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Why WeWork Won't Work -- Hello Neumann!

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On the Seinfeld TV show, the hapless George Costanza only found success when he did the opposite of whatever his instincts told him he should do. That plotline came to mind recently in watching the WeWork story unfold. It seems like a perfect business school case study on how not to run and grow a business.

First of all, WeWork positioned itself as a tech company and a disruptor. In the prospectus for its ill-fated IPO, its promoters said, “We are a community company committed to maximum global impact. Our mission is to elevate the world’s consciousness.” And later they added, “Technology is at the foundation of our global platform” as they touted their “purpose-built technology and operational expertise.”

That’s rather heady language for what is, in essence, not much more than an office rental company that acts as a middleman between landlords and short-term tenants. It’s a business model that has existed for decades with companies like Regus and Servcorp offering up the same recipe. What WeWork brings to the party is basically the same thing plus some high-tech amenities and, when it fails, it won’t be the first one in this industry to take a trip through bankruptcy court.

At the start, WeWork had a number of things going for it. It was led by a young, dynamic and charismatic CEO/founder in Adam Neumann. He was able to persuade enough investors that his idea was a viable undertaking such that the business was fully funded early on and was therefore able to realize really rapid early-stage growth.

Certainly, WeWork grew rapidly, but growth doesn’t always translate into profitability and, sometimes, it conceals much bigger problems. In this case, the company’s revenue in 2017 was almost $900 million, a figure that doubled in 2018 to $1.8 billion. Twelve-month figures through June of this year showed almost $2.6 billion in revenue. WeWork’s investors encouraged the company’s aggressive growth but were looking to cash out in the IPO. Not stated in the prospectus was the risk of what would happen if the IPO didn’t materialize.

While WeWork’s revenue was climbing, its cashflow became increasingly negative. In 2017, earnings before interest, taxes, depreciation and amortization (“EBITDA”, a proxy for cashflow) was negative

$770 million. By 2018, it was negative $1.4 billion and, for the last 12 months through June of this year, the company's financial statements showed another $2 billion EBITDA lost, with no sign of a change in sight. In fact, the prospectus noted that "We have a history of losses and, especially if we continue to grow at an accelerated rate, we may be unable to achieve profitability at a company level (as determined in accordance with GAAP) for the foreseeable future."

When SoftBank, which owns close to 30% of WeWork, became an investor in January this year, the internal valuation of the private company was optimistically estimated at $47 billion. When it actually came time to put the IPO into motion, the valuation was a more conservative $30 billion, which the market failed to take seriously. In the next iteration, the value was chopped down to $14 billion and when it looked like the offering wouldn't even raise that much, the IPO was postponed indefinitely.

In the aftermath of that debacle, Neumann resigned and the company has now taken other steps to right itself, like selling its $60 million Gulfstream corporate jet, laying off thousands of staff, and jettisoning a number of Neumann's friends. It's also taken steps to fix some of its concerning corporate governance issues. However, the company's troubles run deeper than that.

The real problem with WeWork is that its whole business model is flawed with excessive leverage. There's really nothing special about what they do—providing shared office space to short term tenants. But when the economy starts to turn and new business startups decrease or fail more because of the risk of recession, that's when a company like WeWork could really be exposed and have tremendous downside risk. That's because it has long-term fixed expenses that aren't matched with its short-term clients who can come and go as they choose. Like an insolvent bank with long term assets but short-term funding, WeWork is subject to the proverbial "run-on-the-bank" risk because of its massive long-term lease liabilities.

WeWork marketed itself as not just an office landlord intermediary, but as a technology company with a new way of doing things but basically it is a real estate middleman only slightly different from its competitors. It's a story we've seen in countless other businesses in a wide range of sectors—too much leverage and an inability to meet debt obligations when they come due.

In this case, WeWork has some $34 billion of debt in the form of future payments owed on the long-term leases they entered into in order to capture the prime real estate that they needed to attract the high-paying short-term tenants that their business model requires. Many of their properties are in major cities where the economies are strong and real estate values are high right now. So, in many cases they've locked in leases at close to top-of-the-market prices and committed to a debt stream that they may not be able to pay. If forced into bankruptcy, which is a very real possibility, all those landlords will be in line as unsecured creditors for the remaining balance of their lease payments. And a lot more office space will likely come onto the markets where they operate.

In sum, doing the opposite of what you know is right like Costanza may work some of the time but eventually it doesn't. For WeWork and Neumann, the day of reckoning is at hand with its failed IPO and a future workout of its massive lease liabilities is inevitable. The exact timing of this bankruptcy will largely depend on how much more money its equity investors plan to burn in this cash flow negative oven but rational behavior will eventually emerge. Even so, it isn't clear that WeWork will need to exist in its present form after its landlords finally restructure its debts.