The evolution of space-as-a-service

Knight Frank

Power in Partnership

EXECUTIVE SUMMARY

The 2010s was a decade of great change for the London office leasing market.

The desire, or need, for occupiers to better align their real estate to the realities of an ever more volatile operating environment has resulted in increasing demand for shorter and more flexible leases.

The combination of greater flexibility and a greater recognition of the customer has transformed real estate from a fixed physical product to a flexible business service.

The associated rise of coworking operators has changed the real estate narrative and proposition for good.

Coworking operators have extended their reach beyond SMEs and created enterprise solutions aimed at corporate occupiers as an alternative to conventional leases from landlords.

The consequence has been a distinct gap in the offerings of coworking operators and conventional landlords, and a mounting challenge for the latter.

In attempting to close this gap, the inter-relationship between the operators and landlords has evolved, through 3 distinct phases:

- Phase 1 was an uneasy co-existence.
- Phase 2 was one of growing acceptance and convergence.
- Phase 3 has seen a movement towards partnership.

At the start of a new decade, these partnership structures are solidifying and bringing new products and best practice to the market.

These products – known broadly as managed solutions - sit in the middle ground between conventionally leased office space and serviced or coworking spaces.

Through a range of options and services these products provide the customer with a greater opportunity to create bespoke environments that are more in keeping with their objectives and aspirations.

From the landlord perspective managed solutions deliver 5 distinct benefits:

- substantial income uplifts
- the effective deployment of capex
- the removal of operational headaches
- the ability to flexibly market space at either end of the supply spectrum, and
- the ability to leverage the partner operators supply chain, team and service delivery to provide a best-in-class customer solution.

NEW LANDSCAPE NEW SOLUTIONS

The last decade was one of great change within the London office leasing market. Over this time, the relationship between conventional landlords and coworking operators has evolved towards stronger partnership, as has the relationship between the supplier and occupant of office space. The next decade will see these partnership models strengthen further as ever more demanding customers seek more bespoke office solutions.

Disruption through the coworking revolution

The last decade brought great change to the London office leasing market. The desire, or need, for occupiers to better align their real estate to the realities of an ever more volatile operating environment resulted in increasing demand for shorter and more flexible leases. Indeed, by the end of the 2010s, average lease lengths in Central London stood at just over six years. This has clearly challenged those conventional landlords whose business models revolve around the surety of long-term income and the value that it generates.

Enter the many coworking operators who, in taking on more conventional leases and then delivering shorter-term flexible solutions to their customers, have changed both the real estate narrative and market proposition for good.

In terms of that proposition, the growth of coworking, on both the global and London scale, has been remarkable. Over the course of the last decade, the number of coworking centres globally has risen from just 600 to more than 22,000 – representing a growth rate of some 3,600%. Even more astounding has been the number of people using coworking facilities as their principal place of work. This has grown by more than 10,000% over the decade with more than 2.1 million people now operating primarily from coworking space. This explosion of coworking activity has not been anywhere more apparent than in London. By the end of the decade, London was home to more than 1,400 coworking centres – almost three times as many as the next largest market, New York – and is forecast to grow by around 13% per annum (Source: Statista, 2020).

It is unsurprising therefore that the real estate narrative – and the inter-relationship between what has traditionally been termed landlord and tenant – has undergone a significant change in London. Flexibility has been part of that changed narrative. Coworking has enabled the crucial temporal alignment between business planning horizons and real estate, but it has also permitted the rapid scaling (up and down) of activity, facilitated increased levels of collaboration within and between organisations, and enhanced the ability for businesses to respond to commercial opportunity by offering ready-to-operate space quickly and in just the right quantum.

It would be a mistake, however, to believe, as some conventional players do, that flexibility was the only input into a changing real estate narrative. Of arguably far greater importance has been the customer-centricity that the coworking operators have brought to the real estate market. The very positioning of the occupier as a customer, and the elevation of the wants and needs of that customer in the dialogue, is in stark contrast to the traditional dynamic of the market where the supply-side controlled the what, the where and the how much of leasing.

This combination of greater flexibility and a greater recognition of the customer has, in just ten years, transformed real estate from a fixed physical product to a flexible business service. A consequence of that transition has been that the supplier of space – be that coworking operator or conventional landlord – has had to extend their influence beyond bricks and mortar and instead take a strong interest in the creation and curation of the workplace environment and experience. That transition has been easier for the coworking operators, largely due to their origins or prior experiences within aspects of the hospitality sector or within industries with a greater history of customer-centricity. For conventional landlords, it has been a further source of challenge.

"Coworking has enabled the crucial temporal alignment between business planning horizons and real estate."

RISING TO THE CHALLENGE

The three phases of landlord and operator interaction

What has happened in the real estate market is no different from the disruption that has transformed a wide range of industries sectors and marketplaces - a shift towards the provision of more flexible, often short-term, solutions, underpinned and sustained by a mix of technology and the very highest levels of customer service. The consequence has been a distinct gap in the offerings of traditional market incumbents and new market challengers and, as the 2010s progressed, an interesting shift in the inter-relationship between old and new market participants. Simplistically, this inter-relationship moved through three distinct phases.

PHASE 1

Uneasy co-existence

The early part of the decade brought an uneasy co-existence. Many conventional landlords were dismissive of coworking operators suggesting that the rise of coworking was simply the next iteration of the serviced office boom and bust witnessed in the late 1990s and that the 'buy long, sell short' ethos underpinning the coworking business model was not sustainable, particularly in the event of a recession. Some conventional players, and particularly those providing conventional leases in the sub 5,000 sq ft leasing market, did recognise that the early coworking models were particularly attractive to small and medium sized occupiers and therefore represented a rising threat. At best in this phase of maturation, conventional landlords utilised the coworking operators to pass off leasing risk. Essentially, deals with coworking operators were entered into for those last remaining chunks of space within a building that was proving difficult to let to mainstream occupiers or because the sheer volume of demand from the coworking operators constituted an 'easy' deal.

PHASE 2

Acceptance & Convergence

The mid to late 2010s saw this uneasy co-existence evolve towards a more genuine inter-relationship as the characteristics of market demand and their correlation with evolving coworking models became clearer. On the demand side, evidence emerged of the growing appeal of coworking, or more accurately, flexible office products, to mainstream corporate occupiers.

"A new approach is required by both coworking operators and landlords."

Knight Frank's proprietary (Y)OUR SPACE research illustrated this growing corporate appetite. It found that more than two-thirds of the 120 blue-chip corporates surveyed as part of the research were planning to have between 5% and 50% of their global portfolios contained within serviced, flexible, managed or coworking solutions by the turn of the decade – effectively a doubling of the position at the time of surveying in late 2018. The dismissive attitude of some in the conventional market now took on a new danger. As core and flex models of occupation – through which occupiers seek a provision of the bulk of their space on conventional leases but supplement this with options on more flexible space to manage changes in business structure, house special project teams or support rapid headcount acquisition – started to become more representative of market requirements, the danger increased. Some coworking operators who, in response, had steadily evolved their product offering beyond the simple sharing of space by many occupiers towards self-contained, private spaces and floors for corporates as part of an 'enterprise' solution suddenly became a very real, direct competitor to the conventional landlord.

The response from the conventional market took two primary forms.

Firstly, there was a growing recognition that the provision of flexible coworking products within a building could actually activate new assets and serve as an amenity for mainstream tenants seeking this mix of core and flex occupation. In this sense, the letting to a coworking operator often became one of the first rather than the last deal undertaken within a leasing campaign. Hence, the uneasy co-existence became, for many, a more active courting of coworking operators to increase the appeal and value of assets.

Secondly, this period saw the onset of convergence in the market whereby conventional landlords, upon recognising the changing occupational dynamic, sought to mimic the coworking challengers by creating their own distinct products. Hence, we saw two of the major UK REITS, British Land and LandSec bring new solutions to the market with Storey and MYO respectively, whilst The Crown Estate also brought their own flexible product to market as an essential element of their new developments.

Such a reaction from the conventional market ably illustrated both the pervasiveness and evolution of coworking and flexible office space. Yet it is not a response open to all within the conventional market. It is highly capital-intensive with increased capex to deliver a fully fitted product. It is also resource-intensive and requires the acquisition of customer service skill-sets that have not traditionally been associated with commercial landlords. It also brings increased exposure to reputational risk. A model that is about customer service and flexibility puts the landlord closer to criticism (and loss of revenue) if the customer's experience is negative or sub-standard.It is these limitations to universal adoption, alongside some financial challenges for some operators, which has ushered in the third distinct phase in the inter-relationship between coworking operators and the conventional market.

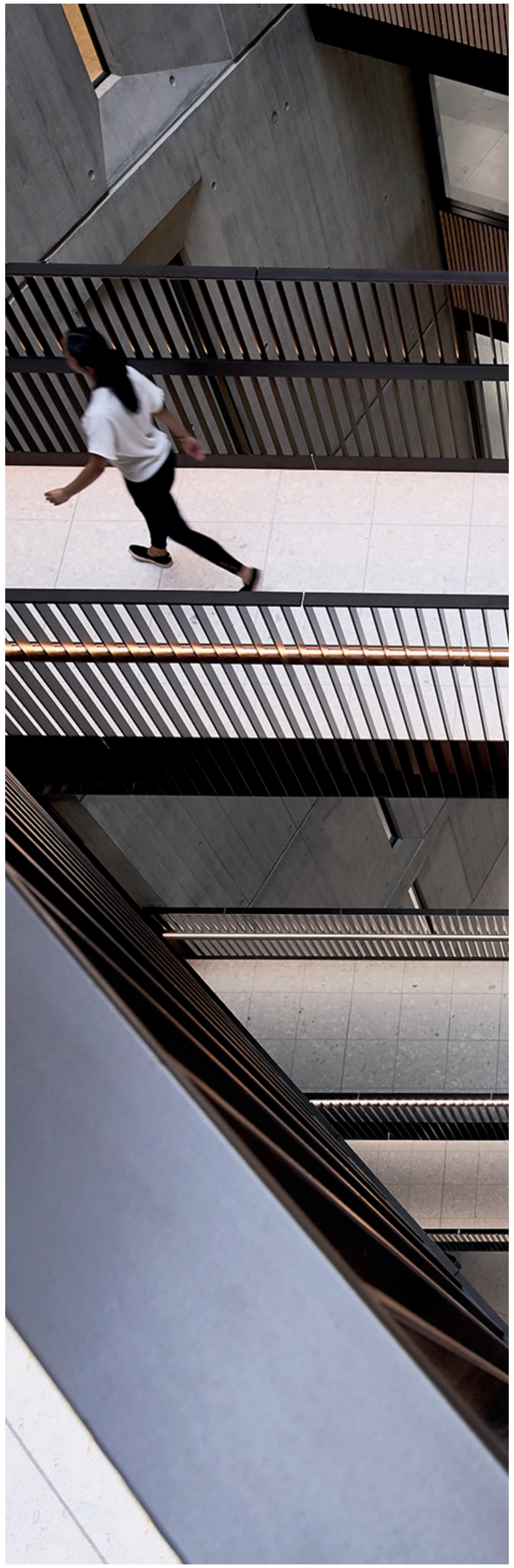
PHASE 3

Towards Partnership

2019 was the year when some of the air from the coworking bubble was released. As noted, many in the conventional market had consistently maintained that the 'buy long, sell short' operational model was not sustainable. That opinion was validated to some degree in 2019 when, following a failed IPO, WeWork's scale-driven and cash-heavy strategy became subjected to modification through an extensive restructure and refinancing. What occurred here, however, was the failure of an operational model, not the failure of the principle of coworking or flexible office models. It is all to easy to conflate the two.

The changed narrative of leasing markets has sustained. But in order to continue to deliver solutions against that narrative, a new approach is required by both coworking operators and conventional landlords. For the operators, the model is rapidly moving from taking on leases towards delivering in partnership with conventional landlords through a defined management agreement, somewhat akin to the op-co or prop-co model that has characterised the hotel market for many years.

This partnership structure works for a far greater spectrum of the conventional market as it provides direct access to the operational expertise necessary to deliver space as a service rather than as a product without the loss of control of the physical product. Essentially, it allows conventional landlords to meet customer expectations and deliver a strong, serviced and flexible workplace experience while significantly reducing the capex, opex or reputational risk associated with self-delivery. For the coworking operator, the partnership model works as it brings them closer to their core competency, namely the delivery of workplace experience and service, without the financial burden of lease exposure. It is also a model that is scalable in that it can deliver flexible and serviced space as an amenity provision for multiple customers within a large building or a managed solution for either entire floors or an entire building on behalf of a single customer.



A NEW SOLUTION THAT'S YOURS

As we enter into a new decade, these partnership structures are solidifying and bringing new products and best practice to the market. These products increasingly sit in the middle ground between conventionally leased office space and serviced or coworking spaces and, through a range of options and services, provide the customer with a greater opportunity to create bespoke environments more in keeping with their objectives and aspirations. They bring conventional landlord's and coworking operators together, drawing on the best of each for the full benefit of the customer.

Essentially, from a landlords perspective, these managed solutions align real estate product with both a hospitality skill-set and, crucially, the real needs of an ever more discerning customer. In particular, these products recognise that as the occupier increasingly invests in their real estate strategically, to support enhanced productivity or deliver stronger business performance, and is seeking greater flexibility to do so, traditional coworking products are no longer the answer. Occupiers want space that is their own, and consequently provides privacy and security, but which draws upon cues from the coworking revolution in terms of workplace design, heightened levels of collaboration through good design, and an aesthetic and experience that truly supports staff.

In bridging the gap between conventional and coworking products, managed solutions allow conventional landlords to respond to the growing demand for flexibility but in a way that is not financially punitive. In essence, there are five benefits to a conventional landlord deriving from a managed solution:

1. Managed solutions can generate a substantial uplift over traditional market income. In offering flexibility and bespoke solutions, we estimate that managed solutions attract a 25%-50% premium above conventional market pricing.

2. Managed solutions allow an effective deployment of capex with no expenditure required on fit-out or services prior to the occupier being secured.

3. The partnership structure provides the landlord with a frictionless solution that presents no operational headaches and negates the need to hire an operational team.

4. The space can be marketed very flexibly as both conventional *and* managed space – essentially, the product can be marketed at either end of the supply spectrum.

5. The partnership arrangement allows the landlord to leverage the partner operators supply chain, team and service delivery to underscore a best-in-class solution to the customer. That solution is entirely customisable to fit with the occupier's requirements, hence ensuring that the landlord is fully customer-centric. It combines a core offering with additional services – such as space customisation, technology or service upgrades – to drive additional revenue generation.

FROM REVOLUTION TO **EVOLUTION**

When new entrants bring fresh thinking into a marketplace, both the narrative and products of that market change irreversibly. Incumbents have to react and respond.

This dynamic represents London's occupational market during the 2010s. The onset of coworking, fuelled by the customer's desire for greater flexibility and service, brought challenges to market orthodoxy. As the decade progressed, behaviours, particularly those of conventional landlords, have subsequently modified to better align with the new landscape.

At the dawn of a new decade, there is a further catalyst for continued modification. It will be less revolutionary but no less significant. It will be a march towards partnership. It will see the further development of managed solutions that combine the expertise of conventional landlords with operational excellence from coworking providers to deliver against the growing expectations of the customer.

This evolution of product will reduce risk to conventional landlords, allowing them to participate in the growing flexible market but without the need to buy-in significant new resource and with clear financial upside.

Such is the appeal of managed solutions that we fully expect that by the end of this decade, they will be the mainstay of London's leasing market and the preferred option for both conventional landlord and customer alike.

To find out more about the evolving managed solutions market, please contact one of our market leading experts.

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