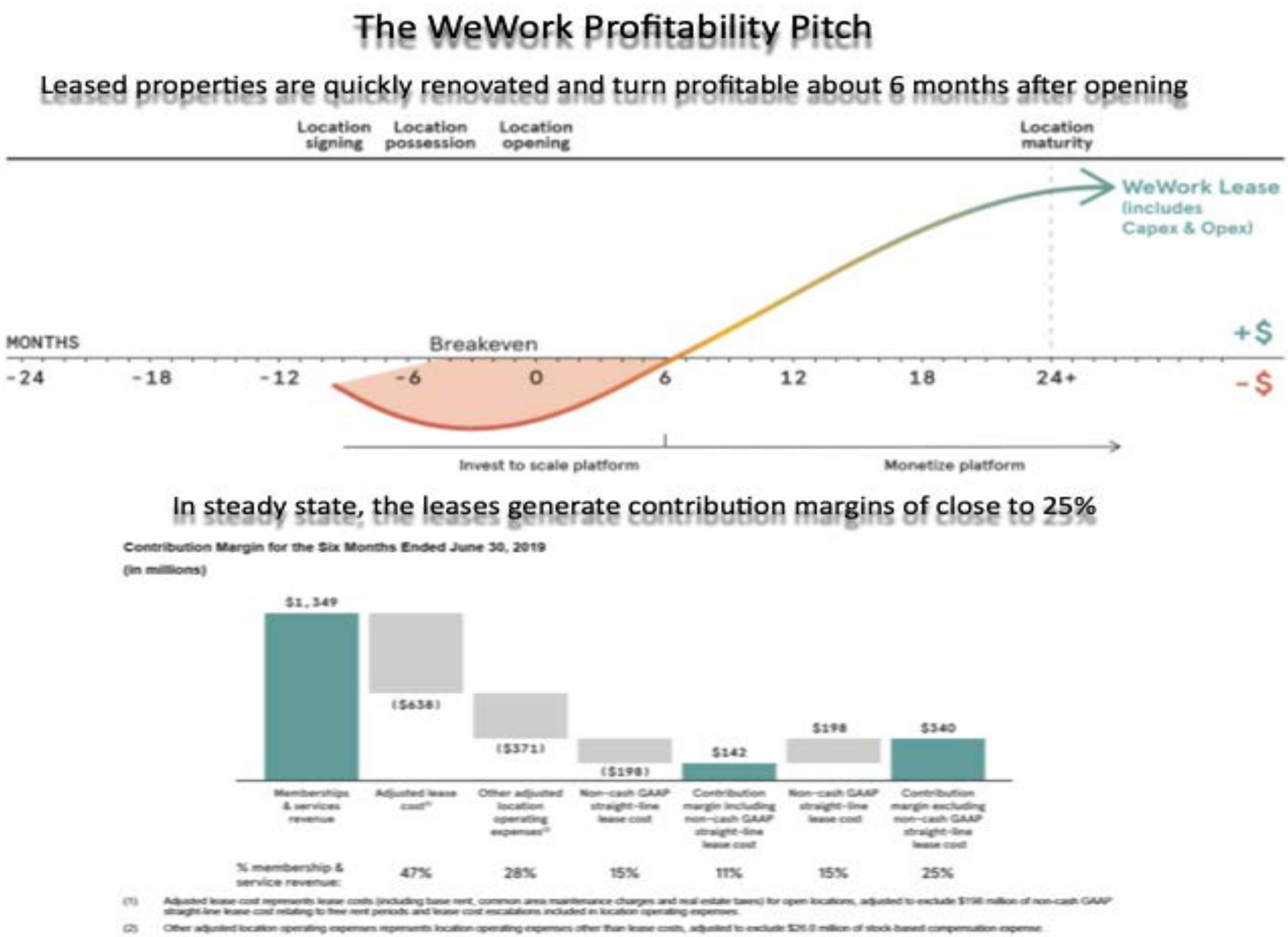
The Office Space Business: Status Quo

- Own and lease: The owner of an office building, who has generally acquired the building with significant debt, rents the building to businesses that need office space, and uses the rent payments received to cover interest expenses on the debt, as well as operating expenses.
- Sensitive to economic shocks: As economies weaken, the demand for office space contracts, and the resulting drop in occupancy rates in office buildings exposes the owner to risk.
- The keys to success: Buy buildings when real estate prices are low and secure their tenants into long term leases when rental rates are high. Use the buffer to protect against downturns.
- Boom and bust: Even the most successful real estate developers have been both billionaires and bankrupt (at least on paper), at different points of their lives.

The WeWork Twist

Step	Sign	Build	Fill	Run
Key Objective	Find location	Refit building to reflect WeWork sensibilities	Build occupancy rates	Maintain occupancy
Actions	Sign lease	Renovate building Initiate marketing	Find and sign new tenants (members)	Maintain building and replace tenants who leave.
Consequences	Lease commitments start	No revenues, but selling costs begin, with substantial cap ex costs.	Revenues begin and grow, as building fills, as do operating expenses.	Revenues stabilize and operating margins improve, as economies of scale kick in.
Financial question	How big is the debt load (from leases) that the building will carry?	How big are the pre-opening costs?	At what occupancy rate does the building break even?	How much, and quickly, do margins improve?
Value Drivers	1. Find desirable locations 2. Keep lease costs low & lease terms flexible.	1. Keep constructions costs low & finish renovations quickly. 2. Market effectively, creating pre-opening excitement & early sign-ups.	1. Fill occupancy quickly 2. Get higher rental revenues 3. Over longer rental periods.	1. Retain existing tenants & fill vacancies quickly. 2. Control building costs.
Company's self-described competitive advantage	Superior location choices, finding buildings in tight real estate markets where demand for flexible space is high.	Economies of scale keep costs and construction time low. Company brand name help attract client attention.	Blend of flexibility & desirable features help fill vacancies quickly, and with high rental rates.	High retention rate reduces vacancies (and costs of filling them).

The WeWork Pitch



An Example

The Building

600 B Street is a 359,000 square foot building in downtown San Diego that was built in 1974.

It was sold for approximately $100 million in 2017, up from $49 million in 2012 and $6 million in 1995.

WeWork leased about 88,273 square feet of this building on a long term lesae, though the lease payment and tenor are not public information. Applying $30/year per square foot, on the low end of SD's downtown rates, the annual payment would be $ 2.65 million

The WeWork Reno

WeWork spent money renovating the space and adding both more flexible space structures and coolness touches (Taco Tuesday, terrace, community bar etc.) . Renovation cost and time frame unknown.

WeWork created roughly 1700 work spaces in the structure and opened for rentals in December 2016.

The Flexible Rental

Private Offices From $660 /mo

Private, lockable, and secure office space to accommodate teams of all sizes.

Learn More

Dedicated Desks From $470 /mo

A desk of your own in a shared office. Set up a monitor or bring a plant; it's your space.

Learn More

Hot Desks From $370 /mo

Access to open workspace in the common area. Bring your laptop, pick a spot, and get to work.

Businesses and individuals can rent space out in units, with discounts for larger numbers, for short or longer periods.

The Model Trade offs

- The Pluses
  - The *WeWork look*, with open work spaces, cool lighting and lots of extras, which appeals to younger workers. It goes beyond cosmetics, also offering business networking, support services and consulting connnections.
  - The *WeWork community*, where the company supplements its cosmetic features with add-on services that range from business networking to consulting services and seminars.
  - Offer of *flexibility to businesses*, especially valuable at young companies that face uncertain futures but also for established companies that are experimenting with alternate work structures.
- The Weakest Links
  - High leverage, first in the long term lease commitments on buildings, and next in operating expenses in each building.
  - A timing mismatch, where the lease payments are for many years into the future, but its rental revenues are short term.

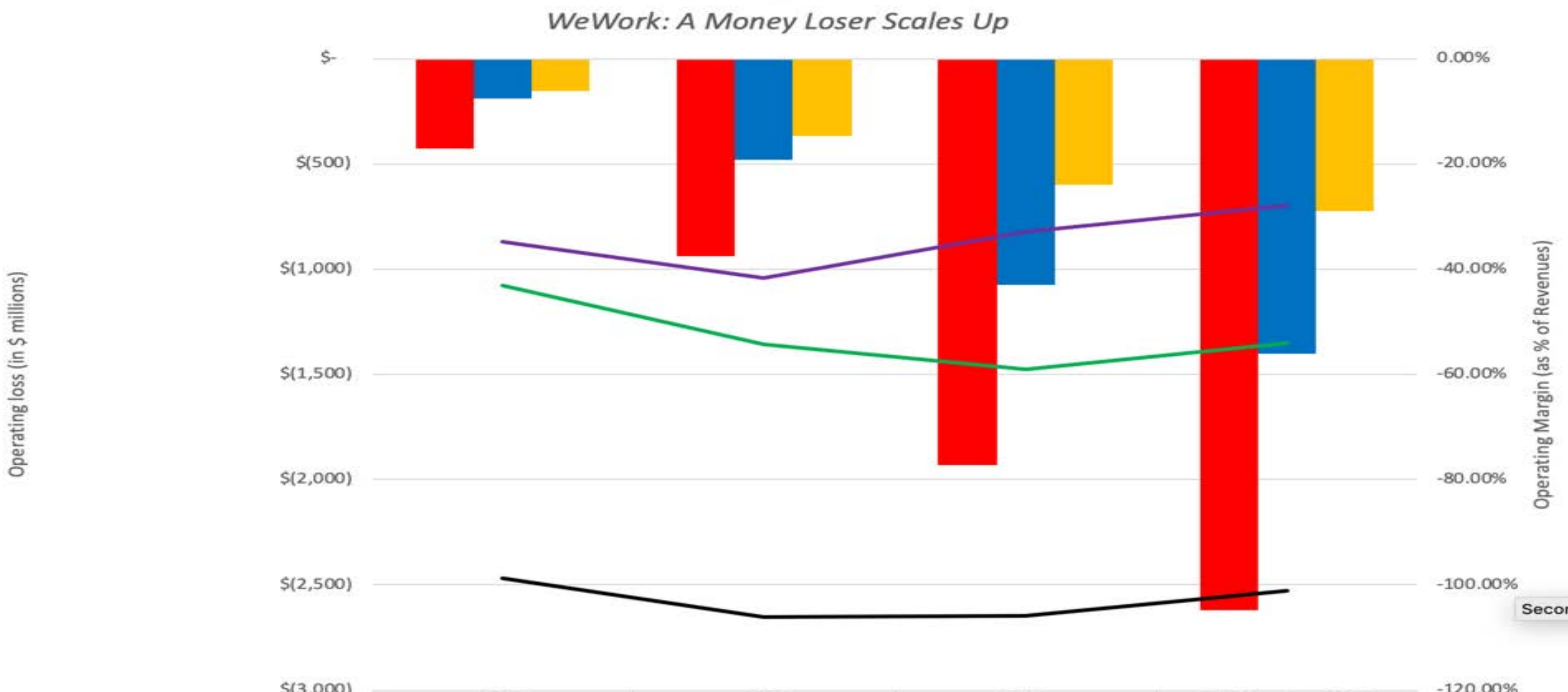
Why WeWorks is more exposed than most..

- Own versus lease: Buying comes with two advantages over leasing.
  - You can decide how much equity to use in buying, allowing you to reduce your financial leverage, if you feel exposed.
  - Second, if the property value rises after you bought it, the equity component builds up implicitly, reducing leverage.
- Explosive growth: WeWork does not just have a mismatched model, it is one that has scaled up at a rate that has never been seen in the real estate business, going from one property in 2010 to more than 500 locations in 2019, adding more than 100,000 square feet of office space each month.
- Tenant Self-selection: By specifically targeting young companies and businesses that value flexibility, the company has created a selection bias, where its customers are the ones most likely to pull back on their office rentals, if things start to look bleak.
- Lack of cost discipline: The survivors of this mismatch try to keep fixed cost commitments low and adjust quickly to changes in the environment. If WeWork is following this practice, its prospectus seems to contain no mention of it.

The WeWork Back Story: Let's start with the good news

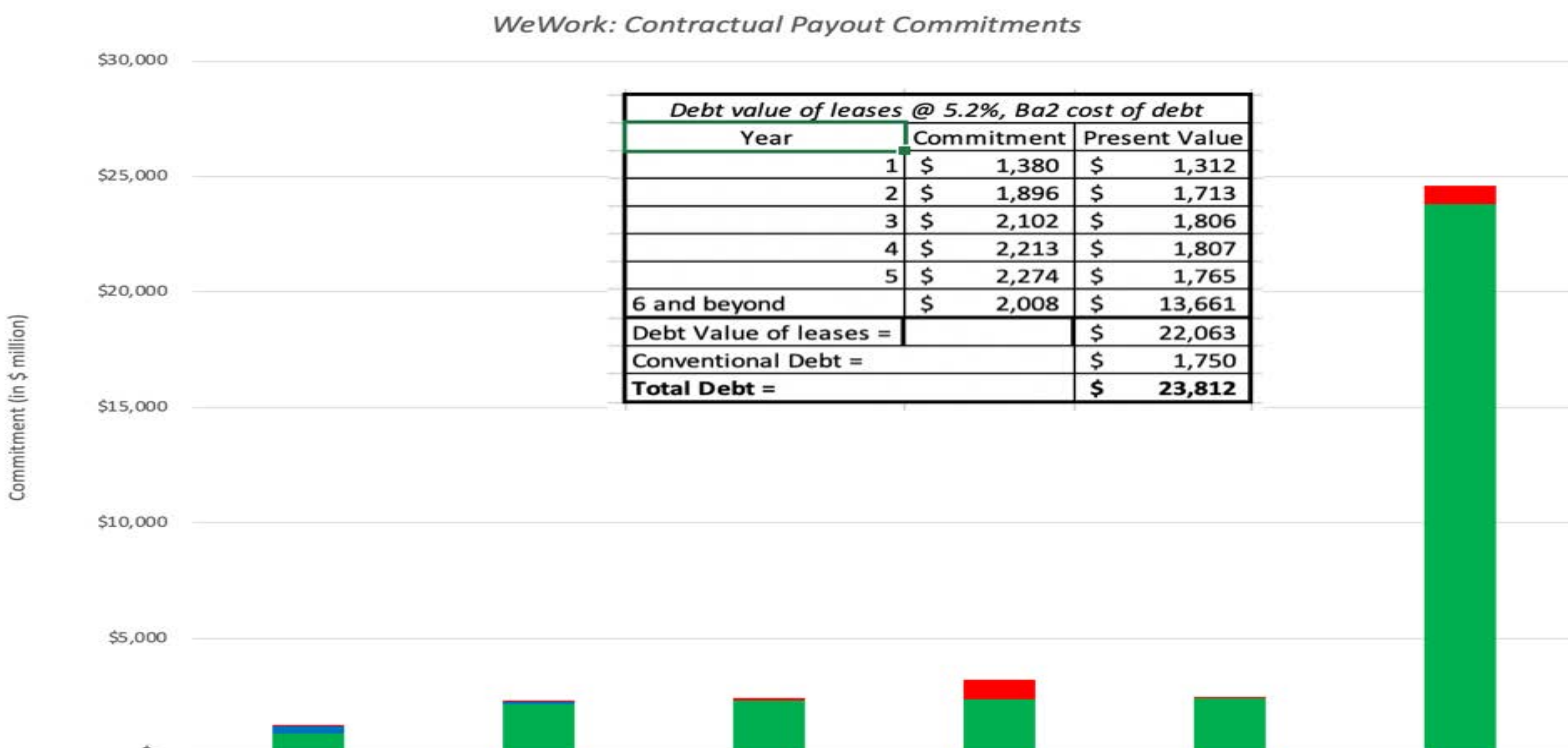
	2010	2012	2014	2016	2017	2018	Jun-19
Revenues ($ millions)	$9	$31	$101	$436	$886	$1,822	$2,593
Members/Tenants ('000s)	0.5	4.0	15.0	87.0	186.0	401.0	527.0
Cities	1	3	8	34	65	100	111
Locations	2	7	23	111	203	425	528

And the bad news is..



	2016	2017	2018	LTM thru June 2019
EBIT	$(430)	$(939)	$(1,929)	$(2,620)
EBITR	$(188)	$(480)	$(1,077)	$(1,399)
EBITR & Pre-opening Exp	$(152)	$(370)	$(600)	$(726)
EBIT/Revenue	-98.62%	-105.98%	-105.87%	-101.04%
EBITR/Revenue	-43.12%	-54.18%	-59.11%	-53.95%
EBITR& Pre-Opening Exp/Revenue	-34.86%	-41.76%	-32.93%	-28.00%

With leverage magnifying everything…



Debt value of leases @ 5.2%, Ba2 cost of debt		
Year	Commitment	Present Value
1	$ 1,380	$ 1,312
2	$ 1,896	$ 1,713
3	$ 2,102	$ 1,806
4	$ 2,213	$ 1,807
5	$ 2,274	$ 1,765
6 and beyond	$ 2,008	$ 13,661
Debt Value of leases =		$ 22,063
Conventional Debt =		$ 1,750
Total Debt =		**$ 23,812**

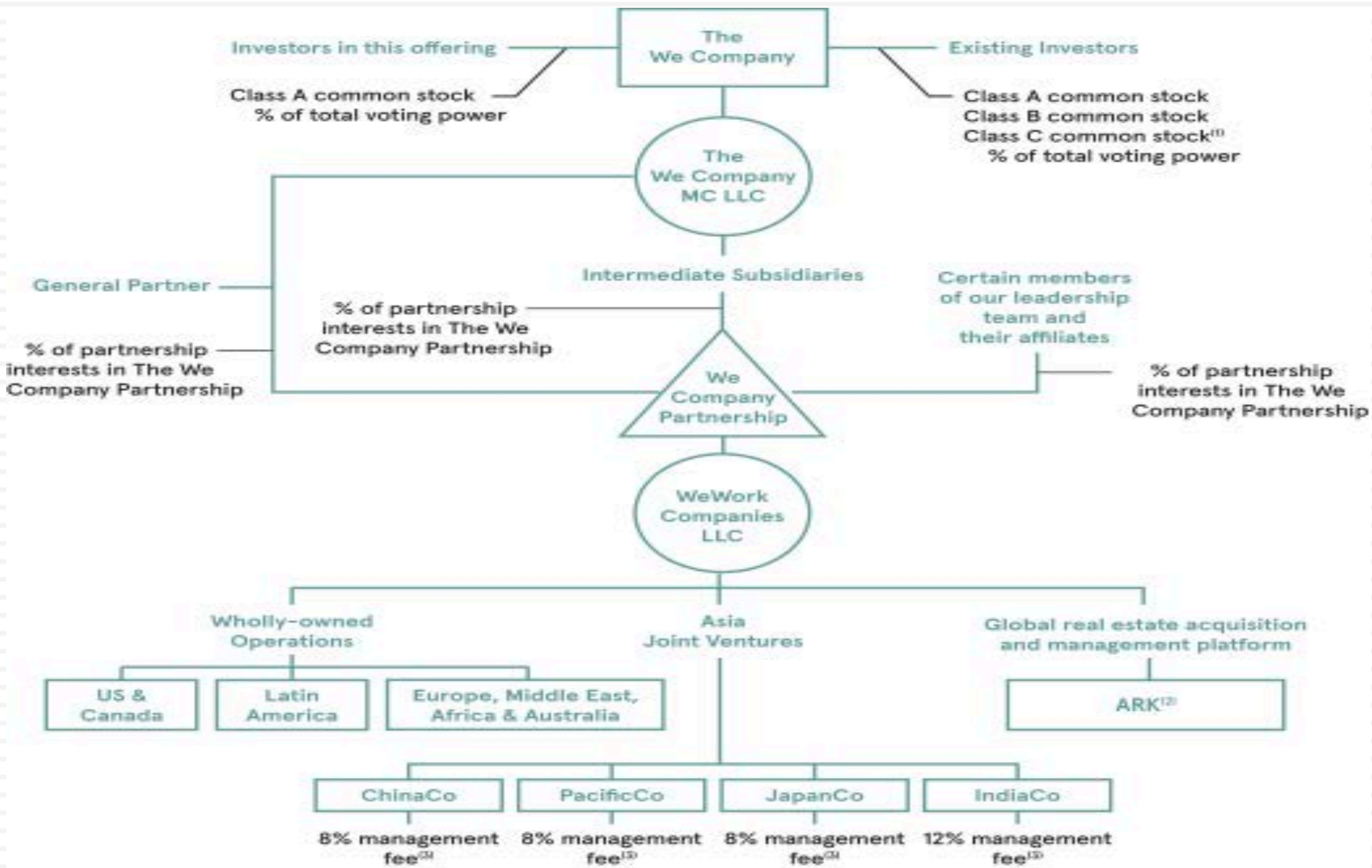
	Rest of 2019	2020	2021	2022	2023	2024 & beyond
Debt	$37	$75	$92	$800	$59	$795
Construction	$340	$86	$2	$0	$-	
Operating Leases	$871	$2,173	$2,332	$2,392	$2,434	$23,832

Issuance Details (Still forming..)

- Magnitude of Proceeds: While the company has not been explicit about how much cash it plans to raise in the IPO, the rumor as recently as last week suggested that it was planning to raise about $3.5 billion from the offering.
- Use of Proceeds: In the prospectus (page 56), the company says that it intends to use the net proceeds for general corporate purposes, including working capital and capital expenditures. In effect, there seem to be no plans, at least currently, for any of the existing equity owners of the firm to cash out of the firm, using the proceeds.
- Further Dilution coming: There is a circularity that affects the value per share used, and resulting share count. That is because the proceeds, since they will stay in the firm, will increase the value of the firm (and equity) by roughly the amount raised, and thus the value per share, but the value per share itself will determine how many additional shares will be issued and thus the share count.

I will do my initial valuation with the rumored $3.5 billion proceeds amount and use the estimated value per share to adjust share count, but these numbers will need to be revisited, once there is more concrete information

Corporate Structure



And Governance

- A Corporate Dictatorship: There are three classes of shares, with the class A shares that will be offering in the IPO having one twentieth the voting rights of the class B and class C shares, leaving control of the company in the hands of Adam Neumann.
- And open about it: The prospectus is brutally direct on this front, stating that "*Adam's voting control will limit the ability of other stockholders to influence corporate activities and, as a result, we may take actions that stockholders other than Adam do not view as beneficial*" and that his ownership stake will result in WeWork being categorized as a controlled company, *relieving it of the requirement to have independent directors on its compensation and nominating committees*.

My WeWork Story

- Meets an unmet and large need for flexible office: The demand comes both younger, smaller companies, still unsure about their future needs, and established companies, experimenting with new work arrangements. There is a big market, potentially close to the $900 billion that the company estimates.
- With a branded product & economies of scale: The WeWork Office is differentiated enough to allow them to have pricing power, and higher margins.
- And continued access to capital allowing the company to both fund growth and potentially live through mild economic shocks.

Translate to value inputs

- Revenue Growth: I will assume that revenues will grow at 60% a year, for the next five years, scaling down to stable growth (set equal to the riskfree rate of 1.6%) after year 10. If this seems conservative, given their triple digit growth in the most recent year, this translates into revenues of approximately $80 billion in 2029.
- Target Operating Margin: Over the next decade, I expect the company's operating margins to improve to 12.50% by year 10. That is much higher than the average operating margin for real estate operating companies and higher than 11.04%, the average operating margin from 2014-2018 earned by IWG, the company considered to be closest to WeWork in terms of operating model.
- Reinvestment Needs: The business will stay capital intensive, economies of scale notwithstanding, requiring significant investments in new properties. I will assume that each dollar of capital invested into the business will generate $1.68 in revenues, again drawing on industry averages.

Closing the input loop

- Possibility of failure: The debt load that WeWork carries makes its susceptible to economic downturns and shocks in the real estate market, and the cost of capital, a going concern measure of risk, is incapable of capturing the risk of failure embedded in the business model. I will assume a 20% chance of failure in my valuation, and if it does occur, that the firm will have to sell its holdings for 60% of fair value.
- Debt load: As I noted in the last section, the company has accumulated a debt load, including lease commitments, of $23.8 billion.

WeWork

The Story

WeWork will be able to grow quickly, taking advantage of an unfilled demand for flexible work spaces from younger businesses and entrepreneurs, unsure about their futurs, and experienced companies, experimenting with new work arrangements. In steady state, it will be able to earn higher margins than typical real estate leasing firms, but faces a high risk of failure, because of its mismatched durations and exponential growth.

The Assumptions

	Base year	*Years 1-5*	*Years 6-10*	*In year 10*	*After year 10*	*Link to story*
Revenues (a)	$ 2,593	60.00% →	1.60%	$ 79,261.99	1.60%	Meets global demand for flexible work spaces
Operating margin (b)	-85.37%	-85.37% →	12.50%	$ 10,066.27	12.50%	Earn higher margins than typical real estare firm
Tax rate	0.00%	0.00% →	25.00%		25.00%	Use NOLs to delay and defer taxes until year 7
Reinvestment (c)		Sales to capital ratio	1.68	RIR =	16.00%	Continue with lease and sub-lease model
Return on capital	-9.36%	Marginal ROIC =	26.61%		10.00%	Brand name sustains excess returns in perptuity
Cost of capital (d)		7.97% →	7.00%		7.00%	Moves to median company cost of capital

The Cash Flows

	Revenues	*Operating Margin*	*EBIT*	*EBIT (1-t)*	*Reinvestment*	*FCFF*
1	$ 4,149	-69.06%	$ (2,866)	$ (2,866)	$ 925	$ (3,790)
2	$ 6,639	-52.75%	$ (3,502)	$ (3,502)	$ 1,479	$ (4,981)
3	$ 10,623	-36.44%	$ (3,871)	$ (3,871)	$ 2,367	$ (6,238)
4	$ 16,996	-20.12%	$ (3,420)	$ (3,420)	$ 3,787	$ (7,208)
5	$ 27,194	-3.81%	$ (1,037)	$ (1,037)	$ 6,060	$ (7,096)
6	$ 40,334	12.50%	$ 5,042	$ 5,042	$ 7,808	$ (2,766)
7	$ 55,112	12.50%	$ 6,889	$ 6,889	$ 8,781	$ (1,892)
8	$ 68,868	12.50%	$ 8,609	$ 7,523	$ 8,174	$ (651)
9	$ 78,014	12.50%	$ 9,752	$ 7,314	$ 5,434	$ 1,879
10	$ 79,262	12.50%	$ 9,908	$ 7,431	$ 742	$ 6,689
Terminal year	$ 80,530	12.50%	$ 10,066	$ 7,550	$ 1,208	$ 6,342

The Value

Terminal value	$ 117,440		
PV(Terminal value)	$ 56,043		
PV (CF over next 10 years)	$ (21,946)		
Value of operating assets =	$ 34,098		
Adjustment for distress	$ 2,728	Probability of failure =	20.00%
- Debt & Mnority Interests	$ 23,812	Included cross holding value of	$218
+ Cash & Other Non-operating assets	$ 6,192		
Value of equity	**$ 13,749**	Last VC pricing was $47 bil, Initial IPO estimate $50-$60 bil, downgraded to $20 bil.	
- Value of equity options	$ 690		
Number of shares	498.85	Preliminary estimate. Will need to be revised when offering is detailed.	
Value per share	$ 26.18		

Too optimistic? Too pessimistic?

Value of Equity in WeWork Today						
		Target Operating Margin				
	Revenue Growith (& 2029 Value)	*5%*	*7.50%*	*10%*	*12.50%*	*15%*
Revenue Growth Rate	*40% (2029 Revenues = $30.4 bil)*	$ (25,448)	$ (19,564)	$ (13,718)	$ (8,254)	$ (2,811)
	50% (2029 Revenues = $50.2 bil)	$ (26,941)	$ (17,428)	$ (8,568)	$ 257	$ 9,056
	60% (2029 Revenues = $80.5 bil)	$ (28,469)	$ (14,108)	$ (161)	$ 13,749	$ 27,652
	70% (2029 Revenues = $126.0 bil)	$ (30,113)	$ (8,542)	$ 12,958	$ 34,430	$ 55,870
	80% (2029 Revenues = $192.7 bil)	$ (32,261)	$ 291	$ 32,764	$ 65,210	$ 97,620

Following up the what if..

- Super charged leverage: If you are puzzled as to why the equity value changes so much, as growth and margins change, the answer lies in the super-charged leverage model that WeWork has created.
- Possible, Plausible, Probable: There are possible, perhaps even plausible, scenarios where the value of WeWork could exceed $50 billion. There are even more plausible scenarios where it is worth nothing. The question in investing rests on what’s probable.
- More option than ongoing business: If you invest in WeWork equity, you are investing less in an ongoing business and more in an out-of-the-money option, with plausible pathways to a boom but just as many or even more pathways to a bust.

The Story Stock

- Valuation is a bridge between stories and numbers, and for young companies, it is the story that drives the numbers, rather than the other way around.
- This is neither good nor bad, but a reflection of a reality which is that bulk of value at these companies comes from what they will do in the future, rather than what they have done in the past.
- There is a danger when stories rule, and especially so if the numbers become props or are ignored, that the pricing that is attached to a company can lose its tether to value.

The Runaway Story

The Runaway Story

Charismatic Storyteller
A narrator, usually a founder or CEO, with missionary zeal and no room for doubt.

+

Big Market Disruption
Story is about a big business that is inefficiently run by large players with bad motives & outdated business models , plotting to undercut him or her.

+

Noble Purpose
The fuel for the runaway story is provided by the benefits that the story teller argues will accrue to society overall, usually helping the under served receive benefits that were hitherto withheld from them.

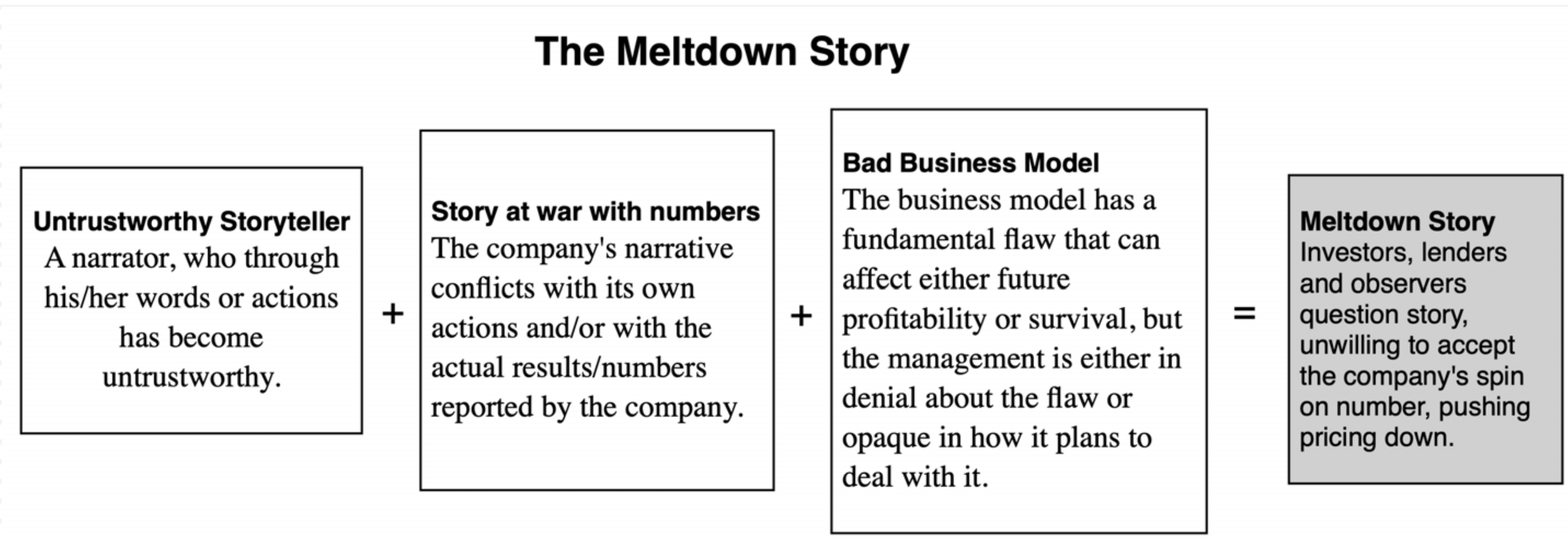
=

Runaway Story
Pricing is untethered to numbers or business model, as investors stop questioning and accept on faith.

And pricing consequences…

Capital Raised by WeWork from intitiation to IPO filing			
Date	*Investors*	*Capital Raise*	*Imputed Pricing*
Apr-09	NA	$17.50	97
Nov-10	NA	$ 41.00	$ 440.00
Jul-11	Aleph	$ 156.40	$ 4,800.00
Jan-12	NA	$ 6.90	NA
Jan-12	Benchmark, GS, Harvard Mgmt,JPM Chase, T. Rowe Price, Wellington	$ 198.80	NA
Dec-14	Benchmark, GS, Harvard Mgmt,JPM Chase, T. Rowe Price, Wellington	$ 198.80	$ 5,000.00
Jun-15	Fdelity, Glade Brook, Capital Partners, JPM Chase, T. Rowe Price	$ 742.50	$ 10,200.00
Jul-15	Horny Capital, Legend Holdings	$ 750.00	$ 15,800.00
Aug-17	Softbank	$ 4,700.00	$ 21,100.00
Aug-17	NA (Debt)	$ 702.00	NA
Aug-18	Softbank (Debt)	$ 1,000.00	NA
Nov-18	Softbank	$ 3,000.00	$ 45,000.00
Jan-19	Masayoshi Son, Softbank	$ 2,000.00	$ 47,000.00
May-19	Amazon, Fidelity, Greenoaks, T.Rowe Price	$ 575.00	NA
	Total Raised	**$14,088.90**	

Can become the Meltdown Story



The WeWork Story Shift?

- CEO arrogance: Adam Neumann has been remarkably short sighted, starting with his sale of almost $800 million in shares leading into the IPO, continuing with his receipt of $5.2 million for giving the company the right to use the name "We" and the conflicts of interest that are sowed all over the corporate structure.
- Game playing: WeWork's continued description (with more than a 100 mentions in its prospectus) of itself as a tech company is at odds with its real estate business model, but investors would perhaps have been willing to overlook that if the company had not also indulged in accounting game playing in the past. This is the company that coined *Community EBITDA* an abomination, where almost all expenses are added back to get to adjusted earnings.
- Denial: Since even a casual observer can see the mismatch that lies at the heart of the WeWork business model, it behooves the company to confront that problem directly. Instead, through 220 pages of a prospectus, the company bobs and weaves, leaving the question unanswered.

An investor/trader cheat sheet

- If you are a VC/equity owner in WeWorks: On the one hand, you may want to pull the IPO and wait for a better moment. On the other, your moment may have passed and to survive as a private company, WeWork will need more capital (from you).
- As an investor, whether you invest or not will depend on what you think is a plausible/probable narrative for the company, and the resulting value. I would not invest in the company, even at the more modest pricing levels ($15-$20 billion), but if the price collapsed to the single digits, I would buy it for its optionality.
- If you are a trader, this stock, if it goes public, will be a pure pricing game, going up and down based upon momentum. If you are good at sending momentum shifts, you could take advantage.
- If you are a founder/CEO of a company, the lesson to be learned from this IPO is that no matter how disruptive you may perceive your company to be, in a business, there are lessons to be learned from looking at how that business has been run in the past. The saying that those who do not know history are destined to repeat it seems apt not just in politics and public policy, but also in business.