Session 2: When Worlds Collide: How an 86-Year-Old Federal Law (The Securities Act of 1933) Exposed the Flaws in WeWork's "Innovative Business Model"

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Abstract: Co-working pioneer WeWork, a wholly owned subsidiary of The We Company, grew meteorically through an extremely aggressive building and master-lease acquisition strategy over the past several years. Substantial, early stage funding from SoftBank, a Japan-based high-tech venture capital investment bank, reinforced WeWork's unicorn status. But was WeWork's business model truly unique, bringing with it the promise of a very profitable real estate operating company in the future? Or was it the company's early stage, venture capital-fueled meteoric growth—without a solid business plan for how that growth and market dominance might translate to a financially stable and profitable operating entity over the long run—that made it the shiny red firetruck in the toy store window that attracted investor attention?

I. Overview

In Session Two of the SITIE2020 Symposium: Innovating the Built Environment, Ryan Mathisen presented his research on how the Securities Act of 1933 helped expose both the flaws of and extraordinary risks posed by WeWork's business model as it prepared to issue an initial public offering (IPO). Mathisen began his presentation with a brief overview of WeWork's founding, as well as SoftBank's subsequent involvement in propelling the start-up to market dominance.[1] He proceeded to explain and explore the problematic portions of the WeWork IPO and ultimately concluded that WeWork's story should serve as a cautionary tale about the risks of "chasing unicorns" to both start-up companies and venture capitalists.

II. The History of Stock Market Regulation

Stock market regulations, particularly the Securities Act of 1933 (the '33 Act), have played an important role in providing current and potential investors with complete and accurate information so as to reduce the amount of speculation required in pricing companies. 86 years after the '33 Act was passed, this very law would help disclose the extraordinary risks associated with WeWork's business model and lead to the incredible devaluation of the company—from an inexplicable $47 billion to a mere $3 billion. Accordingly, WeWork's fall from grace can be explicitly linked to the disclosures required by the '33 Act, specifically the S-1 Registration Filing.

The '33 Act was first enacted to help restructure the economy during the Great Depression after the Wall Street crash of 1929. The crash, although not the only cause, played a large role in

[1] SoftBank Group Corp.is a Japanese multinational conglomerate holding company headquartered in Tokyo. SoftBank owns stakes in many technology, energy, and financial companies. SoftBank began as a software distributor in 1981 and entered the publishing business in 1982. It went public in 1994, and began investing in internet services, like as Yahoo in 1996. Most recently, SoftBank launched its Vision Fund, the world's largest technology-focused venture capital fund, with over $100 billion in capital.

sparking the severe economic downturn. During the 1920s, speculation of publicly traded companies was rampant and far exceeded the actual value of individual stocks. Company owners and stockbrokers stood to profit substantially from the inflated value of stock and oversold the value of companies without having to disclose the underlying financial information. This wild speculation led banks to lend large sums of money, often 75% of a stock's price, to promote and encourage stock purchases. Unfortunately, as unemployment rose and the agricultural sector struggled with a period of poor crop yields, people panicked and rushed to sell their over-valued stocks, triggering a sell-off.

The United States Congress viewed wild speculation as the cause of the 1929 crash. Members of Congress reacted by passing the '33 Act, which generally required companies to disclose four key pieces of information to investors: (1) a description of the company's properties and businesses; (2) a description of the security to be offered for sale; (3) information about the management of the company; and, (4) financial statements certified by independent accountants. An underlying premise of the '33 Act was to give investors key financial information before they invest in securities because the more information available, the less speculation is needed. This required information is both broad and specific and requires that audited Financial Statements be filed with the SEC as part of the registration process. Expanding off of the '33 Act, the Securities and Exchange Act of 1934 then imposed quarterly, annual, and episodic filings in order for a registered company to remain publicly traded.

Since the '33 Act, there have been several other changes and additions to the regulatory landscape of issuance and trading of securities, including: The Securities Exchange Act of 1934 (mentioned above); the Investment Company Act of 1940; the Financial Institutions Reform, Recovery and Enforcement Act; the Sarbanes Oxley Act of 2002; the Dodd Frank Act of 2010; and, the Jumpstart Our Businesses Act of 2012 (JOBS Act). Most significantly, the JOBS Act, which was intended to reduce the regulatory burdens for "emerging growth companies," allows such companies to provide only two years of the required financial records instead of the five years as required by the '33 Act. The JOBS Act also exempts companies from the pay ratio requirements and executive compensation disclosures that were added with the Dodd Frank Act. Ultimately, and in pertinent part, the JOBS Act exempted certain start-up companies, like WeWork, from complying with the full requirements of the '33 Act.

III. The History of WeWork

WeWork primarily conducts business in the office-sharing or "Space-as-a-Service" market. Typically, companies either directly purchase or lease entire buildings or entire floors of buildings to run their business; however, smaller companies do not have the financial resources to do the same. The Space-as-a-Service providers started out by addressing the needs of these smaller businesses by master-leasing entire buildings or floors, building out smaller spaces, and offering subleases or drop-in memberships to smaller companies that may only need a certain amount of space on a floor. Accordingly, WeWork enters into long-term commercial master-leases, renovates then subleases (or subleases then renovates, depending upon the terms of the transaction) that space to prospective occupiers, often on a much smaller scale. As Space-as-a-Service providers, particularly WeWork, became increasingly adept at becoming the Landlord for smaller occupants, in addition to servicing the needs of entrepreneurs and one and two-employee users, larger, potential clients--including those requiring one or more full floors in the company's master-leased buildings--began to take notice, and started working with these SaaS companies as their de facto corporate real estate departments, finding and building-out custom office spaces for regional and local offices throughout the United States. As a consequence of this strategic expansion of its client base, and the size of the Space-as-a-Service transactions in which it engaged, WeWork now counts among its client-tenants very large corporations (i.e. enterprise members) whereby WeWork addresses and customizes their office space needs in various commercial real estate markets.[2]

WeWork was founded in 2010 by Adam Neumann and Michael McKelvey, and it experienced rapid growth and received its first large capital investment in 2012 from Benchmark.[3] Over the next few years, WeWork continued its impressive growth and received more and more capital investments.[4] In 2017, SoftBank, a Japanese technology investment fund, announced an investment of around $4 billion in WeWork. In 2019, a few months before filing the paperwork for its IPO, SoftBank valued WeWork at a whopping $47 billion. Unfortunately, because SoftBank had already pumped billions of dollars into the company, it had significant incentive to inflate WeWork's value ahead of an IPO. A higher valuation would allow SoftBank to claim a positive return on its investment and to sell its current interest in the company to new investors at higher rates. SoftBank's valuation of WeWork ultimately proved to be a "house of cards" after investors were able to explore and analyze the details of WeWork's financial and risk disclosures required by the '33 Act.

IV. Problems Revealed by the S-1 Registration Filing

After WeWork's required disclosures were filed, potential investors found significant issues in each of the general components of required information under the '33 Act. Most importantly, the financial disclosures showed both that WeWork had a history of extraordinary losses, often spending twice as much as it earned, and that there were instances of egregious self-dealing. WeWork essentially put forth a "just trust us" plan to potential investors: "Our management will have broad discretion in the application of the net proceeds of this offering, and investors will be relying on the judgment of our management in this regard."

First, there were numerous eyebrow-raising issues with the description of the company's properties and businesses. Although WeWork claimed to be a technology company, their business model was hardly revolutionary; instead, it merely mirrored traditional real estate business models—lease property to sublease it to make a profit—but at a pretty remarkable scale, in terms of transaction volume and geographic coverage. Additionally, the disclosure revealed a number of pet projects unrelated to the business as a whole. Even worse, the disclosure of risks to the business was over thirty pages long. Among WeWork's potential investment risks were:

[2] According to The We Company's S-1 filing, enterprise members accounted for 32% of WeWork's total membership and 38% of its service revenue for the year ending December 31, 2018.

[3] Prior to founding WeWork, Adam Neumann and Michael McKelvey created Green Desk in 2008. Green Desk was also a shared-workspace business focusing on sustainability, which they founded in 2010. The pair sold their interest in Green Desk and using the funds along with a $15 million investment from Brooklyn real estate developer Joel Schreiber for a 33% interest in the company, they founded WeWork in 2010.

[4] Prior to SoftBank's initial investment, WeWork's investors as of 2014 included J.P. Morgan Chase & Co, T. Rowe Price Associates, Wellington Management, Goldman Sachs Group, the Harvard Corporation, Benchmark, and Mortimer Zuckerman, former CEO of Boston Properties. Further, in March 2016, WeWork raised $430 million in a new round of financing from Legend Holdings and Hony Capital, valuing the company at $16 billion.

- “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 the foreseeable future”;
- “We may not be able to compete effectively with others”; and
- “We have engaged in transactions with related parties, and such transactions present possible conflicts of interest that could have an adverse effect on our business and results of operations.”

The last risk included numerous instances of self-dealing in which the executive board and Adam Neumann engaged. These transactions included company leases with at least four of Mr. Neumann’s properties and the company’s purchase of the trademark rights from Mr. Neumann for $5.9 million to use the word “We.” Prior to the IPO, Mr. Neumann sold a significant number of shares (totaling roughly $362 million) without allowing company employees to do the same, presumably so that the company valuation would remain inflated. Mr. Neumann also took out numerous loans against the value of his shares in the company, one of which was a $500 million line of credit secured by pledges of stock.

Secondly, the description of the security offered for sale was problematic in that it disclosed that Adam Neumann would retain majority control of the company even after the company went public. This disclosure is problematic for potential investors because it effectively means that any investors would be subject to Mr. Neumann’s decision-making, good or bad. Also, the disclosure about the management of the company gave potential investors pause for concern because it allowed Mr. Neumann to not only retain control over the board of directors (i.e. the shareholder’s voice in the company), but it also provided for a succession plan in which Mr. Neumann’s wife would have significant authority in selecting a new CEO without input from the board of directors.

Lastly, and arguably most importantly, the financial disclosures revealed a company that was bleeding cash and had yet to turn a profit. In just comparing revenue against non-growth-related expenses and lease expenses, lease costs and administrative costs alone outstripped the company’s revenue. WeWork also revealed that it signs relatively long-term leases (e.g. 15-year terms), so the company had roughly $47 billion in lease commitments but only $4 billion in committed revenue. Controversially, WeWork attempted to hide these losses by using a metric called a Contribution Margin.[5] This metric allowed WeWork to deduct building and lease expenses from the company’s overall expenses to show a relatively strong profitability. It is worth noting that Uber used the same metric in its IPO filing, but Uber has yet to achieve profitability.

Ultimately, the disclosure requirements of an 86-year-old law helped reveal a company that was plagued by erratic spending, incredible self-dealing, questionable long-term profitability, and seemingly insurmountable losses. Arguably, these required disclosures, and the conclusions they supported, saved potential investors from inevitable catastrophe. In essence, the ‘33 Act did what it was intended to do.

[5] Contribution margin is a product’s price minus all associated variable costs, resulting in the incremental profit earned for each unit sold. The total contribution margin generated by an entity represents the total earnings available to pay for fixed expenses and to generate a profit.

V. Where is WeWork Now?

As a result of the disclosure requirements of the '33 Act, WeWork's IPO ultimately failed.[6] A company that was once valued as much as Target is now worth only a fraction of that. Moreover, at the time of this presentation, The We Company, WeWork's parent company, has withdrawn their IPO application at the request of SoftBank. Both Mr. Neumann and other executives were pushed out, although Mr. Neumann received a "golden parachute" exit package valued at an incredible $1.7 billion. After the failed IPO, SoftBank chose to bail out the company with an infusion of $9.5 billion, in addition to its existing investment of $5 billion prior to the IPO, at a time when WeWork was only valued at around $8 billion, putting SoftBank's overall investment in WeWork "underwater."

The future of WeWork is very uncertain: As of April 2020, SoftBank terminated an additional tender offer of $3 billion. WeWork's prospects have darkened even further since the beginning of the COVID-19 pandemic, which may very well change the landscape of office work forever and ultimately eliminate the office-sharing model altogether.

[6] The We Company filed its Form S-1 Registration Statement with the SEC on August 14th, 2019. Less than two months later, the company filed to withdraw its IPO on September 30th, 2019.