Our flexible future

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As flexible workspaces continue to grow in popularity, joint venture agreements with operators are 1 option for landlords wanting to enter the market

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The rapid expansion of the flexible workspace sector is a global phenomenon. The market has experienced exceptional double-digit growth in the UK, and some estimates suggest it will expand by as much as 30% annually in Europe for the next 5 years. Central London alone saw 230,000m2 leased to flexible workspace operators in 2017 ? a rise of 190% on the previous year, putting it ahead of New York. The number of flexible office centres across the UK also increased by some 10% to more than 5,300 in 2017, and this pace of growth continued last year.

Large blue-chip businesses and smaller entrants are alike attracted by the sector because it reflects the changing realities of modern business and the need for cost-efficient flexibility and scaleability. Given both the increasing demand for flexible workspace and the robust returns it now offers, property owners have increasingly been looking to enter what is probably the most dynamic area of the commercial office market. There are various options available, with the owner?s appetite for risk and target returns determining which is the most appropriate. An understanding of each route into the market will be key to a property owner?s success in capitalising on its fast growth.

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The phenomenal growth of the flexible office market in recent years has led to the realisation among many property owners that space as a service is now a mainstream concept. A recent report by CBRE revealed that 92% of UK office owners believe the flexible workspace sector is on the brink of becoming mainstream, and more than 3/4 of them are considering using flexible office workspace in their portfolios.

What property owners recognise is that flexible workspace is one of the best ways to attract tenants to their buildings and incubate them for future growth. Also, they realise that if they can keep their offer in step with the evolving needs of corporate clients then they will keep their tenants in place for longer. One way they are addressing this is the use of multipurpose products mixing flexible workspace, traditional leases and managed office space to provide a variety of income streams and rents in one portfolio.

To some extent, this evolution of space as a service is a result of generational change and the resultant shift in expectations. In less than 10 years millennials will make up 3/4 of the global workforce, according to Deloitte , while for some time more attention has been paid to well-being and mental health in the workplace. The demand for collaborative and communal workspaces and on-site amenities such as gyms and cafes will therefore only increase.

These services can be provided profitably and increase tenant loyalty through helping to attract the best talent, meaning that flexible workspaces can generate income that might be well in excess of a property?s estimated rental value (ERV).

Capital Economics forecasts the UK flexible workspace market could be worth at least ?62bn, and possibly as much as ?126bn, by 2025. RICS is working on an advisory white paper for surveyors that is expected to be published this year. The presumption is that this paper will broadly follow a formula that takes into account the unique nature of flexible workspaces? income streams. If a valuation formula for the sector is agreed by the market, this will also attract a wider range of property owners and investment funds, further accelerating the sector?s growth.

Probably the most straightforward way for property owners to enter this dynamic market is by signing a traditional lease with a flexible workspace operator. With such space now acknowledged as an integral part of the office market, many property owners are happy to include this in their portfolio. But while this will mean the workspace will be professionally run, the property owner takes no share of the profits generated by the operator and has no control over the occupants, who contract with the operator directly.

The second option is for property owners to create their own operation, such as British Land?s establishment of Storey, the Crown Estate?s recent announcement of its first flexible and co-working office in London?s West End, and Landsec?s recent launch of the brand Myo, among others. This means the operators take on all the risk in a dynamic and sophisticated market, but also benefit from retaining all profits, having complete control over the space and, it is hoped, the loyalty of their tenants.

A third option that some property owners have already taken is to invest in an existing operator, such as Blackstone?s acquisition of a majority stake in the Office Group, valuing the operation at ?500m, or real-estate investment trust RDI?s controlling stake in Office Space in Town?s portfolio in London. Most recently, Asian family office Celvam Management acquired London Executive Offices for ?475m. Brockton and the Carlyle Group have also opted to buy in knowledge and a sound existing business.

An increasingly popular trend is for property owners to enter into joint venture management agreements with operators. These can be best described as the outsourcing by a property owner to an operator of the sales, marketing and all revenue generation of an asset as flexible workspace under the terms of a service agreement. These agreements are quickly becoming a favoured route for commercial property owners as they can provide returns in excess of ERV. Property owners also rightly see such agreements as lower in risk than directly investing in a flexible workspace operator or running their own operation.

Management agreements by definition are not property transactions, they are a service agreement between 2 parties, and this needs to be understood from the outset. If not, there can be issues with valuation, lending criteria and legal points on the agreement. If a property owner chooses to enter a joint venture management with a flexible workspace operator there are a number of factors they should both consider. These are best described as the 5 Rs: revenue, returns, responsibilities, rewards and realism.

Consideration should be given to the kind of revenue streams the joint venture is targeting and the likelihood these will be met. Property owners and flexible workspace operators should both be clear from the start of their relationship what their partner?s income expectations are, as well as their own.

The prioritisation of returns between the parties will need to be established as part of the agreement as well. There are operational and property costs to consider in addition to the rewards ? in other words, the profit distribution ? the details of which will depend on a multitude of factors including the share of costs and risks that each party is assuming and income from additional services that may be provided. All this will be set out in detail in the agreement.

The joint venture management agreement should also clearly define the roles and responsibilities of both parties. The flexible workspace operator should take responsibility for the sales, marketing, staffing and the overall day-to-day management and contact with occupiers. The property owner is likely to have responsibility for the initial capital expenditure and the working capital. A clear understanding of the roles and responsibilities that each party to the joint venture management agreement has will ensure the relationship between the owner and operator gets off to a good start, and that the best possible returns are secured.

Last, it is important that property owners are realistic about their revenue expectations and the time frame over which they should be achieved. Realistic expectations will be crucial in getting flexible workspace operators to embrace the joint venture route, but just as importantly will save potential disappointment later on.

The successful property owners of the future will be those who understand that space is now a service. In seeking to capitalise on this they will need to consider their approach to flexible workspace carefully. For many of the larger property owners such as British Land or Landsec and investment funds such as Legal & General, launching a flexible offer may make sense. But partnering with a flexible workspace operator, ideally through a joint venture management agreement, probably offers the best model to ensure most property owners secure the robust returns they are seeking.

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Further information

- Related competencies include: Workspace strategy
- This feature is taken from the RICS Property Journal (May/June 2019)
- Related categories: Landlord and tenant