RESEARCH

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Property Ownership in a Flexible World

SHORT PAPER

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This Programme supports the IPF's wider goals of enhancing the understanding and efficiency of property as an investment. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high-quality analysis on a structured basis. It encourages the whole industry to engage with other financial markets, the wider business community and government on a range of complementary issues.

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CONTENTS

Property Ownership in a Flexible World

This report examines the recent development and future prospects of the flexible space market (FSM), from the particular perspective of the owner community. The report is based on thirty in-depth interviews.

The FSM is distinguished from conventional leasing by two features: shorter contracts and the provision of service/experience. The current market structure has evolved over the past two decades, and comprises in the order of 6-8%, or 12-16 million sq ft., of the London office market. The growing range of products includes: Managed, Serviced, Coworking and Member space, with more than one product being offered known as hybrid space.

There are a number of operating models, involving different players. For example, 'passive owners' might offer leases to operators, while 'active owners' might enter into management agreements with operators. Some owners 'self-deliver', others set up operating companies.

The challenges for owners seeking to participate in the market are significant. They are not culturally adapted to a service business; they lack skills and resources, as well as, sometimes, the will. Direct involvement requires significant investment and implies scale. Indirect involvement via operators is the more common route, although this requires a high degree of alignment between parties. At the same time, owners are limited in their ability to accommodate global brands in multiple cities, as few operate in more than a handful of global cities.

The report concludes there has been a structural change in the market. The emergence of the FSM is not a fashion but a permanent change in owner-occupier relations. Drivers of this structural change cover economic, business, technological and social factors.

Flexible space appeals to smaller companies – the typical size band of occupiers is 10-15 people. Increasingly, however, Managed (or Enterprise) space is being adopted by larger corporates using a 'core and flex' approach to their footprints. While press commentary is dominated by coworking space, interviews have indicated this potentially more volatile product to be, proportionally, a shrinking element of the market. It is also evident that conventional lease lengths have fallen and are now approaching five years (whereas, paradoxically, some FSM operators are now signing 20-25 year leases), while average occupancy hovers at around three years – the two markets appear to be converging.

A repetitive theme in discussions was that there will be no return to the status quo ante. The occupier market now understands that it can have something different – and better – to what it has been offered in the past. It is also clear that the so-called premium for occupying flexible space is something of a myth: when total costs (headline figures and less visible costs) are considered, the alternatives compare favourably.

That said, the author predicts the FSM will be subject to a 'stop and re-set' – just as developers can over-supply a market, so too operators might get ahead of underlying demand. There is likely to be consolidation, as weaker operators and business models disappear, but the market will continue to grow.

It is also predicted that there will need to be much deeper changes to the supply chain – particularly in the surveying and facilities management professions – in order to supply the resources and skills for the expanding market. Traditional asset management skills will need to be balanced with service culture skills.

EXECUTIVE SUMMARY

The flexible model may transfer itself to other sectors, such as labs and 'sheds', and there might well be others.

Finally, in the meshing together of product and service, a quite different industry may evolve. Rather than describe the FSM as a new product, current trends need to be interpreted as the real estate industry experiencing a major shift in the way that it engages with its customers. The fundamental point to the FSM is that the relationship between provider and the occupier is changing.

While still subject to economic vagaries, and according to interviewees some increasingly over-due consolidation, flexible space will remain and outlive any economic cycle. It might even be the case that, within five years, FSM will no longer be discussed as a distinct sub-sector but recognised for what it is: the industry's new *modus operandi*.

1. INTRODUCTION

This paper examines the recent evolution of the flexible space market (FSM), with a particular emphasis on the response of property owners. The research was commissioned by the Investment Property Forum; and was undertaken by Ramidus Consulting between July and November 2019.

1.1. Method and Approach

While the research involved a literature review and drew upon the direct experience of the research team, the core focus involved 30, semi-structured interviews with a wide range of market practitioners.

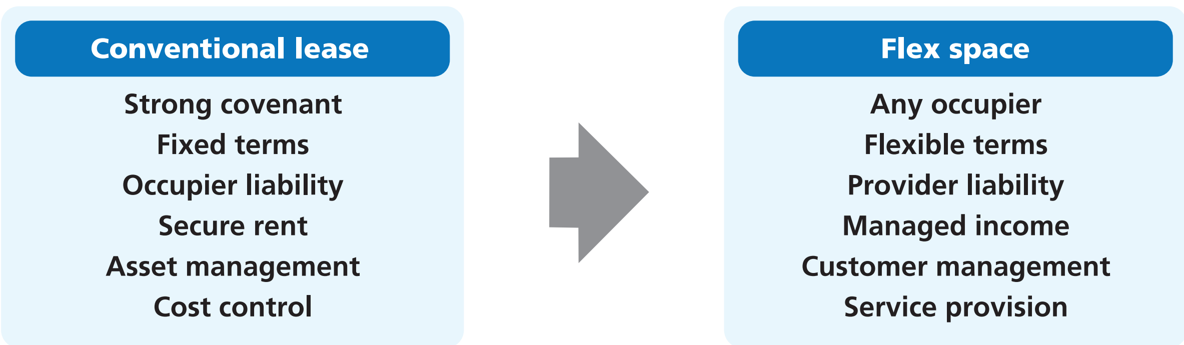
The research had a particular emphasis on London as one of the most mature flexible space markets globally but the findings are relevant to major office markets in the UK. Both owners directly involved in providing flexible space, and those who lease space to providers or who partner with providers were interviewed, as well as owners with no involvement in the FSM. A number of operators and a small number of advisors and specialists also participated in the research.

A defining feature of the FSM is the changing relationship between the provider and occupier of space – traditionally referred to as the Landlord-Tenant relationship – but increasingly replaced by the language of the consumer. Landlords become 'owners' or 'providers', and tenants are members, customers or occupiers. This report fully adopts the consumer market terminology.

1.2. Flexible Space Market Defined

Figure 1.1 compares the characteristics of a conventional lease with the terms in a typical flexible space.

Figure 1.1: Comparison of Occupational Terms



Flexible space has two defining characteristics, compared to traditional leases, both of which must be present:

- Shorter, less onerous contractual terms: and
- A greater degree of service provision.

1. INTRODUCTION

The FSM responds to the highly uncertain business context within which most firms now operate, characterised by short-term business planning horizons and increasing occupier demand more service and greater choice.

The conventional market relies upon strong covenants, fixed terms and secure rent, in a bond-style arrangement. 'Assets' were managed (lightly) and cost containment was a principal driver.

The FSM pays little attention to covenant. Flexible terms ('easy-in, easy-out') are paid for with a fixed, 'unitary charge' that is all-inclusive (rent, rates, service, technology, etc.), without onerous exit terms (such as dilapidations). Another key attractor is the ability to 'flex', or grow/shrink in terms of space occupied. Whether the customer is a company in early growth phase and looking to scale-up, or a larger corporate looking for project/temp space, or space to establish a foothold in a new city, the appeal is strong.

Flexible space is also accompanied by varying levels of service provision, which can make headline costs appear expensive relative to a conventional lease but total costs paint a more nuanced picture, as set out in Section 5.4.

The palette of FSM products, with differing levels of service provided, continues to evolve and is described in more detail in Section 2.3.

2. THE FLEXIBLE SPACE MARKET

2.1. A Brief History

In the early-2000s, radical changes in workstyles and workplace cultures, together with cheap and ubiquitous technology, began to change the ways in which business was conducted, at both the individual and corporate levels, with rise of the FSM being a direct response to such trends. Over the past two decades, commercial property lease lengths have reduced in combination with growing flexibility in terms, as the 25 year, FRI lease has become a more specialist provision; with the average office lease closer to five years today.

> "'Let and forget' models are history. Occupiers just want the services. Owning is more demanding."

Whilst, initially, the FSM provided fairly uniform serviced offices for mobile consultants and entrepreneurs, including drop-in space, reception and mail management, today it is far more sophisticated, with a range of products – with different price and quality components – to suit the needs of firms ranging from one person, to several hundred employees. Most interviewees recognised the significance of the change that had taken place:

> "This is definitely a long-term change that is taking place. It is addressing the long-term imbalance between Landlords and Tenants. It's bridging the gap. In most industries, existing customers receive better treatment. In property it just comes down to another contested deal. This is changing."

Occupiers are continuously seeking to reduce their physical footprint, introduce agile working and use the workplace as a means of conveying their brand and attracting highly skilled and, hence, costly workforce – previously an unattainable blend of flexibility and quality, coupled most recently with a sharper focus on productivity and health and wellbeing in the workplace[1].

2.2. Size of the Market

Data provided by Instant Group, a global platform for flexible space providers, suggest that the number of FSM centres in the UK grew from 4,000 to more than 6,000 between 2015 and 2019[2]. Instant Group has forecast that, in the next four years, this could grow to between 9,000 and 12,000, albeit caveated by prevailing economic conditions.

Instant calculate that the FSM forms just over 7% of the total UK office market, "a far higher figure than any other country we have looked at", with almost 3,100 providers across the UK (up from 2,800 in 2018), almost half of whom (49%) operate just one or two centres. The fragmentation of the FSM supply is shown by the fact that, of the c.3,000 operators, the 10 largest control just 3.3% of the market – behind these larger providers there is a very long tail.

[1] See: British Council for Offices (2017) Defining and Measuring Productivity in Offices and City of London Corporation (2015) Future Workstyles, Future Workplaces

[2] Instant Group (2019) UK Market Summary: Flex is Leading the Way

2. THE FLEXIBLE SPACE MARKET

Various estimates of Greater London's FSM suggest that it comprises between 5% and 7% of the capital's total office stock of 240m sq ft. (or between 12m sq ft. and 16m sq ft.).

Since 2014, growth of London's FSM has been dominated by one company: WeWork has acquired over 60 centres (open and planned), amounting to c.4.5m sq ft., of which at least six exceed 150,000 sq ft. Some planned openings, however, may be put on hold during the company's current (as at the end of 2019) consolidation exercise.

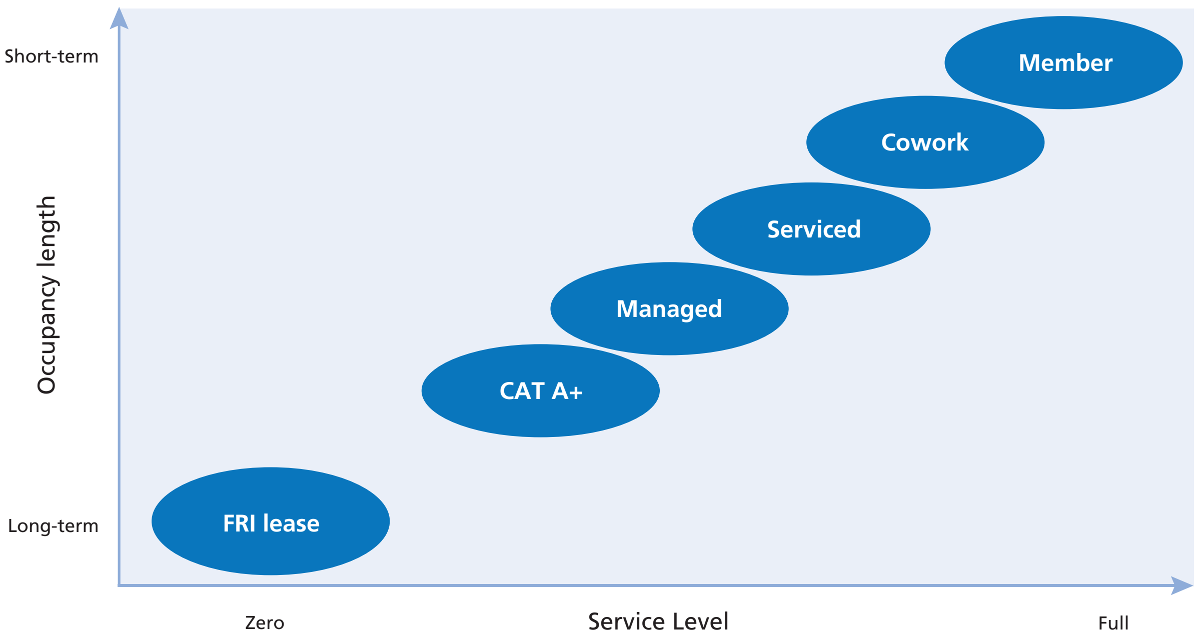
The Instant report also dispels the myth that demand is being driven solely by start-ups and freelancers: for the first time, "25% of individuals put into flexible spaces … were within teams of 50+", requiring an average of over 3,000 sq ft. Firms looking for this scale want "dedicated private space, with a small number of dedicated meeting rooms but also access to communal facilities and relaxation areas". These dynamics highlight the impact of the FSM on the sub-5,000 sq ft. traditional leasing market.

> "The market is not saturated. Bigger companies are coming in. Enterprise space is growing fast as a subsector."

2.3. Flexible Space Products

The market broadly breaks down into managed, serviced, coworking and member products Figure 1.2 shows these products in relation to conventional FRI leases and the recently-introduced 'CAT A+' solution - essentially a CAT B fit-out with 'plug and play' capability. Hybrid space involves more than one offer in the same centre or building, for example managed and serviced or managed and coworking.

Figure 2.1: Spectrum of Flexible Space Offerings, 2019



2. THE FLEXIBLE SPACE MARKET

Managed space (aka enterprise space) provides for smaller occupiers, scaling-up and for larger occupiers wanting flexible space. Occupiers have dedicated or bespoke space, with their own identity, while sharing reception, meeting, conference and other support facilities. Interviewees suggested that the quality of managed space means that there can be no return to what they regard as the previous poorer quality market standards.

> "Smaller occupiers won't revert to traditional leases under a less benign economic climate. Everyone has seen what can happen, so why would you want to go back to the old way."

Serviced offices form the largest component of the FSM. They offer flexibility and the opportunity for occupiers to have a physical presence in the heart of their market, on terms that suit their business models.[3]

Like managed offices, they offer 'easy-in, easy-out' terms, and allow small businesses to avoid the capital costs of establishing a new office. Businesses share the costs of services such as a reception; ICT; security; telephony and meeting rooms, thereby increasing their buying power by reducing the unit cost.

> "The right product includes amenity and community, with private offices."

But even in this most-established sub-market, demand is evolving:

> "There has been a shift in demand for traditional serviced offices. People don't want all the extras like secretarial, mail management, stationery, copying, etc. They do this themselves now. What businesses really want are cleaning, tech and security."

Some interviewees recognised a growing quality differentiation:

> "There are those who provide a desk and a phone, with fairly undifferentiated offers. Then there are those who are mission/purpose-led. They add to a building's purpose."

The FSM has recently seen a rapid rise of **coworking**[4], which offers spaces that encourage interaction and collaboration. Coworking involves the sharing of workspace, typically but not exclusively, by self-employed people, very small firms and start-ups. Large organisations also use coworking to incubate start-ups.

The interior design is likely to reflect the provider's brand, and seek to encourage community, collaboration, interaction and knowledge sharing by members, with cafes, informal seating and shared workspace and events. The combination of individual independence and group sharing is what makes coworking so attractive.

[3] Ramidus Consulting (2016) Clusters and Connectivity: the City as a Place for SMEs Corporation of London

[4] This report distinguishes 'coworkers' as unconnected people who share the same workspace from 'co-workers' as colleagues who work for the same firm.

2. THE FLEXIBLE SPACE MARKET

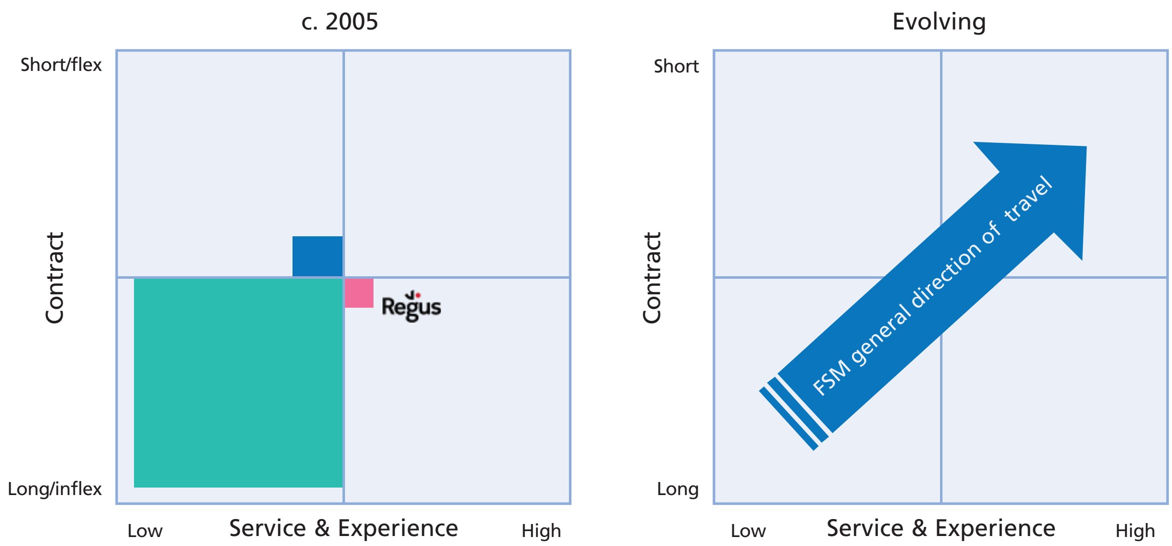
Related to coworking is **member** space. This is similar insofar as it generally appeals to very small firms and individuals, but the centres have more of a club atmosphere; they are smaller and less dense, and are often charged by the hour.

In addition to these four main components of the FSM, there are more specialist offerings. Some are **sector-specific**, for example catering for 'digi-tech' firms (such as Techspace) or 'fintech' firms (Level 39); while the Ministry of Sound's 'The Ministry' caters for those in music and media. Others cater for women only (The Allbright). There are also incubators and accelerators which are based around business support and mentoring, where occupiers enter into time-limited, formal start-up programmes.

2.4. Emerging Market Structure

All interviewees recognised that the conventional real estate model is in the process of a rapid evolution; the main points of difference were in the positions that they each expected to take in this emergent 'new model'. Figure 2.2 presents a model of the market c.15 years ago, dominated by long leases and low service (green box), with the exception of Regus (and a few others) offering serviced offices (pink box) and some managed space (blue box).

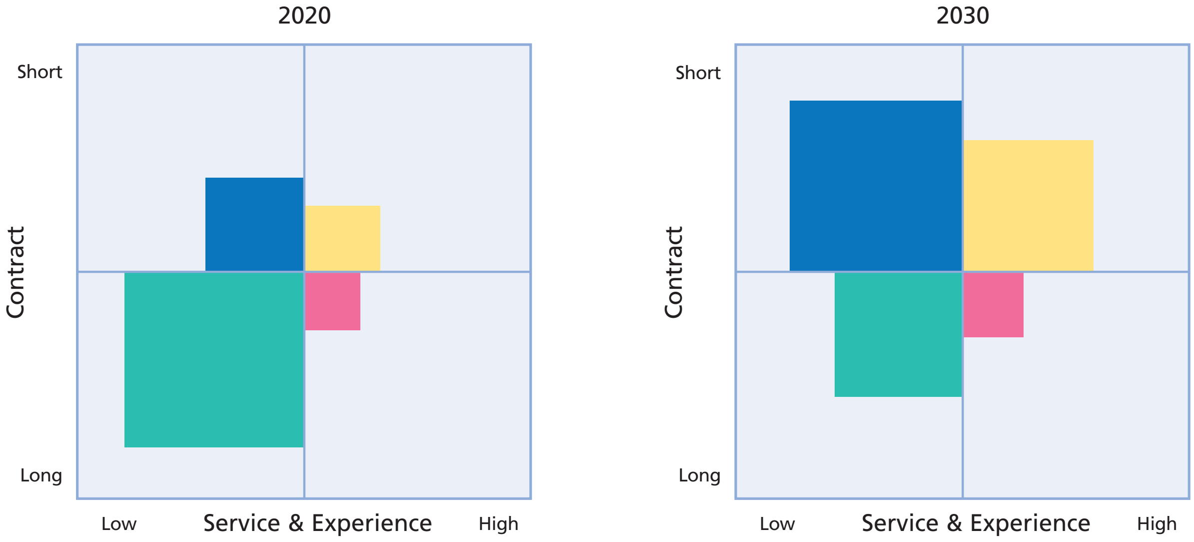
Figure 2.2: Traditional Occupancy (to c. 2005) versus Evolving FSM Market Share



There is now much greater diversity in product offerings, with more activity in providing shorter-term space with a low level of service (blue box), and much more provision of high quality experience on short-term contracts (yellow box). Good quality space on relatively long-terms with moderate service provision (pink box) also remains important – particularly for corporate occupiers.

2. THE FLEXIBLE SPACE MARKET

Figure 2.3: Projected FSM Growth, 2020 to 2030



These trends are likely to continue with:

- Greater provision of shorter term space with a low level of service, particularly through CAT A+ solutions and hybrid solutions); and
- More space offering high quality experience on short-term contracts. This will be particularly the case for higher quality serviced offerings and hybrid space.

3. OPERATING MODELS

Traditional roles and relationships within the property sector are realigning as a result of the growth of the FSM. Owners are having to decide whether to remain ‘one step away from the action’ or get directly involved. The role of the traditional property manager, as rent collector and service charge manager, is under threat from the rise in hospitality-driven services. Operators are new on the scene, finding different ways in which to engage as lessors, partners or owners. The facility management industry has yet to establish a distinctive role in the FSM.

This research revealed an evolving tapestry of supply chain relationships, summarised in Figure 3.1. To simplify a complex picture, we distinguish operator-led, owner-led and investor-led groups.

Figure 3.1: Evolving Relationships in FSM Delivery

Provider	Delivery vehicle	Examples
Operator with Lease	Passive Owner	BE Offices; CBRE (Hana); Instant Group; Regus; ServCorp; We Work
Operator Owner	Self Delivery	BE Spoke; BizSpace; Lab Tech/Labs Enterprise; Uncommon; We Work; Workspace
Active Owner	Self Delivery	Crown Estate; Great Portland Estates; LGIM Real Assets
Active Owner	Owner Op Co	British Land/Storey; HB Reavis/Hubbub; Land Securities/Myo
Active Owner	Operator with Management Agreement	Axa/Convene; Barings/Orega; Derwent/TOG; Dorrington/Hana; Nuveen/We Work
Owner/Investor	Operator Owner	Blackstone/TOG; Brockton/Fora; Carlyle/Uncommon; RDI/Office Space in Town
Non-property Investor	Operator Owner	Celvam Management/LEO; Wifra/Knotel

3. OPERATING MODELS

3.1. Operator-led

Operator with lease + passive owner: This is by far the most common arrangement, whereby a serviced office operator or a coworking operator takes a conventional lease in a building and then offers flexible space. In this sense, the owner is 'passive', beyond holding the head lease and takes no share of the profits generated by the operator and has no control over which businesses occupy the space.

"We'll never have an operational model; we'll do partnering."

Commonplace examples of this model include Regus and WeWork who have completed most of their deals in this manner. But the model continues to evolve subtle variants.

Operator owner + self-delivery: Some FSM operators have sufficient capital and in-house resources to enable them to buy buildings and self-deliver flexible space. This gives the operator total control over the whole working environment, including the building services (which are critical to occupier comfort and productivity).

Examples of this group include Workspace Group, BeSpoke, TOG and Uncommon.

3.2. Owner-led

Active owner + self-delivery: A small number of 'traditional' owners are seeing the benefits of offering flexible space without appointing operators. Benefits include attracting occupiers to their buildings and the opportunity to nurture them through growth and demand for more space. The owner thus retains control of the building and the income.

While almost all owners interviewed realised the need to embrace the FSM to some degree, few were actually launching operations. Those adopting this approach take on all the risk of doing so in a dynamic and sophisticated market but will benefit from retaining all profits, having complete control over the space and the building fabric and (they hope) tenants' loyalty. Examples include:

- **The Crown Estate** has entered the market with its first fully flexible space at One Heddon Street. The new space offers 350 desks with a range of membership options. There is access to shared amenities such as meeting rooms, concierge services and a private roof terrace.
- **Great Portland Estates** is now operating over 100,000 sq ft. of coworking or flexible space, accounting for nearly 5% of its portfolio. With over 130,000 sq ft. of additional flexible space being appraised, this proportion could rise to over 10%.
- **LGIM Real Assets** has taken a two-pronged approach. First, it has launched fully fitted and "work ready" offices within its buildings branded as Capsule, available on flexible terms with options on connectivity and furniture, etc. Secondly, it has changed its procurement of management services across its portfolio (irrespective of flexible office offering) by separating property and facilities management to ensure greater control over service.

3. OPERATING MODELS

This is a particularly attractive option for those with large freehold portfolios, where the component of flexible space might be relatively small and where the overall risk to the core business and modus operandi are minimised. But for many owners, their scale and resource bar them from this approach. Others, such as those managing funds, are limited in their discretion to do so by the varied interests of their investors.

Active owner + owner OpCo: Occurs where particularly large property companies have sufficient scale to justify establishing an operating company, with its own brand, to deliver and manage flexible space. The active owner carries the risk, but benefits from retaining all profits, having complete control over the space. For example:

- **British Land** launched its Storey product in 2017. By the end of 2019, Storey should be operating across 316,000 sq ft. British Land has also launched Storey Club, which will provide additional space for existing Storey members on a completely flexible basis.
- Slovakian developer **HB Reavis** announced its entry to the UK FSM in 2018, launching its HubHub brand at its 85,000 sq ft. development at 20 Farringdon Street. HubHub will occupy 34,000 sq ft., targeted at the whole spectrum of freelancers, start-ups, scale-ups and established companies. Members can take fixed desks or private offices; while the centre offers networking events, business support and access to collaborators.
- **Landsec** launched its flexible offering ‘Myo’ in 2019. It opened at 123 Victoria Street in Victoria, offering flexible office space with customisable fit-out for companies of 10-100 people.

Active owner + operator with management agreement: A growing number of owners are entering into joint ventures or management agreements with operators, enabling the owner to ‘outsource’ all responsibilities for service provision while retaining a share of the earnings within a service agreement. Such agreements are increasingly becoming a favoured route for owners as they can provide returns in excess of a passive lease to an operator with a lower risk profile than directly investing in a flexible workspace operator or running their own operation.

It is critical that the objectives of both parties are fully aligned.

Superficially, such arrangements are very simple: *“They’re not signing a lease. If they out-perform then we have a profit share; if they underperform they pay* [a factor of] *ERV”*. But one interviewee expressed caution: *“You have to be really careful with these* [so that you don’t end up with an agreement where the] *parties … will, ultimately, not be aligned. I’m doing all the work, and the owner is getting half the money”*. The latter point can be overcome if the parties also share the downside; but the overall sentiment of the quote underscores the need for a genuine alignment of aims and outcomes.

In this respect, it is important for owners to find the right partner for each centre, recognising local market characteristics and demand profiles and must be clear about their partner’s income expectations, as well as their own.

3. OPERATING MODELS

Management agreements are the fastest growing area of the market. They represent relatively low risk for the owner, while providing access to stock for undersupplied operators. This represents a significant change: *"management agreements used to be done in distressed buildings. Now we're flipping this"*.

One of the limitations of this model affects fund managers with multiple clients. The differing views and motivations of investors can limit opportunities to introduce flexible space in some portfolios.

3.3. Investor-led

Passive owner/investor + operator owner: Some investors have chosen to involve themselves in the FSM by buying into operators. For example, Brookfield bought into Convene and Brockton bought into Fora. Additionally,

- in June 2017, Blackstone Real Estate Partners Europe acquired a majority interest in TOG, valuing the latter at c£500m; and
- in January 2018, Office Space in Town Limited sold an 80% interest in a portfolio of office premises worth £161.7m to RDI REIT Plc.

Non-property investor + owned operator: A relatively rare arrangement, but possibly more important in the future, is the non-property investor buying into the operator. The most spectacular example of this, of course, is Softbank's funding of WeWork.

- In December 2018, Celvam Management (founder of international telecoms group Lebara) invested c£475m In London Executive Offices.
- In August 2019, New York-based Knotel announced that it had secured $400m in funding at a valuation of $1bn led by Wafra, an investment arm of Kuwait's Sovereign Wealth Fund, with others.

4. SHORT-TERM FASHION OR LONG-TERM DISRUPTION?

> "The Genie's out of the bottle. We're not going back. Flex is here for good."

A key aspect of the research was to establish whether owners believed that the FSM was a fashionable market phase, or whether they believed that it was a long-term disruption that would lead them to change their business or operational models. At least in some media coverage, there has been a sense that the market is being swept along by a fashion that will, come the next economic recession, be corrected.

Referring to wider change, one interviewee commented: *"Demand for flex offices is a natural evolution of changes in other sectors such as retail and logistics. Tech enables it. We are going to shorter leases and* [greater] *service provision."* Some interviewees were cautious about the potential for continued, rapid growth in the sector: *"I'd be surprised if there is the demand for the amount of serviced* [flexible] *office space being created."* Another observed *"It simply can't continue to grow at this rate."* However, the prevailing view was that there remains considerable scope for growth.

> "There is a structural change taking place. Large businesses require flexibility. And traditional leases are cumbersome. The way things are, the whole market is moving; plenty of scope for growth."

Key to understanding the 'fashion versus disruption' debate is to understand the nature of the drivers of change.

4.1. Drivers of Change

The UK now has a mature 'knowledge-based economy', which is characterised by flatter, leaner and more responsive organisational structures and business processes, as well as 'agile working' practices (combining speed and flexibility) which are more mobile and collaborative than in the past, and which depend upon a high level of connectivity. The FSM responds to their needs for workspace.

Change factors Table 4.1 captures some of the meta trends influencing occupiers' demand for space. As businesses become leaner, more cost conscious, and more focused on productivity and access to skilled labour, so they seek flexibility, to reduce their real estate footprints, create a more effective workforce and shift their locational priorities. These have property implications in terms of the provision of commodity space, management of the workplace experience and adaptable fit-out.

> "Large traditional occupiers are increasingly outsourcing functions they don't wish to manage like learning, training, events and project space."

4. SHORT-TERM FASHION OR LONG-TERM DISRUPTION?

Figure 4.1: Change Factors, Drivers and Implications for Property

Change Factor	Drivers	Occupier Agenda	Property Implications
Economy	Knowledge economy Growth of SMEs Switch to TMT growth Artificial intelligence	Short planning horizons Managing uncertainty Disruptive forces Contingent workforce	More product variety Demand for smaller units Turnkey solutions Variety in floor plates Less deep space
Business	Leaner and flatter Cost management Productivity & output Access to labour Competition	Smaller footprint Flexibility & responsiveness Core & flex space Effective workplace Locational priorities	Supply of commodity space Active management Flexible space/contracts Adaptable fitout Space as a service
Technology	Artificial Intelligence Cloud-based technology Ubiquitous connectivity Smart building technology IoT	Agile working Connectivity & permeability Wearable technology Big data in space management Demand management	Integrated, smart BMS Responsive environments Looser fit; easier to run
Social	Health & Wellbeing Work-Life balance Choice & experience Green & sustainable	Attraction & retention Improving productivity Access to health services Multi-generation workplace Diversity	Provide workplace experience Palette of work settings Space as a brand Workplace communities Importance of public realm

As businesses now operate within short-term planning horizons, needing to respond to an ever-changing economic landscape and seeking to maximize their flexibility to adapt, the power of networks, involving collaborative production and multi-disciplinary skills, is critical. More commoditised and non-core activities are undertaken by specialists; more work is undertaken collaboratively, often utilising smaller companies, with many of these companies occupy flexible space.

Indeed, as well as creating start-ups that demand flexible space in its own right, the digital economy is transforming business structures by, for example, enabling small firms to compete directly with large corporates for the same business, as barriers to entry are lowered. The corollary is that small teams from within large corporates may now choose to look and behave like start-ups, in order to compete and to attract and retain staff. Simultaneously, this is driving small-firm formation, encouraging people to work across multiple sites.

The rise of small businesses: The technological revolution and the rise of the knowledge economy has acted as a spur to the growth of small businesses by stripping away many of the barriers to entry that setting up a new business once implied. Instead, today they can exploit new technology to enable them "to go global without being big themselves"[5].

[5] The Economist (2015) Reinventing the Company The Economist 24th October 2015

4. SHORT-TERM FASHION OR LONG-TERM DISRUPTION?

> "There are countless firms with less [sic] than 100 people who don't have dedicated resources to manage space. A large percentage of them will go to flex space."

SMEs[6] comprise 60% of private sector jobs. The number of SMEs has increased by 2.2m (+64%) since 2000, including 278,000 SME employers (+25%)[7]. Nevertheless, the scale of the SME sector has been overlooked in the property market, which has focused on providing for the corporate sector; smaller occupiers have been limited to lower quality space, in part due to their cost constraints, but also to the historical reluctance of owners to let space to smaller occupiers who were perceived to lack covenant strength and to require more intensive management.

The rapid rise of the FSM has changed this permanently: it has given small, tech-enabled firms the ability to choose a higher quality product in which to work. Many owners today recognise the importance of the small firm sector.

Corporate demand: Larger organisations are engaging with the FSM and fuelling the rapid growth of managed or 'enterprise' space, catering for anything from 10 to 100s of people.

> "Are we bothered by having large numbers of small occupiers? Not in the slightest. We have large volumes and they churn. Each year, some leave and some arrive. Given sufficient scale this is not an issue."

Managed space allows larger companies to optimise their physical footprint by responding to business change without making long-term commitments. It also allows them to respond to the needs and desires of a workforce that favours a less corporate-style workplace. One of the largest such commitments in London to date was HSBC's decision to locate c.1,000 staff in WeWork's Southbank Place centre, near Waterloo station.

Owners get it! Interviewees demonstrated an overwhelming recognition of business change in a rapidly changing economy and that the real estate sector has to respond accordingly.

> "We need to create workplaces to attract and energise people… it's no longer about someone going to one building for five days a week …. People work very differently today."
>
> "Real estate has become strategic. There is ever-growing demand for flex space, with a rapidly growing demand from larger occupiers."
>
> "It's really compelling. As traditional landlords, we're having to up our game."
>
> "Space as a service is being used more and more. It's now a hospitality business, through and through."

[6] Note: SMEs refers to businesses employing fewer than 250 people.
[7] ONS (2018) Business Population Estimates for the UK and Regions 2018 Dept for Business, Energy & Industrial Strategy 11th October 2018

4. SHORT-TERM FASHION OR LONG-TERM DISRUPTION?

The range of products available in the FSM is a direct response to these changes in order to cater for the needs of modern business.

4.2. Bubble or Long-term Change?

Despite the predominantly longer term permanent nature of the drivers of change, there remains a minority that contend the sector's rapid growth can only endure for so long, *"before an economic or political crisis blows through the sector, at which point, the entrepreneurs will decamp to their kitchen tables"*. Even among the owner community interviewed, some were sceptical of continued growth in demand for flexible space and were comfortable that low vacancy in their portfolios allowed them to at least defer committing to the sector.

"In the City last year, we had space returned. We had offers from traditional demand and FS operators. We preferred the conventional tenants."

"The 15-20 year lease is a thing of the past. A sea change. People in our space stay on average 3.7 years. Our average stay is not dissimilar to a standard occupier."

"We have no involvement in the flex market; a semi-conscious decision. We have very high occupancy. So not had much opportunity."

Most research participants, however, indicated they were likely to shift in favour of more active engagement:

But change is taking place: *"We will continue to evolve. A flexible future is here"*. Again: *"There is a level of nervousness within the business over FSM operators. But things are changing."*

So what is the truth?

In classic economic bubbles, values rise to unsustainable levels, far in excess of their underlying, long-term value, while less knowledgeable or inexperienced investors continue to purchase in the belief that values can only rise. This does not seem to be the case with the FSM, however.

The research revealed a widespread sense that the FSM represented a structural shift in the market, rather than a cyclical one. Only one interviewee expressed the view that a major reversal in fortunes was imminent; while two others suggested current levels of growth might be unsustainable. Most interviewees, supported by a prevailing view among market analysts and commentators, suggest there remains a large residual demand in both the London and UK markets.

4. SHORT-TERM FASHION OR LONG-TERM DISRUPTION?

> "The whole market is changing. There will be on-going demand for larger floorplate buildings. And that is fine. But the whole market is changing. Never known anything like it."

Whilst not foreseeing a 'crash' in the sector, several interviewees anticipated consolidation (see section 6), whereby the operators with weaker business models and high exposure to high-rented leases (in the context of an economic retraction), might succumb to failure or take-over. This is perhaps underscored by Instant Group's data referred to in Section 2.2, which identified that half of operators nationwide have just one or two centres, while the largest 10 providers control just 3.3% of the FSM.

Whereas, in a classic property development boom, speculative development outstrips underlying demand, which is then followed by a major adjustment, thus creating a glut of vacant space hanging over the market, sometimes for years, until underlying demand returns to absorb the excess, the growth of the FSM is different because its growth has been largely organic. It represents a change in the way in which space is occupied and managed, rather than a massive addition to the amount of stock, whilst, for the occupier, the difference between a 10-year FRI lease and a five year deal on 'enterprise space' is a legal rather than economic matter.

4.3. Coworking versus Enterprise Space

Whilst numerous articles profess to be about the FSM, in fact, many focus on coworking. For example, in The Economist, it was stated recently that *"Co-working firms now account for about 5% of office space in London and New York"*[8]. This is clearly a reference to the whole of the FS market (given that the latter accounts for around 6% of the market), and greatly exaggerates the role of coworking. Additionally, the images that accompany these articles and features invariably show individuals sharing space, often tightly packed in, with beer on tap, informal seating and 'community building activities'.

> "It's the way that the market is going. A bespoke offering for customers' specific needs."

While this might be a fair representation of some coworking spaces, it represents only a tiny fraction of the FSM. Such images have helped to cloud industry discourse: even the author's discussions with well-informed owners, often defaulted to examples, with analogies drawn and comments based on coworking. It is important, therefore, to clearly identify and define the profile of demand for flexible space, not least because coworking is widely seen to be the least robust sub-sector of demand, with the potential for greatest oversupply.

Coworking environments accommodate very small businesses and individuals in standardised work environments, branded by the operator. They are priced by the person, generally on a monthly or pay-as-you-go basis. By contrast, managed or enterprise space provides bespoke modular layouts with private space and security, with occupier branding. Smaller companies typify the occupiers who sign for a six-monthly or annual rolling contract.

[8] The Economist (2019) Redesigning the Corporate Office The Economist, 26th Sept 2019

4. SHORT-TERM FASHION OR LONG-TERM DISRUPTION?

Many managed environments have a relatively low level of service provision and can resemble multi-let buildings. In this sense, the barriers to entry for traditional landlords are lowered.

However, discussions suggested that by far the greatest area of growth for the FSM is for managed and enterprise space, accommodating firms in the 10-100 person size band, rather than coworking or start-up space. The following were typical comments from interviewees:

> "We target established businesses. 30+ people. Not coworking."
>
> "We let to large companies in bigger deals. It's the way that the market is going. A bespoke offering for customers' specific needs."
>
> "The market is not saturated. Bigger companies are coming in. Enterprise space is growing rapidly as a subsector."

Managed or hybrid space is the fastest-growing sub-sector within the FSM. The owners that were interviewed considered they could offer corporate occupiers a number of benefits.

- Flexibility to reflect business planning (c.2 years) and changing needs;
- Provide an outsourced solution for all real estate matters;
- Give complete transparency and certainty over costs and services;
- Provide a quality work environment that maximises experience and productivity among their workers, with tech solutions;
- Provide bespoke, branded space, with security and privacy; and
- A shortened process – not a 9-12 month negotiation.

The prevailing view amongst those interviewed was that *"there will always be requirements from the likes of KPMG to lease 500k sqft. on longer, more traditional terms"*, while *"large banks, say, with thousands of employees will go traditional and in-house because they need the control and to de-risk the process"*.

For smaller organisations, though, *"the solution is flex"*. Such organisations are those *"who are scaling, and global enterprises looking for agility"*.

5. OPERATIONAL ISSUES

This section examines a number of operational issues that featured in interviews, including the customer-focused culture of the FSM, the cost of space in sector, building stock and capital expenditure.

The growth of the FSM requires landlords to consider their approach with care: will they continue to be asset managers? Or will they move towards flexibility and hospitality? There will be room for both and sound reasons for both. Much will depend upon the scale and reach of the owner, their operating model and funding sources, as well as whether an owner chooses direct or indirect involvement.

> "The future is flex. The stigma has gone."

5.1. From Asset Management to Customer Management

Service is the aspect that presents particular challenges for the traditional landlord – owners are accustomed to managing assets (and tenants), not customers, which requires a change in culture and the adoption of new skills. As one interviewee summarised it: "The future is flex. The stigma [of short-term occupation] has gone."

> "Landlords can bring a turnkey solution to the market (CAT A +). But FSM is not an easy business. It's very complex. Very similar to running hotels. Can traditional landlords do this?"

Culture and skills: It is widely recognised that the FSM, depending on the specific product and brand, can have more in common with the hospitality industry than with the conventional property industry. Traditional owners are unaccustomed to dealing directly with occupiers as customers, and there is a cultural gap. As one interviewee implored, *"How many owners can really say they have a service culture? But that is what is required"*.

Even if working through a provider, it was recognised that owners would need to have empathy with a service culture *"... in order to ensure that the objectives of two parties in a management agreement, for example, are aligned. Because if they are not, they are doomed to failure"*.

Direct involvement through a wholly-owned subsidiary operator, for example, implies the recruitment of non-property skills, and *"... giving those people the same career opportunities as more traditional staff"*. Often such skills need to be recruited from outside the property sector, mainly from the hospitality sector. Such recruitment remains small-scale.

Resource: Irrespective of the skills involved, there is also the question of resources. A 40-50,000 sq ft., full service flexible building can easily require between five and seven full-time staff, from front-of-house to back-of-house.

> "If we had the scale, we would have our own offer."

There are really only two differentiators: price and quality. How should owners position themselves? At the high end? They are not set up to do so.

5. OPERATIONAL ISSUES

The risk of getting this wrong can be quite high, and such a commitment will deter many traditional owners. Despite some owners choosing to develop their own offers (such as British Land with Storey and LandSec with Myo), the amounts committed are relatively small, even in London. Consequently,

> "The quantity of stock remaining in traditional owner buildings is still huge and will remain so. Many owners do not have the operational skills to part-take in the market, and will simply choose not to engage with the FSM."

The largest provision of new space is likely to come from traditional landlords buying-in the requisite management skills from the likes of CBRE (Hana) or Savills (Pivot), for example, or through appointing an operator.

The important message for owners here is that, while barriers to entry might seem relatively high (in terms of resource commitment), investing resources in the quality of service is a critical factor in the success of a business model or centre.

5.2. How Far do Landlords Go?

As owners contemplate the opportunities for flexible space within their buildings, consideration must also be given to what kind of service provision is appropriate. Figure 5.1 illustrates five levels of service, not dissimilar to an hotel, each with implications for the commitment the owner must make.

Figure 5.1: Differences in FSM Service Levels

The question of what 'star rating' level an owner might choose to offer will be influenced by their modus operandi. For example, will they be self-delivering (in which case fewer stars are more likely), or do they wish to deliver through a third party partnership (in which case higher star ratings can be achieved)?

5-star will require a large building providing the critical mass to absorb such uses. For example, Convene plans its first international location in London with a 102,000 sq ft. offering at the 1.2m sq ft. 22 Bishopsgate in the City of London. Spanning nearly 51,000 sq ft. across two floors, this will accommodate approximately 600 desks in fully-furnished, flexible work suites that can be customized for small to mid-sized companies.

5. OPERATIONAL ISSUES

A further 102,000 sq ft. will provide meeting and events space, with the capacity to hold 30-300+ person conferences, product launches, panels and networking receptions.

The larger the portfolio, the greater the potential for provision of additional services. Similarly, scale allows an owner to nurture occupiers and 'grow them' within the estate. At the same time, owners are limited in their ability to accommodate global brands in multiple cities, as so few operate in more than a handful of global cities. For a majority of owners, in most situations, the opportunity will be limited.

> "Landlords are not global. We [providers] can offer this anywhere, they cannot."
>
> "There is the question of whether we should set up an OpCo. Are we the right size? Do we have enough stock? We don't think we're ready yet. Some will. While others will have partnerships."

Many owners do not have the operational skills to take part in the FSM, and will simply choose not to engage with the FSM. Others will choose to evolve and develop their own offers (such as British Land with Spaces, LandSec with Myo and Great Portland Estates), but the amounts committed are relatively small.

CAT A+: Some owners spoken to had decided to meet the challenge with a new offering, recognising the significant impact that the FSM had been having on the small lettings market (say, sub-5,000 sq ft.). Such demand is a key target for the FSM, with the consequence that demand for conventional space of this size had *"shrunk dramatically"*.

Consequently, some owners consulted have begun to mitigate the impact of competition from the FSM by offering a 'CAT A+ solution', being, essentially a CAT B, plug and play solution, available at short notice and on flexible terms, but without a service offer.

> "We looked at the slow landlord and tenant world, and wondered how we could speed it up. It struck us that occupiers were looking for 'furnished and work-ready space'."

In some ways, this is a defensive move and unlikely to prove very popular for customers looking for service add-ons. Nevertheless, it provides an additional level of flexibility. One representative owner offered "a two year term, with a six month rolling break 'typically', while another suggested "*The occupier can serve notice any time they like. There is though a sliding scale of penalty. A little like paying off a mortgage early.*"

The market is likely to see a growth of CAT A+ offerings as an increasing number of smaller companies recognise the benefits of flexible space, but require something between the individually-focused coworking and unbranded serviced office space.

5. OPERATIONAL ISSUES

5.3. Suitability of Stock

In this context, scale is a hugely important factor. By way of illustration, if an owner has 20 buildings, say, scattered throughout the country, ranging in size from 20,000 to 50,000 sq ft., then their potential for FSM engagement is likely to differ from an owner of multiple buildings within a single market location. As one respondent put it: *"If you're running five buildings, you need the same resources as 10 buildings. There are scale advantages."*

However, not all buildings suit FSM usage and different buildings will be more suited to different FSM offerings. Key factors will include floorplate (both size and configuration), number of floors and contiguity, quality of hard and M&E services, fenestration/natural lighting and ground floor/reception design.

> "Many buildings are inappropriate for flex working. Some floorplates do not work. They can be too deep. Non-contiguous space is bad. Core location and M&E services have to be right."

Building size can also be an important consideration. At one level, this does not matter: 30,000 sq ft. of flexible space in a 100,000 sq ft. building can work; so too can a whole building of 30,000 sq ft. dedicated to flexible space. But at another level it does. For example, a number of interviewees suggested a minimum entry point:

> "The size of the flex space needs to be 15-20k minimum. Could be the whole building. But, more likely, no more the one-quarter of the whole building. It works better in larger buildings."

Another suggested that *"In very large, central London buildings, the FSM model is easy. Much more challenging in a 50k sq ft. building [sic]."*

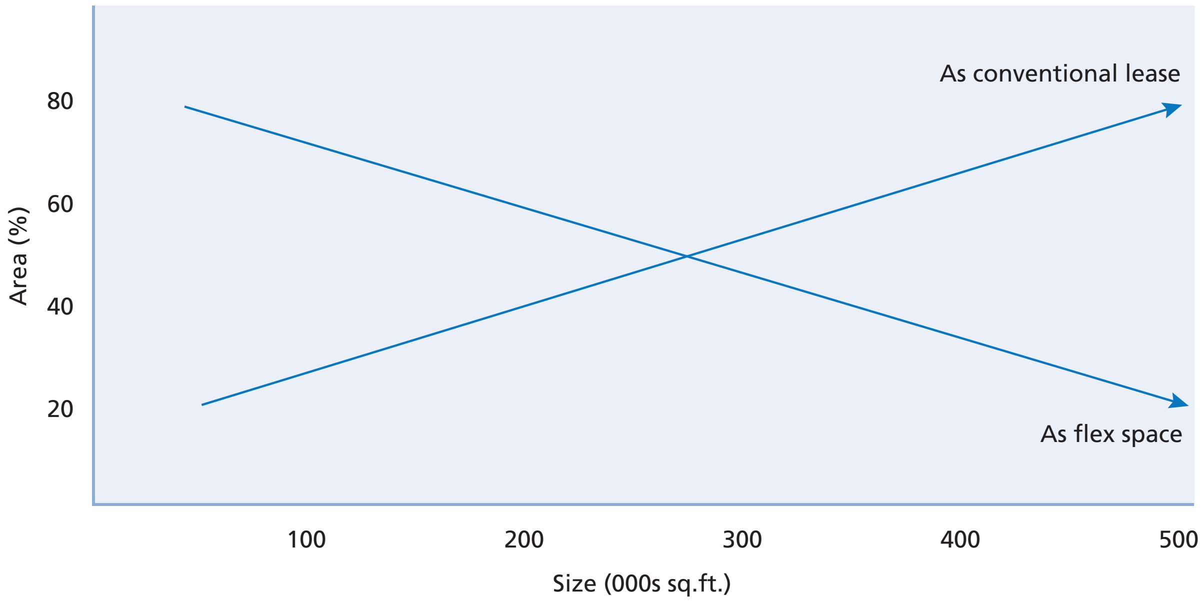
Several owners suggested that less than 30% of a building's total leased as flexible space was positive (mainly from a valuation perspective); while more than 60% was seen as negative. And this imposes limits in the size of flexible operation that is achievable. Other owners expressed approval of a blend of different offerings, the following being typical.

> "In a 100,000 sq ft. building, 40,000 to traditional Cat A space; 30,000 to managed space and 30,000 to pure flex space or coworking seems to work."

Figure 5.2 provides an interpretation of building size and the appropriate proportion of flexible space in graphic format. Whilst not a mathematical proposition, the implication drawn is that, above a certain threshold, as building size increases, so the proportion of flexible space decreases.

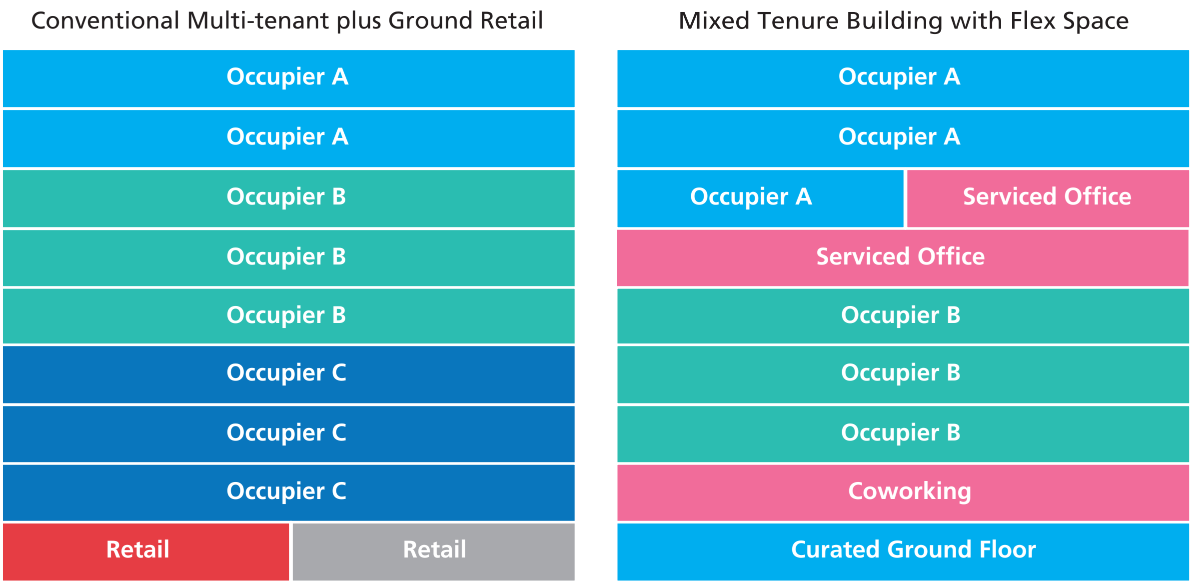
5. OPERATIONAL ISSUES

Figure 5.2: Building Size and Conventional versus Flexible Space



Owners are increasingly seeking to achieve a competitive advantage through blending traditional space, flexible space and turn-key solutions, all supported by a comprehensive set of amenities, leading-edge technology and personalised services (see Figure 5.3). This 'hotelisation' of office space treats occupier as valued guests and provides commercial building occupants with the same quality of service as they would find in the hospitality sector.

Figure 5.3: Tenure of Mixed Space Buildings



5. OPERATIONAL ISSUES

Retention rates will be higher, whilst there will be opportunities to 'churn' occupiers to optimise/maximise revenues and manage risk. Such a model is more sustainable, therefore, with shorter lease terms compensated by saving on voids and fit-out costs.

5.4. Does the FSM Attract a Premium Cost?

A concern underlying the 'bubble' fear is one of occupiers of flexible space paying premium rents unsustainable in the longer term. However, discussions with both owners and operators revealed a certain mythology here, based on a misunderstanding of how total occupancy costs are calculated.

Whilst traditional space is priced on a per square foot basis, flexible space is rented by the desk. A further complicating factor is that many price comparisons include only the obvious 'hard' costs of rent, ignoring softer and hidden service-type costs.

In order to explain the nuances of comparative charges, Table 5.1 compares a conventional lease with the two FSM sub-markets of managed and coworking. The conventional lease assumes an annual rate of £60 per sq ft., with the additional burden of rates and service charge, excluding utilities resulting in a total occupancy cost of £95 per sq ft. The flexible products assume unitary charges of £190 and £160 per sq ft. As can be seen, at this headline level, the coworking and managed models compare unfavourably with conventional leases; but on a 'per desk basis', conventional costs sit somewhere between the two flexible models.

> "You pay £200 per sq ft., but look what you get."

Table 5.1: Comparison of Traditional and Flexible Space Charges

Costline	Coworking Space	Managed Space	Conventional lease
Headline	50 people/desks @ £50 psf[1] = 2,500 sq ft Unitary charge @ £190 psf Headline cost = £475,000 Or £9,500/desk	50 people/desks @ £80 psf[1] = 4,000 sq ft Unitary charge @ £160 psf Headline cost = £640,000 Or £12,800/desk	50 people/desks @ £120 psf[2] Plus growth space (say 8 desks) = 6,960 sq ft Rent, Rates & SC = £95 psf[3] Headline cost = £661,200 Or £11,400/desk
Acquisition	Day One reception	Day One reception	Minimum six months lead-in Broker/legal fees Fit-out CapEx Professional fees Management time Opportunity cost
Occupancy	None	None	Utilities costs Staff (reception, etc.) Landlord approvals
Exit	One month's notice	Six months' notice	Dilapidations Depreciation on CapEx

Notes: [1] Net usable area (desk space only) [2] Net internal area [3] £60 rent; £30 rates; £5 s/c.

5. OPERATIONAL ISSUES

At this level, however, the comparison is not between like and like. To do this, account needs to be taken of 'hidden' or 'softer' costs (summarised in the acquisition, occupancy and exit costs highlighted). In the flex models, the occupier only starts to pay once they enter the space; whereas in the conventional model, costs are incurred from the point of commitment, i.e. lease signing (acquisition costs). At the end of the term of occupation, the flexible occupier simply leaves after a notice period, while in conventional space a tenant will usually be required to agree dilapidations or reinstatement of the premises to their original condition/specification. *"Lease negotiations are a painful, disgraceful, experience, designed to confuse and baffle."* as one interviewee commented, pointedly addressing landlords.

Once these are taken into account and combined with the intangible benefits of business flexibility, the cost-benefit axis shifts somewhat.

Neither multinationals nor scale-ups wish to incur the opportunity cost of the time involved in the conventional model: *"It's all very cumbersome. The early stage process can take 12 months, with many, many line items and processes"*. Then there is the fit-out: *"... complete with delivery team; all very complex and expensive"*.

It should also be remembered, however, that the lower headline cost for coworking comes at a price: higher densities, lack of privacy and security issues, which many businesses find have a negative impact on productivity and business processes.

6. OPPORTUNITIES AND THREATS

The FSM is becoming very crowded, as operators and providers of such space are growing in number rapidly. Owners are engaging, both directly and indirectly, whilst intermediaries are also getting involved. This section summarises some of the more important opportunities and threats to this dynamic and evolving market.

6.1. FSM will Double in Size then Disappear

According to recent research from JLL, upwards of 30% of all commercial office space might be consumed as flexible space by 2030[9]. Contributors to this particular study were generally of the view that structural changes in the demand market meant that the FSM had considerable scope for growth. This is supported by much secondary data and economic analysis. Yet the FSM represents something perhaps more significant than merely a growth in demand by challenging and finding wanting the traditional form of property provision (overlong lease lengths, onerous liabilities and inflexible terms). While similar attacks on conventional leasing have been made in the past, the recent combination of technological advancement and economic change has created conditions for the current challenge to succeed.

As such, there will be no return to the status quo ante and the market for flexible space has the potential to become the dominant way in which the property industry conducts its business. Accepting that there will always be demand for long-term space from large corporates looking for core estate security, the rest of the market could evolve to FSM in one form or another.

Hence, the market could ‘double in size, and then disappear’ by ceasing to be the exception and instead becoming the new normal. This proposition is in line with Simonetti & Braseth, who predicted that, by 2030, most companies’ real estate requirements will be outsourced and consumed on-demand while only 20% taken via traditional long-term obligations.[10]

6.2. Stop and Re-set? Recession and Consolidation

It was clear from the tone of the interviews that the owner community has accepted the FSM represents a structural change in traditional supply. While one interviewee noted there is scope for further growth, there will come a point where adjustments in supply-demand dynamics will be made: *“Growth will continue; but there must be saturation. It’s here to stay; it will not crash and burn. But there will be some fallout.”*

Nonetheless, interviewees also recognised that the FSM *“will not continue to grow in a straight line.”*

- There will definitely be consolidation.
- When there is a correction, those operators without scale, brand, infrastructure and technology will disappear.
- Long-term assets, short-term liabilities – space leased long-term filled with short-term licences require intensive management.
- The strongest and best capitalised are still doing quite well.

[9] JLL (2017) Workspace, Reworked: Ride the Wave of Tech Driven Change
[10] Simonetti R & Braseth H (2017) Your Workplace, On Demand: Five Predictions for the Future of Work Convene

6. OPPORTUNITIES AND THREATS

The most frequently cited potential setback was an economic recession, with such an event expected to lead to a general dampening of demand, with a magnified impact on operators who have *"bought long and sold short"*.

But as one interviewee put it, *All recessions have reduced demand for commercial space. What's the difference? We'll just bear the pain; pass through it and pick up on the other side"*. Indeed, some suggested that the FSM is less vulnerable to economic disruption than conventional real estate because the customer base is more diverse; firms will shrink and transfer from conventional leases to FSM; there will be more freelancers, and the base product will be more affordable[11].

The WeWork effect: Irrespective of recession, there is the WeWork effect. Its phenomenal expansion has transfixed commentators and practitioners alike. One suggested that *"WeWork has been transformational"*; while another said: *"Regus has been around for 30 years, but WeWork's five years has changed everything"*. Interviews were conducted over the period (August to October 2019) when WeWork's valuation was cut significantly, and its planned IPO was withdrawn. Whilst rumours of the unicorn collapsing circulated, interviewees were sanguine of such a prospect; the following was typical: *"Even if WeWork does fail, the market will carry on. Flex space is now established"*. Another said: *"WeWork has shown occupiers what they can have. You can't now shut that off"*.

Consolidation: Whatever the impact of a recession, generally interviewees agreed that the FSM would experience consolidation at some point. Section 2.3 noted that the top 10 providers account for a very small fraction of overall FSM supply and, on the understanding that operators have a variety of business models, those most exposed to long leases, where demand might weaken, will face the greatest challenges.

Consolidation was also seen as a positive dynamic by some. As the market grows and matures, as competition intensifies and price pressures increase, mergers will occur. *"There will most certainly be consolidation; it's just a question of what precipitates it."* Larger operators will buy smaller operators and there is likely be growing clarity between different products in terms of pricing, quality and service offerings.

Within the FSM, perhaps the most vulnerable area is the coworking subsector. Several research contributors felt that, in the context of a recession, the number of coworkers could shrink, as they seek to reduce their fixed costs. As one interviewee put it: *"Demand for flex space is here to stay, but I have concerns about coworking"*. This might cause occupancy rates to rise and income to fall; putting further pressure on operator margins, with implications for property yields and values. However, interviews suggested anecdotal evidence of coworking shrinking as a proportion of the FSM, and therefore becoming less of an issue for the market as a whole.

The average size of centre is also likely to rise as the market shifts from one catering mainly for start-ups, freelancers and entrepreneurs to larger customers in enterprise space, as well as for coworking. Specialisms in particular sectors might grow, such as for FinTech, Digitech and Creatives.

[11] Ropes & Gray (2019) Coworking: A Real Estate Revolution

6. OPPORTUNITIES AND THREATS

Lease lengths and FSM stays: Average lease lengths in the UK have fallen dramatically in recent years, possibly making the rise of flexible space more palatable among traditional owners. According to recent research from Colliers[12], the average lease length today is 5.6 years. In 2005, leases with minimum 10-year term certain, accounted for 88% of all letting activity. As at the end of 2018, that figure had fallen to 19%. Leases of five years or below have been in the majority since 2014. By the end of 2018, they represented 70% of all leases signed in London.

At the same time, the average duration of stays in flexible space has been lengthening. Serviced offices report average stays of 21 months, while managed centres report 35 months. Leases and licenses have thus been converging in terms of occupancy times, in stark contrast to, say, 10 years ago, and lessening the difference in risk profiles between the two markets.

6.3. What about Intermediaries?

The FSM is challenging traditional supply chain relationships. For example, the two key roles performed by property agents: brokering leasing deals between owners and occupiers and managing occupied properties on behalf of landlords.

Methods finding and negotiating with occupiers are changing rapidly with the growing adoption of 'PropTech'. In the US in summer 2019, provider Knotel announced its acquisition of 42Floors, a top search engine for commercial real estate in the US. The deal will give Knotel access to data and technology on over 10bn sq ft. of office space, driving market liquidity.

"The agency world will need to re-invent itself."

"Businesses used to find space through a broker. This has now completely changed. Now through the internet. Flex brokers and a free service. Finding space has changed."

"We will end up in a situation where people come into our buildings on the back of a credit card, for two years. Facilitation by technology. Surveyors will only be used for larger lettings."

Similarly in property management. Traditional approaches – chiefly focused on rent collection and service charge administration – are increasingly outdated. Landlords are now being forced to provide more service. They have to work harder to maintain high occupancy levels: *"Owners will have to offer something to occupiers in multi-let buildings"*.

Some firms have begun to respond, as CBRE recently announced the establishment of its Hana product[14], a wholly-owned flexible space delivery vehicle that seeks to partner with owners through traditional lease agreements, hotel-like management agreements or participation arrangements. It is aiming at large, global occupiers that want the service level of the FSM, but in a corporate environment. Hana has been deployed at three locations: LGIM/Mitsubishi's 245 Hammersmith Road scheme (28,000 sq ft.); Oxford Properties' St Martin's Court EC4 (100,000 sq ft.) and Nuveen's 70 St Mary Axe, EC2 (40,000 sq ft.).

[12] Business Centre Association (2017) The UK Business Centre Market

6. OPPORTUNITIES AND THREATS

6.4. From Office Space to All Space

This primary focus of this research has been on the office sector, but the benefits that occupiers in the FSM enjoy should transfer to other sectors. Two examples to illustrate this point.

Industrial property: Stenprop is a specialist industrial owner/developer that plans to become the UK's first 'serviced industrial provider'. The group is quoted as stating that it aims to offer tenants of its multi-let industrial estates the same sort of flexibility that serviced office tenants have and that it plans to roll the service out across the 520-plus tenants that occupy its 33-estate portfolio. Under the new strategy, it will move away from the traditional leasing model and allow its tenants to sign up for six weeks to six years on its Smart Lease online platform[15].

Stenprop argues that a simple, three-page lease will help cut both void periods and the cost of getting tenants in. Stenprop will offer its customers a range of products when they move in, from utilities and IT to forklift, racking and security solutions. This innovation is being enabled through proptech, via firms including Realla, VTS, Coyote and Happy Inspector.

Laboratories: RUNLABS, founded in 2018, has been described as 'the WeWork of the biotech sector'. Biotech, and life sciences generally, is a rapidly growing area, where collaboration and innovation are, arguably, even more important than in the office sector. To date, however, there have been no 'turnkey' or 'easy in- easy out' solutions on offer. RUNLABS has chosen Paris for its first facility: a 160,000 sq ft. building, capable of hosting around 30 companies and more than 800 researchers[16].

RUNLABS is now looking at sites in London's 'knowledge quarter', around the King's Cross, Bloomsbury and Fitzrovia areas and near the Wellcome Trust, UCL and the Francis Crick Institute. The area *"is filled with the greatest hospitals, universities, clinics and technology companies in the world"*. A growth in 'flex labs' may occur as the costs and pressure on space continue to intensify.

6.5. Overview

One of the most important outcomes from the interviews was that that most owners now recognise the permanence of the changes that have taken place in the FSM. It is not regarded as a passing phase, but as a structural shift in the market, responding to real occupier needs. Most agree that the FSM will continue to grow as occupiers seek and expect more experience-based services from the workplace.

There are risks as well as opportunities, however. Table 6.1 summarises the benefits and risks to owners associated with a growing FSM.

[15] https://www.propertyweek.com/news/stenprop-plans-to-become-serviced-industrial-provider/5097115.article
[16] https://www.propertyweek.com/insight/welcome-to-the-wework-of-biotech-interview-with-steven-marcus/5101999.article

6. OPPORTUNITIES AND THREATS

Table 6.1: Risks and Benefits of a Growing FSM

Opportunities & Benefits of the FSM	Threats & Risks of the FSM
Respond to evolving occupier agenda and changes in demand	There is no need. Plenty of conventional demand to serve
Appeal to a broader base of occupiers	Exposure to non-core business area Opportunity cost
Enhance income from service provision	Selecting wrong operator for a local market
Ability to nurture/grow existing occupiers through growth	Exposure to voids in event of economic jolt
	Vagaries of management agreements and partnerships
	Investment in fitouts, people and systems/processes
	Exposure to 'weaker' providers
	Possibility that demand for FSM declines

The FSM has evolved from individuals and entrepreneurs in coworking space to corporates taking space for several hundred employees, the twin benefits of flexible terms and added services are clear. Having tasted the new world, it is highly unlikely that even a major economic shock will impart a sufficiently large jolt to cause a reversion to the status quo ante of FRI leases and onerous obligations.

There can be little doubt that the property market is evolving in response to the rapid expansion of the FSM. Traditional supply chain relationships are changing: the traditional landlord-tenant relationship, intermediated by property/assert managers (surveyors) is yielding to a new model. The extraordinary growth of operators (both as lessees and as freeholders) has turned the old model on its head. But the critical point is that they have introduced, popularised and normalised the provision of service, or more grandly, experience.

So where do traditional property companies fit into this new world order? This study revealed an incredibly dynamic supply chain, not least amongst owners. Some have joined in, others are 'waiting and seeing' and a small number have decided not to make a move. There is no clear pattern between types of owners, their size, legal status or culture.

"Currently we are not certain whether to do our own thing, or to partner with an existing provider. It is very early days and our thoughts are not yet fully developed."

"We've been in discussions with a serviced office space provider for a while. But the issue for us is that they want us to pay for their fit-out and if it goes well for them they might give us some rent. We're thinking we might as well do it ourselves and take all the rent."

6. OPPORTUNITIES AND THREATS

The defining features of the FSM are flexibility in contractual terms and a greater or lesser degree of service provision. While most owners can cope with the former, they are not 'geared up', either with the skills/resources or operating models, to provide service/experience directly.

It is in this meshing together of product and service that provides the material for the evolution of a quite different industry. The property product has always been compromised in having two customers: the investor and the occupier, with the former normally winning out. It seems now that the scales are being rebalanced.

A flexible space race beckons. Interviews with leading participants suggest that the FS market will continue to evolve, with an increasingly diverse range of offerings for occupiers, particularly in London and core UK cities. However, opinions vary on how much provision will be sufficient, with views still evolving.

The primary conclusion of this research is that the industry needs to go through a major shift in the way that it engages with its customers. Whilst responding to demand signals, the expansion of the FS market is not comparable to overbuilding during a development cycle, when the resultant downside is one of substantial vacant space. The fundamental point to the FSM is that the relationship between the provider and the occupier is changing.

While still subject to economic vagaries and, according to interviewees, some increasingly over-due consolidation, the case for flexible space should outlive any economic cycle.

In this respect, it might be the case that within the next five years, the FSM will cease to be discussed as a distinct sub-sector and will be recognised for what it is: the industry's new *modus operandi*.

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