AVIVA INVESTORS

CO-WORKING SPACE: THE FUTURE OF OFFICE DEMAND?

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INTRODUCTION:

Though by no means a new sector, the serviced offices sector is undergoing a period of significant growth and evolution. Driven by improved technology, the way we work and the way businesses are organised is changing rapidly. Therefore, the type of workspace businesses require is also changing. This note looks at what this means for the serviced office sector, why we expect it to continue to expand and how real-estate investors should adapt.

KEY POINTS:

- We expect demand for serviced offices and co-working spaces to continue to grow in the medium term.
- Technology is reshaping businesses, and their need for office space, while facilitating flexible working.
- Serviced office users value flexibility. Short leases allow businesses to grow, downsize or relocate quickly. Also, short leases can be a cost effective option for start-ups and small businesses.
- In addition, businesses in co-working spaces benefit from access to collaborative communities and attractive work environments.
- Office demand is changing. Flexible office space is likely to account for an increasing proportion of all office space. Meanwhile, there are going to be fewer big firms and those that remain will be less likely to sign long leases.
- Owners of real estate will be disadvantaged without a strong understanding of this increasingly important part of the market.
- Serviced office providers are vulnerable to a downturn as they have fixed liabilities that they might struggle to meet if demand weakens.
- However, demand has been robust despite the economic weakness of recent years and structural drivers are strong.
- Real estate investors need to assess the quality and fit of serviced office operators as well as property fundamentals.

SERVICED OFFICES – A MATURE SECTOR AND ALREADY A SIGNIFICANT OCCUPIER OF OFFICE SPACE

In many respects, serviced offices comprise a mature office sector. Regus, the leading serviced-office provider, has progressed from its first lease on an office building in Brussels in 1989 to having almost 3,000 workplaces in 106 countries serving customers ranging from single-person start-ups to large multi-nationals[1]. So the sector is already a significant occupier of office space in many markets. For instance, Deloitte[2] estimates that 3.4% of Central London floor-space is let to serviced – office operators. The Business Centre Association[3] (BCA) estimates that across the UK, the serviced office sector operates in space equivalent to all the commercial office space in the City of London.

A RAPIDLY-EVOLVING OFFERING

The sector continues to evolve rapidly to provide a broader array of options for occupiers seeking flexible office solutions. Deloitte[4] identifies three broad types of serviced office on offer:

Serviced/Flexible office:

– Fully-equipped and managed office space taken on a desk-by-desk basis with meeting room and breakout facilities as further benefits. The most common type of space, it is popular with small and medium-sized businesses as well as with large companies seeking overflow or project space.

Co-working space:

– Run on a membership basis, with the membership fee giving access to office space, meeting rooms, wi-fi and networking opportunities and events. Popular with freelancers, entrepreneurs, start-ups and small businesses looking for flexible and collaborative working spaces.

Virtual office:

– Offers the use of the operator's address and phone lines to create the image of a working office. Additional facilities such as meeting rooms often available. Popular with small business, often start-ups with few employees.

New entrants have driven innovations in the serviced-office sector. While many new entrants are relatively small, niche players, one new entrant, WeWork, has grown rapidly and has drawn a lot of attention to trends in the sector and co-working habits generally.

[1] RBC Capital Markets Equity Research, "Regus PLC, getting growth potential for free from here", May 2016.
[2] Deloitte Real Estate, "The London Business Footprint, the Growth of Serviced Offices", 2015.
[3] "The UK Business Centre Market", A report for the Business Centre Association by IPD and Snapdragon Consulting, October 2014.
[4] Deloitte Real Estate, "The London Business Footprint, the Growth of Serviced Offices", 2015.

THE FUTURE OF HOW WEWORK?

- Established only in 2010, WeWork has grown very rapidly and now operates 113 office locations in 33 cities across 12 countries, predominantly in the US but also in major office markets such as Paris, London, Sydney, Shanghai and Seoul[5].
- WeWork's business model is to lease office space and divide it into desk-sized chunks, usually in fashionable cities such as San Francisco and New York, and rent it out on a month-by-month membership basis. Open floor plans and shared meeting spaces allow very high density.
- A key component of their US offering is the option of competitively-priced healthcare insurance. This is less relevant in Europe but nevertheless WeWork takes advantage of its strong bargaining position to offer tenants competitive rates for local amenities, such as gym memberships.
- The company's narrative revolves around catering to a new generation of creative workers willing and able to pay for the networking opportunities on offer in WeWork's centres. Networking is facilitated by shared communal spaces and community events.
- Many investors are convinced by this narrative. By mid-2015, WeWork had attracted investment of $960m to support a valuation in excess of $10bn[6]. This war chest is allowing it to expand its network of locations rapidly, building on its first-mover advantage. Growth of memberships appears to be just as rapid, however, with the company reporting high occupancy across its locations.
- Such a valuation implies that investors don't see WeWork as the future of serviced offices – they see it as the future of offices.
- Critics counter that it needs its backers as it is burning cash to capture growth. They worry its business model is vulnerable in a downturn given the mismatch between long lease liabilities and monthly memberships. While its early years coincided with relatively subdued office lettings markets, this is no longer the case and ongoing expansion entails rising rent liabilities. Barriers to entry are relatively low and competition is increasing.

Established companies are also responding to changing work habits by broadening the range of services they offer. For instance, Regus, whose main brand focuses on the traditional serviced/flexible-office segment, has launched an array of other brands to target emerging parts of the sector and emerging ways of working. Its offer includes[7]:

- "Spaces", its co-working brand, expanding rapidly in Europe, North America and Asia-Pacific. Regus doesn't believe this growth cannibalises its existing demand as it plays to a different demographic.
- Regus Express – co-working spaces in convenient locations such as motorway services, airport terminals and shopping malls.
- Signature Group, its luxury offering.

Regus hopes that this breadth of offer will allow it to expand from close to 3,000 locations currently, to up to 20,000 locations in coming years[8].

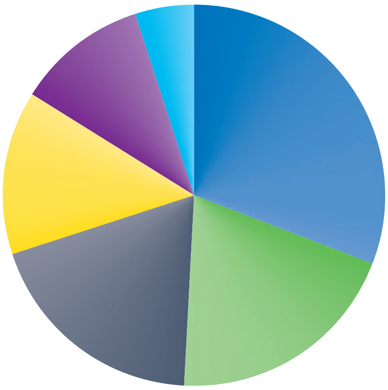
[5] https://www.wework.com/locations as at 13 September 2016.
[6] "WeWork Operating Overview", Eastdil Securities, Q4 2015.
[7] RBC Capital Markets Equity Research, "Regus PLC, getting growth potential for free from here", May 2016.
[8] RBC Capital Markets Equity Research, "Regus PLC, getting growth potential for free from here", May 2016.

A BROADENING ARRAY OF OCCUPIERS

There are signs that the supply push from new and established serviced-office providers is meeting growing demand from a broad array of potential occupiers. While start-ups and small-to-medium sized enterprises (SMEs) remain an important part of occupier demand, the sector is also increasingly appealing to larger companies seeking flexible project space, for example. And demand is not limited to the technology and media sectors. Data from the BCA show a broad range of occupiers taking flexible space in the UK, with business services and creative industries firms accounting for 40% of demand.

Established business-service providers are using serviced office space to attract and retain talent while benefiting from networking opportunities. KPMG for example are deploying staff at WeWork as it helps them attract talent while also giving them access to up and coming businesses which could well be future customers of theirs.

Occupier business by sector, UK



Other	31%
Business Services	20%
Creative Sector	19%
Industrial and Distribution	14%
Financial and Insurance	11%
Third Sector	5%

Source: BCA, The UK Business Centre Market, 2014

> *The supply push from new and established serviced-office providers is meeting growing demand from a broad array of potential occupiers.*

THE GROWING APPEAL OF NON-TRADITIONAL LEASES:

In many respects, the increasing acceptance of flexible office space is part of a move away from traditional lease structures. In many markets, lease lengths have been shortening for several years and many occupiers value the transparency and simplicity inherent in flexible lease structures. Though, on a per-square-foot basis, serviced-office space can appear more expensive than traditionally-leased space, flexible space is generally taken on a "one fee covers all" basis. So the extra costs of traditional leases – security, reception and cleaning costs for instance, as well as reinstatement costs incurred at the end of a lease – are avoided.

In fact, serviced-office operators suggest that occupiers make sizeable savings by only paying for the cost of space they use. Regus describes this as a movement to viewing "property as a service" and suggests that cost savings of 60-80% are possible for clients who reduce their fixed-cost base and use flexible office solutions to fill the gaps[9]. And there is independent research backing up these claims. A report by the Chartered Institute of Purchasing and Supply[10] found average savings of almost 80% across a number of scenarios and, according to Unwired Research, over 50% of office desks are unoccupied at any one time[11].

SECTOR HAS SEEN GROWTH THROUGH A PERIOD OF ECONOMIC WEAKNESS

The strong recent growth in the sector has come against a backdrop of economic weakness. In Central London, Deloitte found a 67% increase in the volume of space occupied by serviced offices in the ten years to 2014, a turbulent economic period. And across the UK as a whole, the BCA estimates that 43% of centres in its sample opened between 2005-2009 with a further 21% opening during 2010-13. Across the Atlantic, WeWork's stellar growth since 2010 has coincided with an often sluggish recovery from the "great recession" of 2008-9. Meanwhile Regus has grown strongly in emerging markets through this period.

[9] RBC Capital Markets Equity Research, "Regus PLC, getting growth potential for free from here", May 2016.
[10] "The True Cost of the Flexible Office", Chartered Institute of Purchasing and Supply, 2003
[11] RBC Capital Markets Equity Research, "Regus PLC, getting growth potential for free from here", May 2016.

AND KEY STRUCTURAL DEMAND DRIVERS APPEAR TO BE IN PLACE FOR FURTHER GROWTH

The sector's strong growth suggests there are structural trends that are driving an increase in demand for flexible office space. What might these be?

One obvious driver is the increasing prevalence of **flexible working**. In the UK, for instance, the Work Foundation estimates that at least one third of the entire labour force works remotely all or some of the time, a figure that equates to roughly 10 million people[12]. It also finds that, by 2015, nearly 40% of organisations had embraced mobile working and expects this number to rise to over 70% by 2020. With over 80% of managers believing that flexible working is of benefit to their business[13], this expectation appears very plausible. Technology, of course, is a key enabler of this trend and with super-fast broadband, smartphones and other mobile devices increasingly ubiquitous, the Work Foundation suggests we may be approaching a "tipping point" where mobile working becomes the norm. It reckons that adoption of mobile working is most prevalent in small and especially start-up organisations which have been "born digital".

And **start-ups** in turn are becoming increasingly common. In the UK, for instance, there were over 600k new company formations in 2015, up from c440k in 2011[14]. In fact, company formations have been rising strongly since the late 1990s with the recession of 2008-9 barely interrupting this trend[15].

Self-employment too is on a strongly rising trend. In the UK, the total number of self-employed people rose to almost 4.8m in June 2016, an increase of almost 1m since late 2008[16]. While not all of these are involved in the type of knowledge work that requires significant office space, data on the number of **freelancers** suggests that many are. According to IPSE, the membership body supporting independent professionals and freelancers, there are nearly 2m freelancers in the UK, an increase of 36% since 2008[17]. This suggests that freelancers account for roughly 6% of all UK workers in employment.

Technology is a key driver of the growth of freelancing. It has increased connectivity and reduced the costs of information. Examples are the online platforms and marketplaces designed to match employers with talent. One of the biggest hurdles for contractors and small independent businesses is business development and filling their project pipeline and these platforms are designed to reduce this burden. Examples include Contently, which matches independent writers and businesses, and HourlyNerd which connects companies with business consultants. Such sites are examples of how the internet has lowered transaction costs to such an extent that it is more efficient to use the market by outsourcing than retain employees in-house. JPM argue that in addition to small business growth, demand for flexible working space will also come from large firms as they open up their networks and shrink in size[18]. Indeed, they view the implications of technological change for office formats as transformative: as firms embrace open networks, the demand for flexible work space will grow.

All of these trends point to a future with a more distributed workforce in need of flexible office space. In fact, co-working spaces can be thought of as an enabler of flexible working as much as an outcome of the trend.

12 "Working Anywhere, A Winning Formula for Good Work?", The Work Foundation Lancaster University, January 2016.
13 "Flexible Working: Goodbye Nine to Five", Institute of Leadership and Management, 2013.
14 http://startupbritain.org/startup-tracker/
15 "Incorporated Companies in the United Kingdom", June 2016, Companies House
16 "UK Labour Market", August 2016, Office for National Statistics
17 "Exploring the UK Freelance Workforce in 2015", John Kitching, IPSE & Small Business Research Centre Kingston University, April 2016.
18 "The Evolving Office", J.P. Morgan Cazenove, November 2016

CHANGES TO ACCOUNTING STANDARDS MIGHT ENCOURAGE TENANTS TO SEE PROPERTY AS A LIABILITY

Meanwhile, forthcoming changes to accounting standards may also drive a significant increase in the number of tenants seeking flexible office solutions.

Under IFRS 16 and effective from the 1st January 2019, companies in more than 100 countries will be required to bring all major lease commitments onto their balance sheets, including real estate leases. Globally, it is estimated that c$3trn of lease commitments will be brought onto company balance sheets[19] while in the UK, it is estimated that c£200bn of commercial property leases will need to be acknowledged[20]. In addition, the administrative burden for commercial real estate will increase because the lease liability will need to be re-assessed every time there is a lease event and every time the rent changes. In such circumstances, it appears very likely that companies will increasingly scrutinise the opportunity costs of having capital in property and will likely seek to reduce such costs. This could drive an increase in serviced office space demand to minimise rental liabilities on balance sheets.

So – for a whole host of reasons – the serviced offices sector is likely to become an even bigger component of the tenant base for investors in office real estate.

[19] https://www.accountancyage.com/aa/news/2441603/new-lease-accounting-rule-brings-usd3trn-onto-company-balance-sheets
[20] http://www.cushmanwakefield.co.uk/en-gb/news/2016/03/uk-occupiers-face-adding-200bn-of-property-leases-to-balance-sheets/

KEY CONSIDERATIONS FOR INVESTORS

For property owners, the service-sector tenant may be of increasing value. The sector is expanding strongly and appears set for further structural growth. Furthermore, leases can be signed on attractive terms. WeWork often signs 15-year leases though these can be in exchange for up-front leasing concessions, notably fit-out costs[21].

However, landlords need to be cautious of the covenant strength offered by serviced office providers. The key risk of their business model is that the operators have largely fixed liabilities (long leases) but are vulnerable to declining revenues in the event of an economic downturn, or perhaps just a tech slump in the case of, for example, WeWork given that appears to be vital to its occupier base.

So they are vulnerable to a downturn and operators generally insist on the landlord taking exposure to this operational risk. Regus's standard procedure is that each centre is a standalone legal entity with little by way of group guarantee, transferring operating risk to the landlord[22]. Likewise, WeWork typically operates each centre as a property-level limited liability corporation[23].

Taking on serviced office tenants therefore requires careful consideration: not just of the suitability of the property and location, but also of the quality and appropriateness of the operator. There is a high service component to what most users of flexible office space pay for, just as people staying in hotels expect to be well cared for. Assessing operator's abilities to meet such expectations may not be in a traditional real estate investors' skill set. However, with the universe of traditional office leases set to shrink, investors that fail to build such capabilities are likely to be disadvantaged.

[21] "WeWork Operating Overview", Eastdil Securities, Q4 2015. WeWork often takes relatively large leases, average of 50,000sqft. This is unusually large, Deloitte figures show an average of 20-25,000sqft in Central London.
[22] RBC Capital Markets Equity Research, "Regus PLC, getting growth potential for free from here", May 2016.
[23] "WeWork Operating Overview", Eastdil Securities, Q4 2015.

Important Information

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