UBS Asset Management

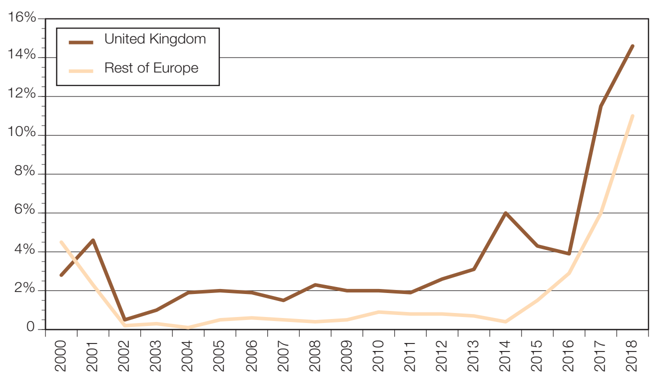
Offices, the new operational asset class

The office has been a constantly, albeit relatively slowly, evolving commercial real estate asset class in the post-war period. But as serviced-office providers have rapidly penetrated the market over the past few years, the process of change is being forced to accelerate. We are somewhat sceptical over the sustainability of the business models employed by some of the new operators, and, as with many others, struggle to get our heads round the lofty valuations and the rather questionable accountancy practices.

But this scepticism over the operators doesn't change the fact that there has been a fundamental shift in both corporate and SME occupiers, which has fuelled the exceptional growth in this segment. To put this in context, the serviced-office sector, which had never contributed more than a few percent of take-up until recently, accounted for approximately 15 percent of take-up in the UK and 11 percent in continental Europe in 2018, according to data from PMA.

CBRE's annual occupier survey gives us some insights into the attractions that corporate occupiers see in the serviced-office model, which is now the key driver of the growth in these operators. It's not surprising to see that addressing short-term demand increases was the most selected response in the 2019 survey. In the current growth environment in Europe, where supply is very tight in many markets, having the flexibility to increase capacity in a wide range of locations without having to sign a long commitment to space is clearly a fundamental attraction to the model. But perhaps it is more surprising that reducing costs is also frequently cited as a reason for using flexible office space.

Serviced-office take-up (% of total)



Source: PMA 4Q18

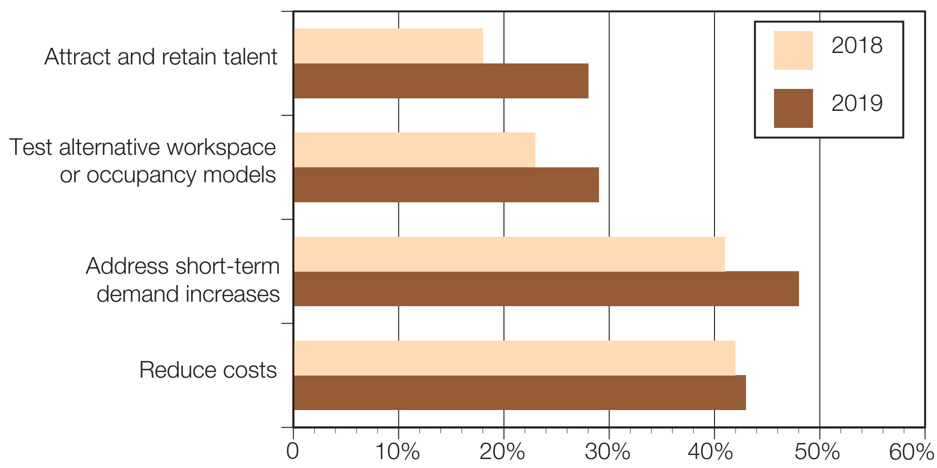
Please note that past performance is not a guide to the future.

Conventional wisdom would suggest that serviced-office providers give "soft benefits" to occupiers with regards to flexibility and the range of service provisions that are available, but at a cost that equates to a higher rent than a traditional office lease. But this all depends on the timescales involved and how much visibility the company has on its future occupational needs. This is demonstrated by a study JLL carried out into a hypothetical company of 30 staff in Hamburg choosing between taking on a traditional lease or a serviced-office option. The conclusion was that it would be four years before the initial startup costs (fit-out costs, legal costs, agent fees, etc) were amortised by the lower passing rent compared with opting for the higher rent of a serviced-office model with no initial costs. There are also accounting benefits in many jurisdictions for companies opting for the shorter term liabilities of the serviced-office models, as traditional quarterly or annual rents often have to be included as future liabilities on the balance sheet. This frees up cashflow for other investment, which is particularly important to SME companies.

With serviced providers prepared to go as far as carrying out bespoke fit-outs of large sections of space for corporates looking to take on expansionary space, but only asking for a six-month commitment back in return, it's easy to see how many of the largest corporate occupiers have also been tempted into the sector. This can often be to house a creative team and become more competitive in the labour market than the standard offering of a corporate headquarters-style office building. But perhaps the main benefit to the corporate occupier is that the serviced provider can take the "risk" (effectively the long-term leasing liabilities and fit-out costs) associated with a traditional model off the table for a small rental premium. But clearly these liability risks don't disappear; they have now just been passed on to the operator and this potentially could lead to some major disruption if the markets take a negative turn.

Under a downturn, we expect that the corporates that have used serviced offices for overflow space or creative outsourcing will simply repatriate those teams within the main headquarters building, where head-count reduction will have freed up space. The counter argument from the operators is that, in a downturn and period of uncertainty, more companies will opt for the flexible option. We're not convinced this will work in practice, however, as this implies that all companies are operating on short-term leases, which gives them the option to choose between

Reasons cited for using flexible space (% respondents)



Source: CBRE Occupier Survey 2019

one or the other. With traditional lease structures still dominant, this is unlikely to be the case, and companies will have overriding leases on their headquarters, which will exceed the period of downturn. To fully optimise their occupation (when pressures on costs are accentuated), they will seek to maximise their usage of the space they already have a liability over and exit the most flexible units.

Although the serviced-office sector may continue to grow, particularly in parts of Europe where it has seen less penetration so far, we expect there will always be demand for traditional, longer lease office buildings, as any larger company will still require its own location for branding, client meetings, senior management offices and other functional purposes. We expect that even within the traditional leasing structure, there will be significant changes over the next 10 years. The length of the traditional lease will come under increasing pressure, and the expectations for service provisions will be much stronger. As discussed previously, although the day-to-day cost may appear higher for the occupier, the trade-off between low, upfront costs and flexibility will push demand towards the buildings that are able to offer these provisions within the traditional leasing structure.

This presents some significant challenges to the traditional office landlord. To offer more service provisions will inevitably lead to a significant increase in management requirements, and the capex required to keep these buildings up to date and to compete has already increased significantly in some markets. And the whole structure of the valuation process will need to be reconsidered. Longer unexpired lease lengths are nearly always considered to be accretive to the value of the asset, so how will things change if an office becomes more operational and, by definition, has shorter firm-lease contracts? Unfortunately, some of these challenges may encourage continued resistance of landlords who wish to cling to the traditional core model of leasing up as much of their building to strong corporate covenants for as a long as possible. But we believe that failing to recognise and adapt in response to the early signs of structural change within the occupier market can have significant negative implications for longer term performance. And a very current example of how this can play out is being demonstrated in parts of the UK retail sector, which have tried to cling to the traditional core model of long-term leases and failed to adapt to the changing occupier landscape upon which the relative success of the investments ultimately depends.

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CORPORATE OVERVIEW

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