Markets High yield bonds

More on WeWork and its bond offering -- updated

APRIL 25, 2018 12:46 AM

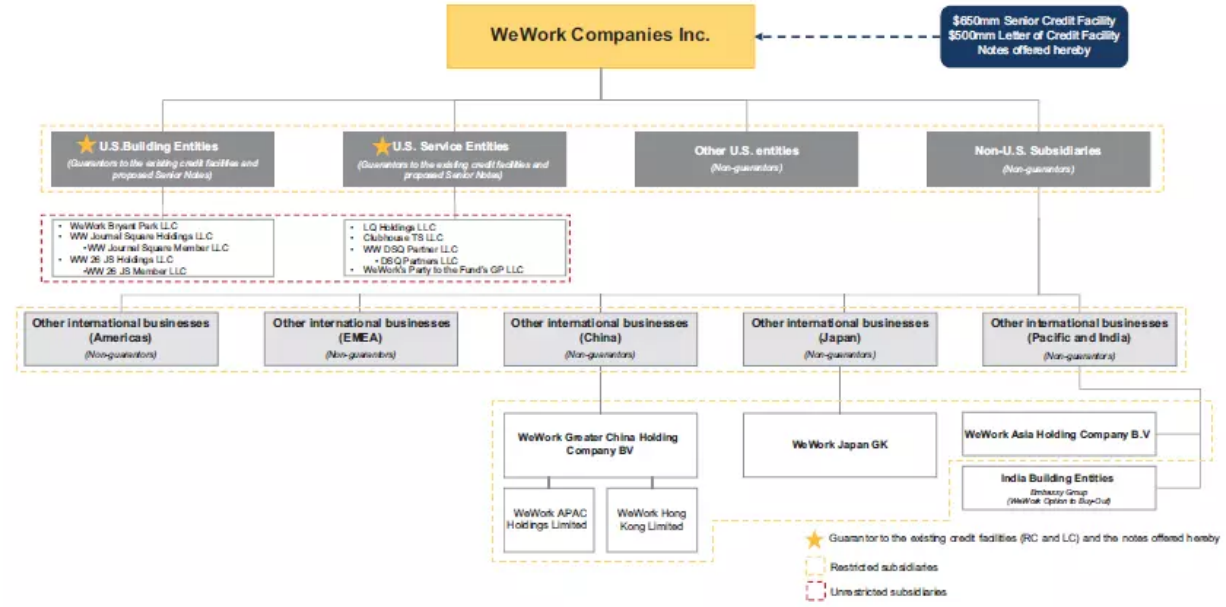
By: **Alexandra Scaggs** and **Eric Platt**

Office-space manager WeWork is planning to sell $500m of high-yield notes maturing in 2025, in a deal expected to price this week.

One reason this matters is that it is the first time the company has sold debt to investors (it has a $650m revolving credit facility and a $500m letter-of-credit facility). After Monday's pricing of a bond offering from Netflix, the sale of notes could test the extent of the market's appetite for high-yield bonds.

Yet even more interesting is the opportunity to get a sense of how exactly WeWork's business works. The company has an “asset-light” model and leases most of its workspace locations -- beyond that it has been promoting its lifestyle and fitness offerings (https://www.nytimes.com/2018/02/17/business/the-wework-manifesto-first-office-space-next-the-world.html) and planning an expansion into education (https://www.nytimes.com/2017/11/20/nyregion/private-schools-startups-wework-wegrow-new-york.html).

The prospectus and presentation for the note sale, which was reviewed by Alphaville and the FT, gave us a look at the company and its financials.



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There will be lots more to come about this offering, but we wanted to briefly highlight a few interesting points about the company.

First, the balance sheet:

WeWork Companies Inc.
Consolidated Balance Sheets

(in thousands, except share and per share amounts)	December 31, 2017	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents[1]	$ 2,020,805	$ 506,597
Accounts receivable, net of allowance of $1,713 and $1,247 in 2017 and 2016, respectively	35,582	18,047
Lease incentives receivable (including amounts due from related parties of $10,336 and none in, 2017 and 2016, respectively)	117,779	49,436
Due from related parties	1,200	1,309
Other current assets (including loans to employees of $1,790 and $130 in 2017 and 2016, respectively)	251,730	45,966
Total current assets	2,427,096	621,355
Property and equipment, net	2,337,092	1,451,897
Restricted cash[1]	150,314	73,745
Deferred lease acquisition costs, net	31,031	13,313
Equity method and other investments	57,217	25,705
Goodwill	156,117	5,317
Intangible assets, net	84,519	3,912
Other assets (including loans to employees of $2,000 and $10,900 in 2017 and 2016, respectively)	120,686	43,275
Total assets[1]	$ 5,364,072	$ 2,238,519
Liabilities		
Current liabilities:		
Accounts payable and accrued expenses	$ 314,267	$ 190,295
Members' service retainers	195,081	94,560
Capital lease obligations, current portion	1,649	1,178
Loans payable to related parties	26,088	—
Other current liabilities	75,359	9,159
Total current liabilities	612,444	295,192
Deferred rent	1,674,730	900,731
Capital lease obligations	50,764	52,060
Other liabilities	64,104	33,801
Deferred income taxes	4,469	—
Total liabilities[1]	2,406,511	1,281,784
Commitments and contingencies (Note 18)		
Convertible preferred stock; 173,947,306 shares authorized, and 170,300,623 and 136,902,228 shares issued and outstanding in 2017 and 2016, respectively	3,405,435	1,678,301
Noncontrolling interests	854,577	—
Equity		
WeWork Companies Inc. shareholders' equity (deficit):		
Common stock Class A; par value $0.001; 459,934,875 shares authorized, and 30,299,542 and 8,227,764 shares issued and outstanding in 2017 and 2016, respectively	30	8
Common stock Class B; par value $0.001; 183,942,797 shares authorized, and 131,787,453 and 150,617,244 shares issued and outstanding in 2017 and 2016, respectively	132	151
Additional paid-in capital	407,804	86,769
Accumulated other comprehensive income (loss)	(9,924)	8,005
Accumulated deficit	(1,700,493)	(816,499)
Total WeWork Companies Inc. shareholders' equity (deficit)	(1,302,451)	(721,566)
Total liabilities and equity	$ 5,364,072	$ 2,238,519

(1) As of December 31, 2017, total assets and total liabilities of consolidated variable interest entities ("VIEs") were $936,920 and $105,221, respectively. Total assets of consolidated VIEs included $727,278 of cash and cash equivalents and $19,999 of restricted cash as of December 31, 2017. The assets of consolidated VIEs can only be used to settle obligations of the VIE and the VIE creditors do not have recourse against the general credit of the Company. There were no consolidated VIEs as of December 31, 2016. See Note 2 for additional details.

The accompanying notes are an integral part of these consolidated financial statements.

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- WeWork uses an asset-light model, which means it does not directly own most of its workspaces. But it does appear to own some properties, as it reports **$43.7m of capital-lease assets** (https://www.investopedia.com/terms/c/capitallease.asp), which have the economic equivalent of ownership, on its balance sheet.

- In comparison, operating leases make up **$1.9bn** of the value of its property and equipment.

Now on to its income and operational results:

Consolidated results of operations

The following tables set forth our consolidated statements of operations and other key metrics for the years ended December 31, 2016 and 2017:

(Amounts in thousands, except percentages and where noted)	Year Ended December 31, 2016	2017	Change $	Change %
Consolidated statement of operations information:				
Revenue:				
Membership revenue	$ 414,531	$ 822,092	$ 407,561	98.3%
Service revenue	19,824	44,346	24,522	123.7
Other revenue	1,744	19,566	17,822	1,021.9
Total revenue	436,099	886,004	449,905	103.2
Expenses:				
Community operating expenses[1]	433,167	814,782	381,615	88.1
Other operating expenses[1]	—	1,677	1,677	N/M
Pre-opening community expenses	115,749	131,324	15,575	13.5
Sales and marketing	43,428	143,424	99,996	230.3
Growth and new market development	35,731	109,719	73,988	207.1
General and administrative expenses	115,346	454,020	338,674	293.6
Depreciation and amortization	88,952	162,892	73,940	83.1
Total expenses	832,373	1,817,838	985,465	118.4
Loss from operations	(396,274)	(931,834)	(535,560)	135.1
Interest and other income (expense), net	(33,400)	(7,387)	26,013	(77.9)
Pre-tax loss	(429,674)	(939,221)	(509,547)	118.6
Income tax benefit (provision)	(16)	5,727	5,743	N/M
Net loss	(429,690)	(933,494)	(503,804)	117.2
Net loss attributable to noncontrolling interests	—	49,500	49,500	N/M
Net loss attributable to WeWork Companies Inc.	$(429,690)	$ (883,994)	$(454,304)	105.7%
Key financial measures:				
ARPPM (in ones)	$ 7,384	$ 6,928	$ (456)	(6.2)%
Adjusted EBITDA[2]	$ (94,322)	$ (193,327)	$ (99,005)	105.0%
Adjusted EBITDA Margin	(21.6)%	(21.8)%	(0.2)%	
Adjusted EBITDA before Growth Investments[2]	$ 1,055	$ 49,444	$ 48,389	4,586.6%
Adjusted EBITDA before Growth Investments Margin	0.2%	5.7%	5.5%	
Community Adjusted EBITDA[2]	$ 95,943	$ 233,147	$ 137,204	143.0%
Community Adjusted EBITDA Margin	22.1%	26.9%	4.8%	
Location Contribution[2]	$ 243,610	$ 494,036	$ 250,426	102.8%
Location Contribution per Desk (in ones)	$ 2,285	$ 2,373	$ 88	3.9%

N/M = Not meaningful

(1) Exclusive of depreciation and amortization shown separately below.

(2) See "Summary—Summary historical consolidated financial and operating information—Key financial measures" for a reconciliation to the most comparable GAAP measure.

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- WeWork reported a net loss of $883m in 2017, excluding a loss of about $50m attributable to its "noncontrolling interests" in Asia. We calculated its EBITDA at **negative $769m**, while the company reported an adjusted EBITDA of negative $193m and a loss from operations of $932m.

- **Total 2017 revenues were $886m**, with the majority coming from membership ($822m) and the balance generated by services, sponsorships, ticket sales to WeWork-branded events and more.

- The investor presentation focusses on a non-GAAP income measure it calls **“community-adjusted EBITDA”**. That's essentially EBITDA excluding the cost of sales: Employees' cash compensation, advertising/event expenses, and new-location costs. That figure is positive, which means it's profitable if you exclude its cost to grow profits.

- So, how costly has the company's growth been? WeWork had 208,000 desks at the end of 2017, which breaks out to about $1,300 of per-desk [**updated:** quarterly] revenue from membership and services. [**updated:** For the whole year, the revenue per desk is around **$4,166**.] Of course, the company added about 100,000 new desks over the year, so we must assume that they did not all contribute to revenue equally. But even so, it is ~~well~~ below the level needed to cover net annual capex for each new desk added, which was **$5,631**, according to the prospectus.

- The costs of physical growth -- renovations, buying furniture and financing new leases -- were included in the **$1.5bn** spent on **investing activities**, which was **$604m** higher than last year. The company did not break out the aggregate numbers, but did say that **$351m of the yearly increase** was the result of workspace renovations and financing new leases.

- The balance of the growth in investment spending came from its acquisition of Meetup ($141m); investments in software ($6.1m); and notably, **loans to employees and related parties ($20m)**.

- One note about investing activities: Some of WeWork's renovation costs are offset by “tenant improvement allowances” paid to WeWork by building owners. The prospectus says these reimbursements occur “upon completion of predetermined milestones”, but does not specify what these milestones are.

- The company's cost of **stock-based compensation was $277m in the fourth quarter**. That was up from $6.2m the prior quarter, and eclipsed its $258m of 4Q membership revenue. (That figure seems to address its own employees, as stock-based compensation paid for consulting services barely budged, rising to $2.6m from $2.3m.)

[**Updated:** For those wondering how some of those operating metrics are calculated, here are the community-adjusted EBITDA reconciliations:

The following table reconciles our net loss to Adjusted EBITDA, Adjusted EBITDA Before Growth Investments, and Community Adjusted EBITDA for the periods presented:

(Amounts in thousands, except percentages)	Year Ended December 31, 2016	2017
Net loss	$(429,690)	$(933,494)
Income tax (benefit) provision	16	(5,727)
Interest and other (income) expense net	33,400	7,387
Depreciation and amortization	88,952	162,892
Adjustments for Impact of Straight-lining of Rent[a]	188,746	272,927
Stock-based compensation expense[b]	22,660	295,362
Stock-based payments for services rendered by consultants[b]	1,594	7,326
Adjusted EBITDA	(94,322)	(193,327)
Other revenue[c]	(1,744)	(19,106)
Other operating expenses[d]	—	1,322
Sales and marketing[e]	42,653	139,180
Growth and new market development[f]	33,245	98,336
Pre-opening community expenses[g]	21,223	23,039
Adjusted EBITDA before Growth Investments	1,055	49,444
General and administrative expenses[h]	94,888	183,703
Community Adjusted EBITDA	$ 95,943	$ 233,147
Membership and service revenue	$ 434,355	$ 866,438
Adjusted EBITDA Margin	(21.6)%	(21.8)%
Adjusted EBITDA before Growth Investments Margin	0.2%	5.7%
Community Adjusted EBITDA Margin	22.1%	26.9%

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The location contribution reconciliations follow:

(3) Location Contribution represents our membership and service revenue less total lease costs included in community operating expenses, both calculated in accordance with GAAP, excluding the impact of Adjustments for Impact of Straight-lining of Rent included in community operating expenses. Location Contribution per Desk is calculated by dividing Location Contribution by Desks at Consolidated Locations. Desks at Consolidated Locations as of December 31, 2016 and 2017 were 107,000 and 208,000, respectively. See "Management's discussion and analysis of financial condition and results of operations—Key financial measures" and "Non-GAAP financial measures" for an explanation of why our management this metric and certain of the limitations of this metric.

The following table reconciles our membership and service revenue less total lease costs included in community operating expenses, both calculated in accordance with GAAP, to Location Contribution for the periods presented:

(Amounts in thousands, except where noted)	Year Ended December 31, 2016	2017
Membership revenue	$ 414,531	$ 822,092
Service revenue	19,824	44,346
Membership and service revenue	434,355	866,438
Less: Total lease costs included in community operating expenses	(283,468)	(534,715)
Membership and service revenue net of lease costs calculated in accordance with GAAP	150,887	331,723
Plus: Adjustments for Impact of Straight-lining of Rent included in community operating expenses	92,723	162,313
Location Contribution	$ 243,610	$ 494,036
Location Contribution per Desk (in ones)	$ 2,285	$ 2,373

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And its measure of average revenue per physical member (ARPPM) is calculated by dividing membership and service revenue (excluding revenue from its housing memberships) by "the average of the number of WeWork memberships as of the first day of each month in the period."]

More than a dozen banks (https://www.ft.com/content/648b2026-4757-11e8-8ae9-4b5ddcca99b3) are ~~working~~ listed on the deal, [**updated**: though JPMorgan is running the show,] and there has already been some talk of upsizing, as the FT has reported. S&P rates the bonds at B+, and says "net sources would exceed uses even if its EBITDA declines 15 per cent," which perhaps makes sense considering the fact its EBITDA is negative.

Related links:

WeWork to test junk bond appetite with $500m sale (https://www.ft.com/content/648b2026-4757-11e8-8ae9-4b5ddcca99b3) -- Financial Times

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55 MINUTES AGO By: Jemima Kelly

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Gone with the wind Apr 27, 2018

I read elsewhere that its long term lease obligations are in the order of USD 18 bn - as a possible Bond holder that kind of liability would worry me a great deal

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Gone with the wind Apr 27, 2018

Why such a big difference between what the company reported EBITDA was and the one you calculated ???

"We calculated its EBITDA at **negative $769m**, while the company reported an adjusted EBITDA of negative $193m"

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Alex Scaggs FT May 2, 2018

@Sunfast The company added back more than $300m of stock-based compensation -- which would make sense if it were not for the fact stock-based comp rose 45x from the previous quarter -- and $273m to adjust for the impacts of straight-lining rent expense, which I still need to work through.

Report Share Recommend | Reply

max May 2, 2018

@Alex Scaggs LMK if I can help on working through straight lining the rent; that's taking the difference between the discounted rent at the beginning of the lease and the average rent.

Blows away even the community adjusted EBITDA. When the discounts end, cash outflows will be _more_ than the lease expenses...

Report Share 1 Recommend | Reply

MC2 Apr 26, 2018

Whilst I quite like the concept that WeWorks offers, concepts like "community adjusted EBITDA" are a massive red flag from an investment standpoint. Credible business don't need to resort to such straw clutching.

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safeSpace Invader Apr 27, 2018

@MC2 The business is credible. The equity valuation isn't.

Report Share 4 Recommend | Reply

the Jay walker Apr 26, 2018

Five years from now good chance it will go bust

Report Share 4 Recommend | Reply

Usecommonsense Apr 26, 2018

Insane. This a great article thanks.

Report Share 4 Recommend | Reply

max Apr 26, 2018

How is the "straight lining of rent" attributed? Footnote (a)

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jimlindsey Apr 26, 2018

This is a great analysis. I'll add that the renovation costs funded by a landlord (Tenant Improvements) occur only once per lease term (10 to 15 years in the case of WeWork). If you believe a WeWork space's "cool factor" depreciates over 10 to 15 years then this isn't a problem. But if the cool factor depreciates in say 3 years then new capital will be required every 3 years to refresh the space. When that happens it will be WeWork picking up the tab, not the landlord.

Put another way, EBITDA as currently reported DRASTICALLY understates the long term run rate for investment costs.

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Parisbound Globetrotter Apr 26, 2018

@jimlindsey The tenant improvements are probably a good mix of longer term capital expenditure (building out the space from "raw" concrete floors) and a fixtures+furniture that depreciate much quicker. Given the nature of their fit outs, the quality is often higher (and more expensive!) than a more standard office fit out and likely to depreciate faster. It should also be noted that, given the very high speed growth they are aiming, they are typically paying top rents on each market to obtain the buildings they want. There are also landlords that are reticient to have them as tenants (given the unproven nature of their business model), so they often have to compensate with high(er?) nominal rent payments.

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jimlindsey Apr 26, 2018

@Parisbound Globetrotter @jimlindsey Agreed that the build out of the space is above average cost and is meant to be "fashion forward". Therefore, we should expect it to depreciate faster than a typical build out.

Regarding your theory that they are paying above market rents: All else being equal that makes sense, but in practice I haven't observed that to be the case. From my experience, there has been enough vacancy in the office world that WeWork has had no trouble finding willing landlords. In many ways WeWork brings an extra level of cache to the building (the spaces are very nice!)

My opinion: there is a coworking model that has a future, but it will not be the WeWork model. I love the WeWork aesthetic and applaud their design. But the product offered (accounting for all the costs) is simply too expensive for the mass market. The WeWork product could find a home with niche consumers that demand a premium experience, but this is the opposite of WeWork's mass market approach. As Ben Graham would say: sometimes growth destroys value!

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diminishingreturns Apr 25, 2018

I love two things about their numbers... first that their "Community Adjusted EBITDA", to the extent that it has any meaning at all, is essentially their gross profit and not at all related to EBITDA.

Second, they have managed to finesse this number to be bigger than the actual gross profit that you read off the accounts e.g. $886 m - $815 m = $72 m (and that is if you rather charitably ignore "Pre-opening community expenses" and of course depreciation).

Alex, very much look forward to your next posts!

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Upaswellasdown Apr 25, 2018

It is not true that "a dozen banks are working on this" - only the lead-left bookrunner (I think JPM). the others are passive and collecting some fees in return for presumably the RCF.

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lp1997 Apr 25, 2018

@Upaswellasdown Hi, just a quick question, what does RCF mean here? Thanks!

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lp1997 Apr 25, 2018

@Upaswellasdown Is it the revolving credit facility? And the non-lead banks here are collecting some fees up-front for entering into the revolver arrangement?

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Alex Scaggs FT Apr 25, 2018

@Upaswellasdown ah right, just because the prospectus had a dozen banks on it doesn't necessarily mean that they're all *working*. I've heard the same -- thanks for reminding me I had that in here, will update again!

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1 reply

northern lights Apr 25, 2018

..and the founders were selling stock last year. That says they are worried about the WeWork value bubble bursting, which it will.

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Gabo Apr 25, 2018

How does it justify not including other operating leases as capital leases? Presumedly they're long term too?

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Upaswellasdown Apr 25, 2018

@Gabo I've never seen operating leases lead to assets on balance sheet. Is this something to do with IFRS 16?

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Gabo Apr 25, 2018

Well it wouldn't be required in terms of ifrs but analysts and cfa like to adjust operating leases to become An asset and liability and then depreciate it. I guess if depends on how long the lease is. Part of their model seems to be asset light but in the end how can they function with short term leases.

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Upaswellasdown Apr 28, 2018

@Gabo I completely agree that long-term operating leases constitute a liability (and therefore presumably an asset), I've just never seen US GAAP report it this way

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Most_entertained Apr 25, 2018

Quick question, why is Stock-Based compensation added back to Net Loss to get Adjusted EBITDA. Shouldn't it be at the line before Community Adjusted EBITDA?

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Alex Scaggs FT Apr 25, 2018

@Most_entertained Good question! I'm working on a post that should address some of that, will have it up ASAP

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CreditSwap Apr 25, 2018

@Most_entertained It's a non-cash expense. Add it back to Net Income as a proxy EBITDA is a proxy for cash flow run rate of the business.

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wonky-tonk Apr 25, 2018

In Ye Olden Times, there used to be a metric called "lease-adjusted leverage".

This business rents property and then sublets it. There's already a boatload of leverage embedded in the underlying landlords; slapping an intermediate layer of junk gearing between the landlords and the actual

tennants seems... well, "frothy" is probably the polite term.

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