



Co-Working in China: Disrupting The Workplace

how co-working blossomed amidst China's epic economic transition



Foreword

China is in the midst of transforming itself from "the world's factory" into a global innovation center. At the same time, co-working has become an important vehicle to help Beijing achieve its vision of "mass entrepreneurship and innovation"(双创). Having witnessed tremendous growth in the past few years, the Chinese co-working space industry is now entering a phase of consolidation and operational enhancement. A number of winners are likely to emerge to lead this sector as it further penetrates the office market.

How An Evolution Caught Fire

China is becoming the World's Startup Nation. Over six million new businesses were registered in China in 2017, likely the world's highest^[1]. A total of 142 unicorns, or private companies valued at US\$1 billion or more, with an aggregate valuation of US\$772 billion call China home. This is the greatest concentration and highest total valuation anywhere globally^[2]. China's venture capital market is seeing more capital invested on a monthly basis in 2018 than the United States^[3], making the Middle Kingdom the world's center of capital supply to support innovation.

Once considered "the world's factory", China now aspires to become a country known for technology sophistication and innovation. China's top-down

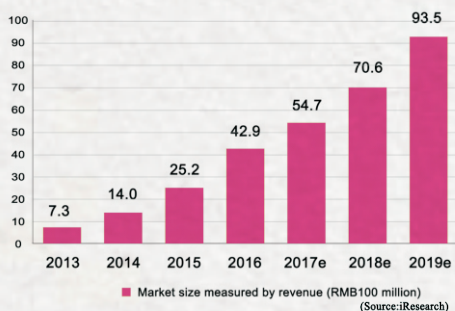
national campaign to make "mass entrepreneurship and innovation" (双创) one of the "double engines" for economic growth was significantly reinforced in 2015, when "mass entrepreneurship and innovation" was written and emphasized in the government report that year. Chinese premier Li Keqiang has served as champion for the government-led movement. Aside from frequently participating in startup and entrepreneurship events, premier Li visited Shenzhen's Chaihuo Maker Space in January and 3W Coffee in Beijing in May in 2015, putting a new type of work space on news headlines and in front of the public.

It is against this backdrop of macro policy environment that 2015 became the year when co-working blossomed

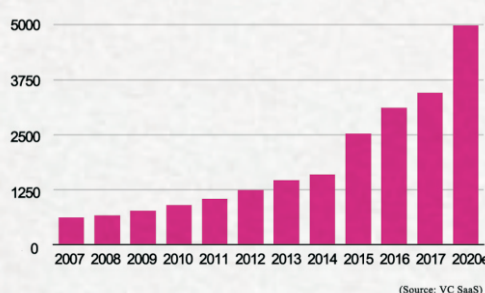
in China. There were a total of 2,530 co-working space locations in China in 2015, up from 1,600 in 2014, according to Chinese data tracker VC SaaS. The number of co-working space locations would nearly double between the two years of 2014 and 2016.

The market size of the Chinese co-working industry grew from RMB1.4 billion in 2014 to RMB2.52 billion in 2015. That number grew further to RMB4.29 billion in 2016 and RMB5.47 in 2017, and is expected to reach RMB9.35 billion in 2019, representing a 53% compound average growth rate (CAGR) for the sector between 2013 to 2019, according to Chinese market research firm iResearch.

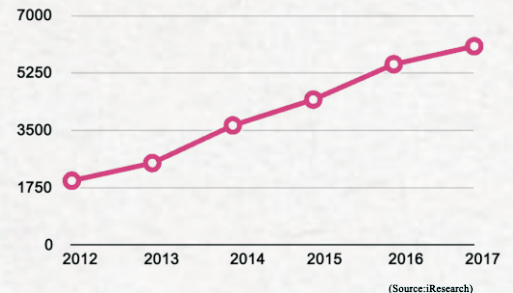
Chinese Co-Working Space Market Size



Number of Co-Working Spaces In China



Numbers of New Businesses Registered In China (in thousands)



Most of China's largest and best-known co-working companies, including naked Hub, Ucommune, Mydream+, Weplus, Fountown and Woo Space, were all founded in 2015. The strong growth of the sector was supported by venture capital firms putting money into the space. The number of venture capital investments in the co-working sector skyrocketed from just 3 in 2014 to 28 in 2016^[4].

Hong Kong: Harboring Convergence

As the most expensive markets globally for office rentals, Hong Kong is uniquely positioned to nurture the growth of co-working and to serve as a place of convergence.

The island city was ranked as the world's highest-priced office market in 2017 by real estate services firm CBRE. Office rentals in Hong Kong's Central business district were 76% more expensive than Midtown Manhattan and 98% pricier than West End, London^[5].

At the same time, both Beijing and the Hong Kong governments have placed innovation in the city as leading policy priorities. Influential Chinese companies including Tencent Holdings Limited and Alibaba Group Holding Limited, both among the global top publicly traded companies in terms of market capitalizations, have recently launched investment funds to support startups in Hong Kong.

High costs, including office rentals, have been a key barrier for startups to overcome in Hong Kong. As governments push to encourage more startups to help build a more innovation-led economy in the Greater Bay Area, co-working has become the answer to solve both challenges.

As of July 2017, co-working space companies, as well as serviced offices with co-working elements, occupied 960,000 square feet of office space in Hong Kong. The area is expected to grow to 1.5 million square feet by the end of 2018, according to estimates by real estate services firm CBRE. The expected 2018 co-working office surface area would indicate 300% growth for a five-year span between 2013 and 2018, as co-

working space in Hong Kong only stood at 700,000 square feet in 2016 and 500,000 square feet in 2013, according to CBRE data.

An important characteristic of the Hong Kong co-working space market is the dominance of international brands. At present, about 61% of them are international brands. This is mainly because global co-working juggernaut WeWork's two current locations in Wanchai and Causeway bay have 150,000 square feet. WeWork, with a valuation of over US\$20 billion, is opening two more locations. Another 28% of the Hong Kong co-working space are local brands and 10% are from mainland China, according to CBRE.

Real estate services firm Jones Lang LaSalle predicts that as much as 30% of corporate commercial property portfolios could be utilizing flexible workplace solutions, which include co-working spaces, by 2030 in Hong Kong. That means the co-working space sector has plenty of room for growth in Hong Kong. But the pace of the market growth depends on how quickly co-working space operators are able to roll out enterprise models that accommodate larger corporate occupiers, rather than only catering to startup communities.

Co-Working: Economics Of Scale

Co-working works best when there is scale. That is because the core of co-working, compared to traditional office space, is the extra "value add" that include services, community building and synergy. This "value add" follows the rule of economics of scale, meaning costs will reduce per unit from increased total output of services. Simply put, winners of co-working will be those that can achieve the biggest overall size.

The most basic business model of co-working is increasing the rental price of an office space via creative design, standardized services and building a community. Rental prices could double after converting a traditional office space into co-working. For example, a co-working operator could rent an office space in Beijing for RMB5 per square meter per day. The same office, after being converted into co-working space via redesign and decoration, could fetch rental prices between RMB7 to RMB12 per square meter per day, according to a report by Chinese startup service firm 36Kr.

Aside from securing a high

occupancy ratio, ideally above 90%, the next challenge comes from how to increase non-rental revenues. Non-rental revenue comes from add-on services such as business registrations; tax and accounting services; membership; event space rentals; incubation; consulting and more.

Only with scale can these non-rental revenue sources become something with much bigger potential. Rental income is finite after 100% occupancy is reached, but non-rental income could provide potentially infinite opportunities. In addition, non-rental revenues deepen the connection between the tenant and the co-working company. It also helps smooth out volatile rental income. Hot desks and offices at co-working space have much more flexible terms compared to traditional office tenants, who are often locked in for multiple years.

The biggest Chinese co-working company Ucommune was able to secure around 8% of revenues from non-rental income in 2017, and hopes to increase that to over 10% in

2018. Another Chinese co-working space operator Kr Space achieved over 20% non-rental income last year, according to its parent company 36 Kr. Kr Space was able to make the highest non-rental income in the industry because it offers more services to startups, including incubation and advertising services from the group's other units. This is an example of the benefit of synergy, where larger scale is critical in increasing this non-rental income ratio.

Therefore, a wave of mergers and acquisitions has taken place since the second half of 2017 in the Chinese co-working space. Ucommune made three acquisitions this year as it purchased smaller peers Workingdom, Woo Space and Wedo. In another major deal, WeWork agreed to acquire Shanghai-based co-working space operator naked Hub in April 2018^[6].





A List of M&A Deals In China's Co-Working Space

04-2018	Ucommune acquired Shanghai-based Workingdom
04-2018	WeWork China acquired naked Hub
03-2018	Ucommune acquired Beijing-based Woo Space
03-2018	Ucommune acquired Shenzhen-based Wedo
01-2018	Naked Hub acquired Australia's Gravity
12-2017	Naked Hub acquired Shanghai-based Raise
04-2017	Ucommune acquired Beijing-based New Space
03-2017	Shanghai-based We+ merged with Guangzhou-based Cowork
03-2017	Woo Space acquired Beijing-based Fourwork

Scale provides direct value in convenience. Ucommune, for example, has over 150,000 square meters (1.6 million square feet) of co-working space across 41 locations in 16 cities in China as of April 2018, excluding its locations outside of China. This means its 22,000 members are able to use any of these locations when traveling and enjoy the luxury of choosing between different

locations within one city. Similarly, the combination of WeWork and naked Hub created the biggest co-working company in China. By the end of 2018, WeWork and naked Hub together will have 40,000 members in 40 locations in Greater China, providing unparalleled convenience to its combined membership^[7].

The industry consolidation is far from

over, but leaders have emerged. WeWork and naked Hub, Ucommune, and Kr Space are currently the best-funded, highest-valued and largest players. More deals are likely through next year to make the strong even stronger.



Global Expansion And Deeper Connections

The economics of scale and benefits of synergy extend beyond national borders. Major Chinese co-working companies are all eyeing expansion in Asia and globally as strategic priorities. Ucommune has opened co-working spaces in Hong Kong, Taiwan, Singapore, Jakarta, New York and Los Angeles. In May 2018, Kr Space rented seven floors with 83,000 square feet in One Hennessy building in Wanchai, Hong Kong, as its first foray outside of mainland China.

Asia, especially Southeast Asia, will be where the hardest battles are fought for market share between major Chinese co-working players, global giant WeWork and local companies. In Indonesia, WeWork plans to open two spaces in the third quarter 2018. For Ucommune, a key driver of its global ambition is to serve the needs of the Chinese companies eyeing international expansion. That means places like Singapore, Hong Kong and India are where Chinese companies are most likely to target when considering global expansion.

Similar to mainland China and Hong Kong, co-working space in Asia is a story of rapid growth. In Japan, demand for co-working space is strong due to the high ratio of freelance workers. In

2017, Japan had around 11.22 million freelancers aged between 20 and 69, comprising 17% of the entire working population, according to crowdsourcing firm Lancers Inc. In India, JLL expects the country's co-working industry to grow by 40% to 50% in 2017. More fundraising rounds, as well as merger and acquisition deals, are expected across the region in 2018.

For all co-working space operators, how to fully leverage physical space and maximize network effect to provide the best value-added services will be the biggest differentiator in the years ahead. Companies have made various attempts to offer innovative services beyond basic business support, such as online shopping, fitness classes, and remote control of smart office locks. The innovations within this space is limitless.

On the other hand, capturing the network effect can reinforce the "value add" of co-working space. How to build a community both online and offline; how to provide social network and synergy among members; and how to balance public and private spaces are the questions that need to be answered by co-working companies in their day-to-day operations.



Conclusion

Co-working space will be the future of work, and China will be the main stage where this evolution takes place. The industry is likely to enter a phase of consolidation and operational value-add. Those who win the race toward scale and true value-add will become the defining force of the workplace of tomorrow.

Case Study:

How naked Hub Helped Redefine Co-Working In China

naked Hub is a great success story in the Chinese co-working space. After its announced merger with WeWork in April, the company is becoming part of the absolute industry leader in co-working globally.

Founded in Shanghai in 2015 by South African entrepreneur Grant Horsfield and his wife Delphine Yip, naked Hub was created as an extension of its parent company naked Group's belief in creating a community inspiring people to live well, live healthy and "live naked".

"(The) deeper meaning (of naked) is the attitude to live a simple, sustainable life, stripping away the excess and getting back to basics," said Delphine Yip-Horsfield, who graduated from Harvard University with a masters degree in architecture.

This concept is reflected in the design, atmosphere and community building efforts of naked Hub. All naked Hub co-working spaces are designed to give a sense of relaxation and rejuvenation. Bright spaces filled with natural light, large green walls of plants, floor-to-ceiling windows and original

shades of wood furniture give people the feeling they are back in nature.

The atmosphere at naked Hub follows the same philosophy. The "living room" space in every naked Hub co-working location, where members meet over free coffee, tea and beer, provides an environment ideal for relaxed conversations and brainstorming new ideas. Ping Pong tables, swimming pools, sleep pods, gym equipment and yoga classes are some of the innovative elements naked Hub has experimented in its co-working space.

Culture is an important differentiator of naked Hub. Paying homage to local culture builds a deeper connection among the people, the physical space and the brand. For example, naked Hub's location in Shanghai's historic Huangpu District draws inspiration from "Old Shanghai", integrating elements of the city's classic Shikumen style buildings with features of brick walls and lane houses. The Hong Kong naked Hub location in Sheung Wan incorporated elements of Cantonese culture, utilizing dim sum bamboo steamer as the lamp shades.

naked Hub treats the idea of being "green" seriously. It has partnered with U.S. Green Building Council, the creators of the most widely used green building system LEED, to develop sustainable and green co-working platforms in China. All office spaces of naked Hub use environmentally friendly and green materials, as well as systems in place to ensure indoor air quality.

These distinctive characteristics set naked Hub apart from other Chinese co-working space operators. The unique design, the back-to-basics atmosphere and the warm community makes naked Hub a torch-bearer of high standards and creativity. Now, with its combination with WeWork, naked Hub - together with its new partner - will lead the next stage of evolution toward the future of work.



Footnote:

¹ iResearch: 中国联合办公行业研究报告2017 (China Co-Working Industry Research Report 2017)

² China Money Network: <https://www.chinamoneynetwork.com/china-unicorn-ranking>

³ China Money Network: <https://www.chinamoneynetwork.com/2018/05/04/chinas-venture-capital-market-tops-world-as-15-6b-deployed-in-april-alone>

⁴ iResearch: 中国联合办公行业研究报告2017 (China Co-Working Industry Research Report 2017)

⁵ CBRE: <https://www.cbre.com.hk/en/global/about/media-center/2017/09/13/global-prime-office-rents-q2-2017>

⁶ China Money Network: <https://www.chinamoneynetwork.com/2018/04/11/wework-to-acquire-chinese-co-working-firm-naked-hub-for-400m>

⁷ WeWork: <https://www.wework.com/zh-CN/blog/posts/wework-naked-hub>

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