

Ignoring the flex space revolution could be costly for office investors, but jumping right in could also be risky

- > Flexible office space is playing a growing role in office markets globally
- > Technology innovations have made it easier to create flexible office space
- > Flex space operators can be likened to liquidity providers

Flexible office space ('flex space' or 'co-working') is playing a growing role in office markets in Europe and globally, with significant implications for investors in non-listed real estate. Growth has been rapid, with the volume of flexible space in the world's 20 largest cities doubling between 2014 and 2017. In 2017, around 1 million square meters were let to flex space operators in those cities. Given that European real estate investors are currently raising their allocations to the office sector, it is becoming more and more important for them to understand the potential and risks of flexible office space.

Recent technology innovations – such as smartphones, WiFi and more powerful laptops – have made it easier to create flexible office space, as evidenced by the emergence of operators such as WeWork and Servcorp, who allow occupiers to move easily into new markets and adjust their space footprint at short notice.

Flex space operators have effectively taken on the role of 'maturity transformers', leasing space long-term and sub-leasing it

short-term, and obtaining a rental premium for doing so as a reward for undertaking a long-term asset liability and trying to actively match it with a short-term income stream on a rolling basis. These operators may often provide for a more efficient use of space than traditional leasing models and can be strong tenants, both for 'core' and more management-intensive buildings. Working with flex operators via revenue sharing models can also lead to a wider tenant base and higher occupancy in the portfolio.

However, there may also be significant risks associated with letting space to flex space operators. If leasing market conditions deteriorate, they may face declining income in the short term to set against relatively fixed outgoings, threatening the success of their business model. Over time it may well emerge that only the largest operators are able to manage this kind of internal risk effectively, leading to the dominance of a small number of large operators, who may then be able to negotiate down the rents paid to property owners potentially below levels paid by traditional landlords.

Growth of the flex space model could also mean a reduction of transparency in the lettings market. Furthermore, there may be a greater risk of contagion, as a one-off shock in the flex space market – such as the bankruptcy of a global provider – could mean higher office vacancy levels globally. Equally they may represent a significant single-occupier exposure within a portfolio.

The growth of flex space is a good example of 'creative destruction' that investors and managers should consider embracing to reap benefits, but only when keeping a close watch on existing and potential risks

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