Flexible offices call for flexible owners
2019

Research

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INREV
Ito Tower, 8th floor
Gustav Mahlerplein 62
1082 MA Amsterdam, The Netherlands
+31 (0)20 235 86 00 | research@inrev.org | www.inrev.org

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Executive summary

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.

> 'The growth of flex space is a good example of 'creative destruction' that investors and managers should consider embracing to reap benefits'

Section 1

Introduction

1. Introduction

Almost a third of the average real estate investor's holdings are in the office sector. Allocation to offices increased from 28.9%[1] of the total real estate portfolio in 2018 to 34.4% in 2019.[2] The vast majority of that capital targets core-style offices.[3] But the office sector is evolving: flexible office space is on the rise and is gaining momentum. It has already impacted European real estate markets – and therefore, by extension, investors in non-listed real estate products based on those markets. This report assesses the potential and risks of flexible office investment.

Investor appetite for offices has always been high due to the liquidity of the sector as an investment asset and the demand for office space in any service-based economy, and the rise in office allocations shows the continued strength of interest in the sector from investors.

At the same time flex operators have come to play an increasing role in the sector. This, however, may open up risks – but also opportunities – when investing in the offices. Given their growing allocations to the sector, investors need to understand what lies behind the hype and build a stronger awareness of the particular characteristics of this subset of the office market.

1 Source: ANREV / INREV / PREA Investment Intentions Survey 2018

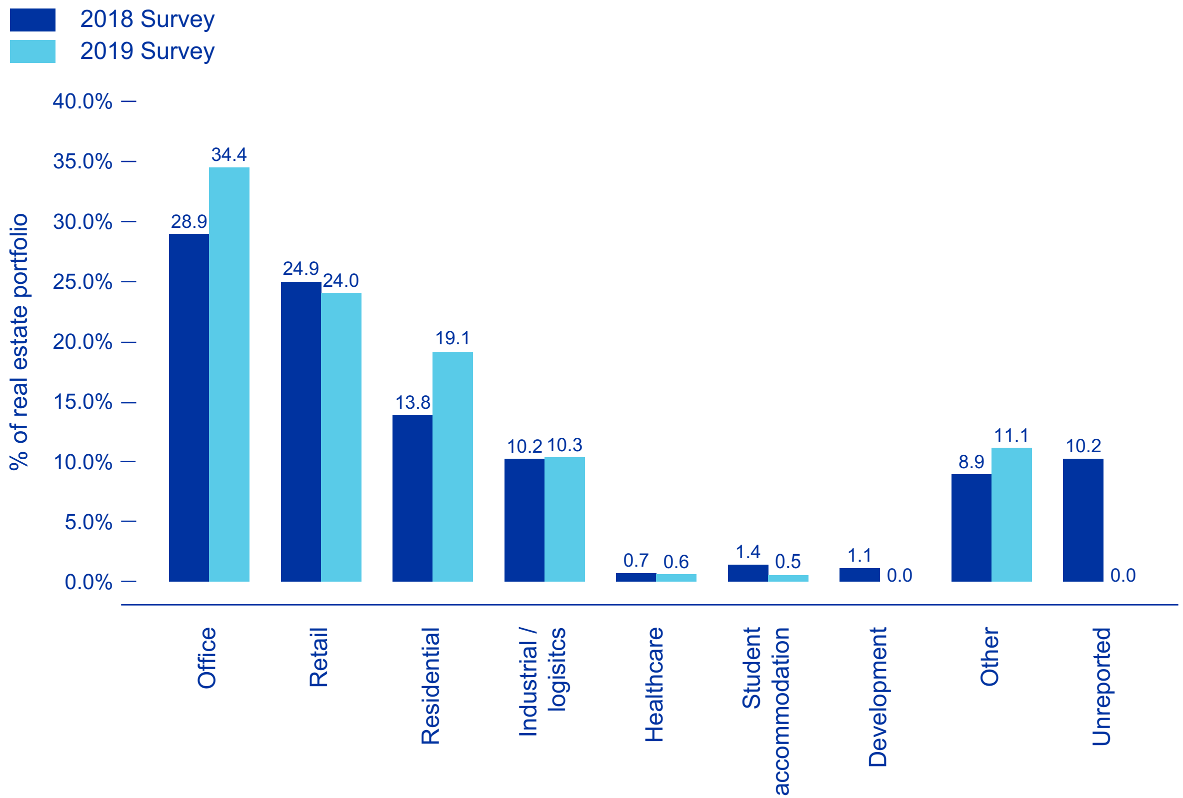
2 Source: ANREV / INREV / PREA Investment Intentions Survey 2019

3 Source: ibid

INREV would like to thank the focus group for their contributions to this paper:

- Olafur Margeirsson, Real Estate Strategist, Investment Management, Zurich Insurance Company Ltd
- Zoltan Szelyes, Head Global Real Estate Research, Global Real Estate, Credit Suisse Asset Management (Schweiz) Ag
- Iryna Pylypchuk, Senior Market Analyst – European Real Estate Research, Fidelity International

Figure 1: Allocations to real estate sectors as a proportion of overall real estate portfolio



Source: ANREV/ INREV / PREA Investment Intentions Survey, 2018 and 2019

2. Creative disruption

Demand is king

As a starting point, it is important to understand the reasons underlying the structural shift toward flexible office space. Surveys indicate that the occupiers of such space are looking to improve their employees' productivity, grow their business, stay competitive, recruit and retain top talent, and ultimately maximise their profits.[4]

These drivers are not new. Companies have always aimed to raise productivity, while providers of flexible offices first emerged in the 1980s. However, recent technology innovations – such as smartphones, WiFi and more powerful laptops – have given occupiers more scope to implement flex space visions. This enabling effect of technology is likely to strengthen in the future as advances such as 5G and self-driving cars, which may provide even more flexibility of where to work, come to fruition.

Flex space has many potential attractions. Expenditure on occupying real estate is often a significant part of a company's outgoings, so any reduction in that outflow can impact on profits. A more flexible real estate footprint is also attractive for many companies, particularly during periods of slow demand growth. Furthermore, while a business is growing, the ability to easily set up operations in a new market can be highly attractive. New IFRS accounting rules, effective from this year, requiring tenants to report leases

of 12 months or longer as liabilities (and the relevant rented space as an asset) on their balance sheet, could also encourage companies to seek more flexible and short term leases.[5]

Between 2014 and 2017 the number of square metres of flexible office space doubled in the world's 20 largest cities. In these cities – in 2017 alone – around 1 million square meters were let to flex space operators, and this trend showed few signs of slowing in 2018. It is expected that most current grade A development projects in European and US cities will, at least in part, be let to flexible providers. And some analysts predict flexible office space could account for around 30% of some corporate portfolios by 2030.[6]

4 Source: IWG (2018). The Workspace Revolution: Reaching the Tipping Point

5 Source: Ernst & Young (2016). *Real Estate Leases: How will IFRS 16 impact real estate entities?*

6 Source: JLL (2018). *Disruption or Distraction: Is flex space here for good, or just the latest real estate fashion?*

‘New accounting rules will encourage companies to seek more flexible and short term leases’

The sands in the office space market are clearly shifting. Office owners should expect flexible space to become more prevalent going forward. But how should owners respond to this new trend? The banking industry may provide a number of insights on this question.

Space intermediation: The flex space operator as a liquidity provider

What flex office occupiers are after is space liquidity: the ability to increase or decrease their real estate footprint at short notice. Just as borrowers at a bank are after the ability to use a line of credit at a short notice. Such privileges are typically achieved at a price premium and can be compared to paying for a line of credit, i.e. liquidity, provided by a bank. The higher the liquidity, e.g. overdraft vs. a mortgage, the higher the price, i.e. the rate of interest, per unit.

To date, the right to use most office space has been traded directly between the asset owner and the occupier. Now, however, with the occupier demanding more liquidity in their real estate footprint, the supplier is under pressure to modify their business model. Or, as was the case in banking, new institutions have developed to act as intermediaries for liquidity. For offices this role is being taken by the flex space operator.

Banks are maturity transformers: their assets, e.g. mortgages, are long-term while their liabilities, e.g. deposits, are short-term. Flex space operators such as Regus, WeWork and Servcorp are mirroring the maturity transformation role of banks, and like banks hold long-term assets and short-term liabilities, flex space operators lease office space long-term and sub-lease it short-term. In exchange for performing this maturity transformation role, along with added tenant services, flex space operators receive a fee in the form of the rent differential between long term and short term leases – similar to the interest rate differential banks obtain between their assets and liabilities.

Providing liquidity has its own risks

Flex space operators – apart from their expertise in creating an attractive office environment – are, like banks, specialists in cash flow and liquidity management. But as the history of banking shows, cash flow management is open to sudden liquidity crises. Flex space operators are subject to the same risk: during downturns, they risk losing occupiers who are forced to curtail their operations while difficult trading conditions persist, at the same time being contractually obliged to pay rent to the end owner of the office space.

Flex space operators have looked to limit this risk by three main strategies. First, they may sign a revenue and profit-sharing agreement with the asset owner, as CBRE’s new flex space operator, Hana, has done.[7]

Second, they may try to establish new rental models with their landlords that allow for a better matching of asset and liabilities. Such contracts often include a small fixed rent, with a significant variable component based on the net cash flows to the landlord. Management contracts, similar to those for hotels, are also starting to appear, with the flex operator just earning a fee for their services while the landlord takes the cash flow and occupancy risk.

7 Source: Financial Times. “CBRE moves into flexible office sector”. 31 October, 2018.

‘The potential end result – as in banking – is that the flex space market ends up being oligopolistic’

A third way to mitigate risk is scale. In the way that a small bank with only a few branches has little chance of sharing sources of liquidity within its limited network, flex space operators may seek to build up a large network of offices, especially across geographies providing some economic diversification. A local economic downturn can then be temporarily subsidised via other branches of the network.

Networking effects and the dangers of market dominance

As in banking, the most structurally stable flex space operators may well be those with the largest networks. These businesses are also likely to see economies of scale and scope, along with the market benefit of offering clients access to office space in multiple cities under the same rental contract – a feature particularly valuable for the footloose employees of large multi-national companies.

The potential end result of these networking effects – as in banking – is that the flex space market ends up being oligopolistic: in time it is characterised by a few large operators active across many countries. This could lead to potential joint venture opportunities between investors and flex-space operators, e.g. when expanding in a market. But this could also mean increasing market power for the flex space operators, who, due to their sheer size and scale, may then be able to negotiate lower rents, potentially rendering the traditional landlords less competitive. This could hurt the asset owner in the long run, as not all market rental growth might flow through from the flex space operator. This could pave the way towards revenue and profit-sharing agreements becoming more widespread to provide a better balance of risk-sharing and performance capturing between a landlord and a flex-space operator.

Confusion and contagion

Another potential downside of the flex space model is a reduction of transparency in the space market. In a market largely dominated by co-working providers, it would be difficult to estimate the true vacancy rate and what exposure the end tenants have to the economy and specific industries. Most information would likely stay within the flex-space companies. This would make market analysis more difficult and could also impair price discovery.

However, the largest risk could come from greater connectivity between markets. A lesson of the GFC was that interconnectedness can lead to contagion. An idiosyncratic shock in the flex space market, such as the bankruptcy of a global provider, could mean higher vacancy levels globally and a stronger correlation between rental growth in different cities. While this may currently seem a remote possibility, the rapid growth evident among some flex space providers could combine with significant asset-liability mismatches to exacerbate such risks. The growth of co-working has increased credit and counterparty risks for investors across the market, as most of these companies have a credit rating below investment grade.

3. Concluding remarks

So what should investors and managers do?

Flex space models may be disrupting the office market, but they are here to stay, at least for the foreseeable future. Such operators may prove to be strong tenants, not only under longer-term contracts in well-positioned buildings, but also for assets that require more management input, for instance due to high vacancy or because they work better in a network of offices which the tenant has access to rather than as a stand-alone location. And working with flex operators via revenue sharing models can lead to a widening of the tenant base and a higher occupancy level in the portfolio.

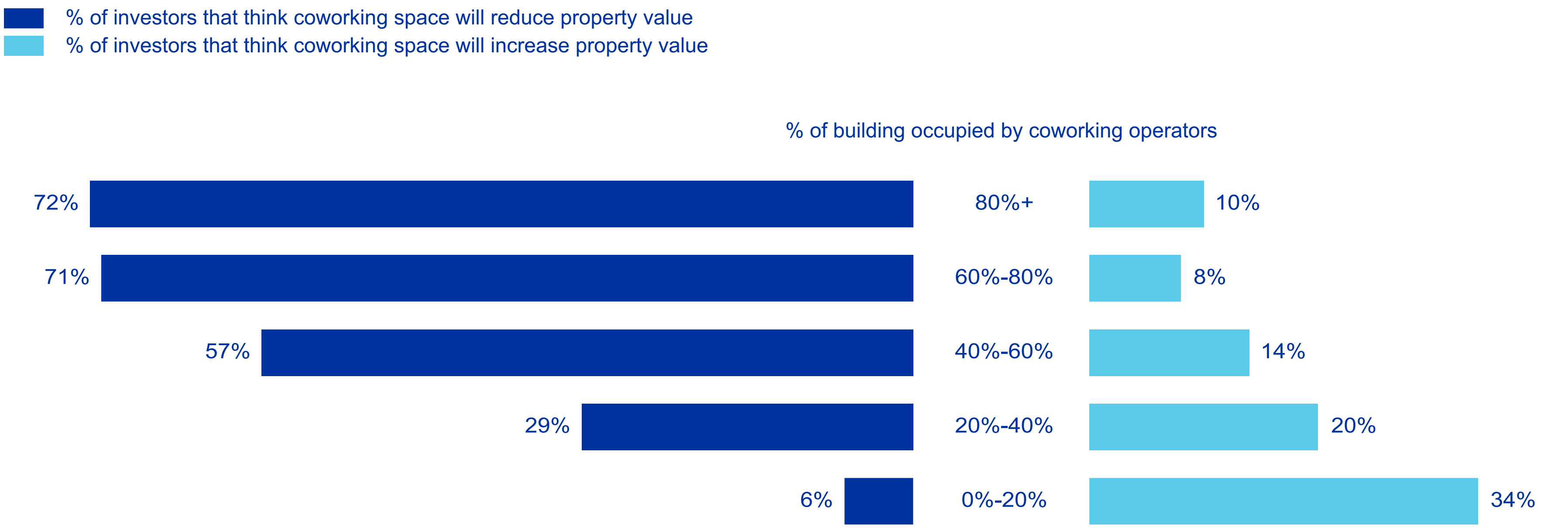
An increasing exposure to flex space is also likely to mean new risk management challenges. At the fund level, there may be a desire to limit counterparty and credit quality risks from flex space operators by limiting the number of such tenancies, just as good bond portfolio managers limit their exposures to a single industry or company.

There is also evidence from the US that exposure to flex space operators needs to be managed carefully at the building level. Investors tend to think that co-working has a positive impact on building valuations when it takes up less than 20% of the space, has a neutral effect for a 20%-40% exposure, but a negative impact on value for any greater level of co-working.[8]

The impact on building values could well be similar in Europe. Managers may therefore want to use flex space to add some spice to

8 Source: CBRE Research, Americas Investor Intentions Survey 2018

Figure 2: A modest exposure to co-working operators may be most profitable for investors



Source: CBRE Research, Americas Investor Intentions Survey 2018 a building's tenant mix, but may think twice about giving over the whole property to this type of tenant. And bringing networking effects into the equation, well diversified and established flex-space operators with a proven track record are more likely to limit credit risk in the building lease profile.

However, there is not much in terms of hard data to quantify this thinking and some experts may argue that only the test of time and market evidence collected on the downward spiral of an economic and investment market cycle will allow to draw firm conclusions on the true valuation impact and creditworthiness of the co-working operator exposure.

The only thing constant is change

Today's office investors may choose to stay inside their comfort zone, doing what they know has worked for decades. But the growth of flex office space is a good example of the 'creative destruction' described by the economist Joseph Schumpeter, 'the process of industrial mutation that incessantly revolutionises the economic structure from within, incessantly destroying the old one, incessantly creating a new one.'[9]

Like the entrepreneurs that Schumpeter alluded to, today's asset owners and managers will need to 'contribute will and action' to reap profits – and stay competitive – in this changing environment. Yet, while doing so they should remain prudent and keep a close watch on the path ahead, for the territory is still scarcely mapped.

9 Source: Joseph Schumpeter (1942). Capitalism, Socialism and Democracy

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