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Co-working is growing walls: The maturation of the flexible office sector

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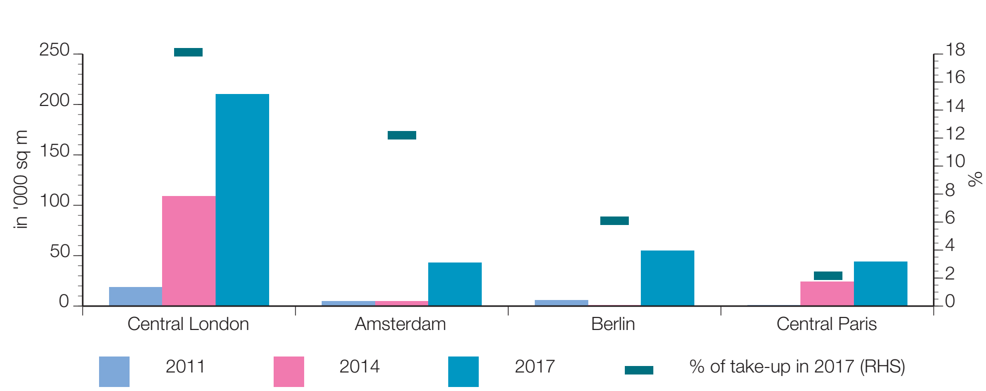
Changing working trends underpin flexible office demand

Flexibility in lease terms and space has been on the rise since the 1980s, when serviced and managed offices were common. At that time, it was predicted that technology would lead to a rapid increase in homeworking and, consequently, dispersion of the workforce. So far, this prediction has not become a reality. While technological change has allowed "office" work to be less dependent on a certain place or time, working preferences have changed as the share of millennials[1] in the workforce has increased. The office is no longer seen as "just" a place to work; it has also become a place of communication and collaboration. In addition to focusing on social aspects, millennials put a higher emphasis on amenities and services in their working environment. Businesses, on the other hand, increasingly believe that an employee's happiness is directly correlated to his or her likelihood of success and, as a result, are trying to align their real estate decisions to the shifting demands of their employees. While the traditional office sector is challenged by the changing requirements, flexible offices are better suited to cater to these "well-being" needs. Besides the technological evolution and behavioral changes, economic trends, such as the rising levels of self-employed and contingent workforce, is the third key driver behind the growth story of flexible office space in recent years. While flexible office take-up has only represented a minor share of the overall take-up (<2 percent) over the past four decades, key European cities like Amsterdam, Berlin, Paris and London have all seen a growing influence of this subsector on the overall leasing market, with 4 percent to 18 percent of the overall office take-up in 2017 being attributed to flexible office space.

Viability of segment supported by a maturing occupier base

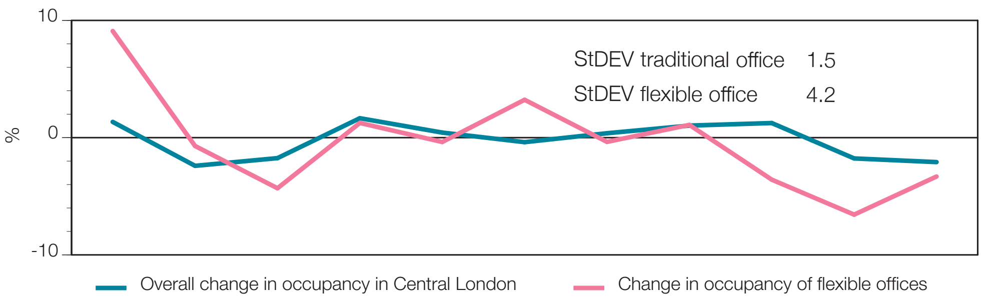
Technology has enabled the development of new, more flexible working concepts, which have been experiencing explosive growth since the end of the global financial crisis. Flexible working operators seized the opportunity in the last downturn and received significant returns by signing long-term leases with low rents and selling small units for shorter periods of time. Initially mainly driven by freelancers and start-ups looking for an opportunity to rent space on a desk-by-desk basis in an open-plan environment that encourages collaboration, flexible office take-up in recent years has shifted towards a more even split with SMEs and large corporates.[2] The main advantage of integrating flexible office space into their real estate strategy is the ability to adjust the space requirements in line with any changes in the underlying business development and, therefore, increase space efficiency. It furthermore allows them to test certain locations, markets, office layouts and services for a certain period of time. This can help to increase employees' happiness and, subsequently, productivity, as well as retain and attract talent. To benefit from better economics, corporates are willing to sign slightly longer leases (18 months–24 months) in exchange for a rental discount compared with the traditional membership model. A recent occupier survey by CBRE in the United States found that 65 percent of corporates expect to integrate flexible office space in their portfolio by 2020. The open-plan co-working model is well suited for collaboration-seeking start-ups and freelancers. Larger companies prefer dedicated desks or private rooms. As the sector evolves, hybrid models are increasingly emerging, which combine elements of co-working (cost, flexibility and community) with those of business centers (dedicated desks, private space, fit-out) to capture a greater range of occupiers. In line with the evolution of hybrid space, new operators, including WeWork, Spaces or The Office Group, have entered the market and have largely been responsible for the rapid increase in flexible office demand.[3]

Flexible office take-up in key European cities



Sources: JLL, CBRE, PMA, AXA IM – Real Assets

Higher volatility of underlying flexible office demand



Sources: JLL, Regus, AXA IM – Real Assets, Regus occupancy in Central London

Mismatch of long-term liability and short-term leases

Signing a long-term lease and selling it short-term at a higher rent is not only the main rationale of flexible office operators, but also the key risk of the business model. Profits are heavily reliant on the occupancy level, with breakeven occupancy quoted at around 70 percent to 80 percent. The majority of currently active flexible office operators have so far existed only in an expanding economy, benefitting from rental values, high occupancy and increasing margins. Due to real estate being the highest cost component of flexible office operators (around 40 percent[4]), the rationale of the business model fades at or near the peak of the real estate cycle, and high initial rental agreements lead to shrinking margins. The structure of elastic revenue and high fixed costs make the business model risky, as short-term obligations are generally the first to be terminated in a downturn, with occupancy rates being very sensitive to any changes in market conditions. The hybrid model offers higher income stability, as it targets an element of guaranteed occupancy similar to corporate and group travel hotel bookings, which lowers the risk of a loss in occupancy levels. A more diversified tenant base can also help to protect from significant membership loss due to the downturn of an individual industry.

As the barriers to entry in this market are very low, competition is high, with scale being the only way to increase margins.[5] The race for market share drives the rapid expansion of operators, with the risk of the market to overshoot and become saturated before a correction occurs. Akin to the hotel sector, the emerging winners are expected to dominate the market. While this may take a decade to play out, ultimately we expect that the sector will remain more cyclical than traditional long-let offices due to the mismatch of long-term liabilities and short-term leases.

The impact on property values

Despite the increasing importance of the flexible office sector, there remains a question about the correct pricing of flexible office space within an individual asset or portfolio. In contrast to the traditional office sector, the higher volatility of the flexible occupancy rates lead to a less predictable income stream. Due to the lower income security, investors generally perceive flexible office space as more risky and want to be compensated for this risk with higher returns. While the evidence on the sale side is still very limited, an analysis by Jones Lang LaSalle in the United States indicates that the impact on cap rates increases in line with the share of space allocated to flexible offices. Over the past few years, the majority of buildings with a significant allocation to flexible workspace (>50 percent) traded at a discount of 50 basis points to 100 basis points to compensate for the risk. The risk perception seems to vary strongly by the proportion of flexible office space in one building. A couple of floors that are leased to a flexible office operator with the provision of amenities and services, as well as project space and flexible overflow, is seen as a benefit to the rest of the building. The brand of the operator can also increase the attraction for traditional occupiers. A recent survey by CBRE suggests that the building value even increases for an office building with less than 30 percent of flexible office space and could potentially capture a premium up to 35 basis points.[6]

Conclusion

Flexible office solutions continue to mature and are being more widely adopted, even by larger corporate occupiers, responding to the change in workers' behavior and underlying technological improvements. As a result, we believe there is a place for exposure to this subsegment in property investment portfolios, given that demand is unlikely to dissipate anytime soon. The integration of flexible space should, however, be considerate of the underlying risk of the operators' business model: the mismatch of long-term obligations and short-term leases. The ongoing shift to a more corporate tenant base with longer lease agreements, particularly within the hybrid business model, provides an opportunity to mitigate this risk. But ultimately, we feel a single asset's exposure to flexible offices of around 25 percent may allow investors to capture the benefits without the drawback of more limited liquidity and higher income volatility inherent with office buildings fully occupied by flexible office operators.

[1] Millennials will make up 50 percent of the global workforce by 2020 (CBRE, 2017).

[2] Startups and freelancers accounted for 78 percent of all leased flexible office space in 2012 vs. 55 percent in 2017, while SMEs/larger corporates increased their share from 22 percent to 45 percent (*Deskmag* survey, 2018).

[3] The Top 5 operators in Central London (WeWork, TOG, i2 Limited, Regus, London Executive Offices Group) were responsible for almost 70 percent of the flexible office demand over the last five years (CBRE, 2017).

[4] *Deskmag,* 2017

[5] Gross margin for locations less than 2,000 square meters is 5 percent–15 percent, versus 40 percent for an average of 5,000 square meters (ZHAI, 2017: *A Study of the Co-Working Operating Model).*

[6] *CBRE Investor Intentions Survey 2018*

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