A look at London's serviced office market in the wake of COVID-19 and what the future may hold for the sector

Knight Frank

COVID-19 SERIES

LONDON SERVICED OFFICE MARKET

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THE IMPACT OF COVID-19 ON LONDON'S FLEXIBLE OFFICE MARKET

1

Flexible offices in London now total 14m sq ft, which accounts for 6% of total London office stock

2

WeWork accounts for 27% of the flexible office market, which equates to 1.6% of total office stock

3

Take-up by the flexible office operators has been declining over the last six months, falling to under 200,000 sq ft at the end of Q1, compared to almost 1m sq ft in Q3 2019

4

Flexible offices have been worst hit by COVID-19 due to social distancing rules – many operators have been deferring rents and we could see space being offloaded

5

Lease flexibility and terminations by businesses occupying flexible space is putting operators under pressure. Those with greater exposure to corporate enterprises are faring better

6

Flexible providers have a vital role to play in providing short-term solutions, helping businesses transition back to the workplace

We review the rapid growth of London's flexible office market and explore the negative impact of social distancing and COVID-19 on the sector, evaluating what impact a surge in flexible office release space could have on submarket vacancy rates.

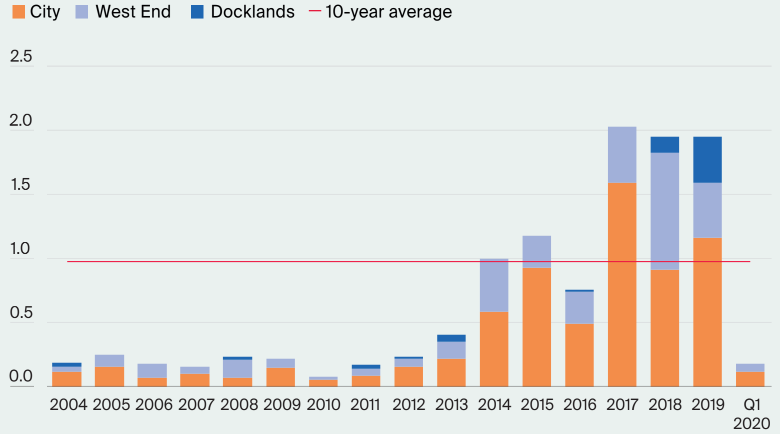
London's flexible market robust for the past three years

London's flexible office market has accelerated in recent years and regularly accounts for a significant portion of take-up annually. In 2019, the sector accounted for 21% of take-up, coming second only to finance (28%). Take-up reached 1.95m sq ft in 2019, up 44% year-on-year and double the 10-year average.

In the last five years, figures suggest that the sector has acquired over 7.8m sq ft – the majority of which has been concentrated in the City Core, which has attracted 65% of the total.

Fig 1. London Flexible Office Take-up

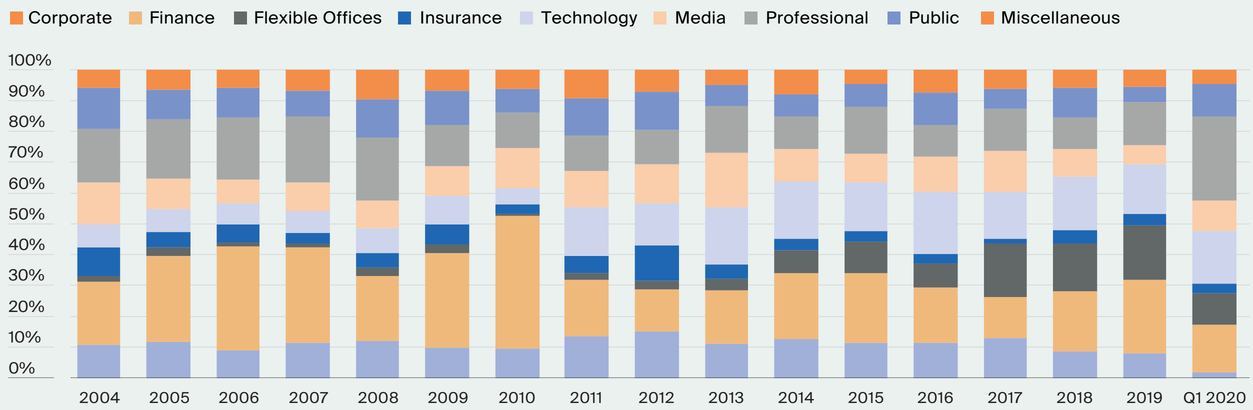
million sq ft



Source: Knight Frank

Fig 2. London Take-up by Sector

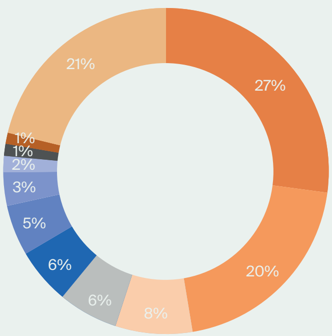
% share of take-up



Source: Knight Frank

Fig 3. London's top 10 flexible office operators (by space leased)
% share

- WeWork
- IWG plc
- TOG
- Workspace Group plc
- The Argyll Club
- Landmark plc
- Knotel
- Fora Space
- Convene
- Office space in town
- Others



Source: Knight Frank

Activity starting to slow

Take-up by flexible office operators has been declining over the last six months, falling to under 200,000 sq ft in Q1 2020, compared to approximately 1m sq ft in Q3 2019. Still, we estimate that flexible office providers now occupy around 14m sq ft in London, equivalent to 6% of total office stock. For context, this is roughly the same amount of office stock as the entire West End Core submarket.

WeWork and IWG (incl. Regus, Spaces and No18) are currently the two largest flexible operators in London, by space let, who combined have acquired around 6.6m sq ft across more than

TABLE 1. LONDON TOP 10 FLEXIBLE OFFICE PROVIDERS (BY SPACE LET)

	% SHARE	
OPERATOR	FLEXIBLE OFFICE STOCK	LONDON OFFICE STOCK
WeWork	27%	1.60%
IWG plc	20%	1.20%
TOG	8%	0.50%
Workspace Group plc	6%	0.40%
The Argyll Club	6%	0.30%
Landmark plc	5%	0.30%
Knotel	3%	0.20%
Fora Space	2%	0.10%
Convene	1%	0.10%
Office Space In Town	1%	0.10%
Others	21%	1.30%
Total Market		**6.00%**

Source: Knight Frank

140 locations. WeWork has fewer centres in London, 71% of which are based in the City, compared to IWG who have significantly more centres, 50% of which are in the West End.

Flexible offices worst hit by COVID-19

There is no doubt that there are some concerns for the flexible office sector. Operators dependent on daily traffic will be most impacted by the ongoing situation surrounding COVID-19. There are already many reports in the press showcasing a large list of well-known operators who are asking landlords for rent discounts or holidays.

Knotel, for instance, is currently in talks to give back 20% of its portfolio, the largest percentage of which is in Manhattan. Workspace Group has been inundated with rent deferral requests and says it has only collected 50% of the rents it was due at the end of March.

In contrast, The Ministry of Sound, which has its own coworking concept, is launching an initiative to takeover space being run by struggling flexible office operators. It is looking to strike management agreements and take over space from distressed operators, thereby minimising any potential loss of income and void periods for landlords.

Those with greater exposure to corporate enterprises, i.e. businesses with over 500 staff, are likely to fare better given the longer lease commitments.

We've reported previously that the relatively high volume of serviced office providers in London would eventually drive consolidation in the sector. This process appears to have commenced in advance of the COVID-19 crisis, with Prospect Business Centre, for instance, with representation in Leeds and London, being acquired by Inc & Co Property Group in March. Others with weak balance sheets are expected to face similar pressures and will likely face a similar fate, or be forced to exit the market. Indeed Central Working went into administration last October, while San Francisco based Rocketspace announced its departure from the UK in December 2019.

Those with greater exposure to corporate enterprises, i.e. businesses with over 500 staff, are likely to fare better given the longer lease commitments. 40% of WeWork's tenant base is comprised of businesses that fall into this bracket, for instance.

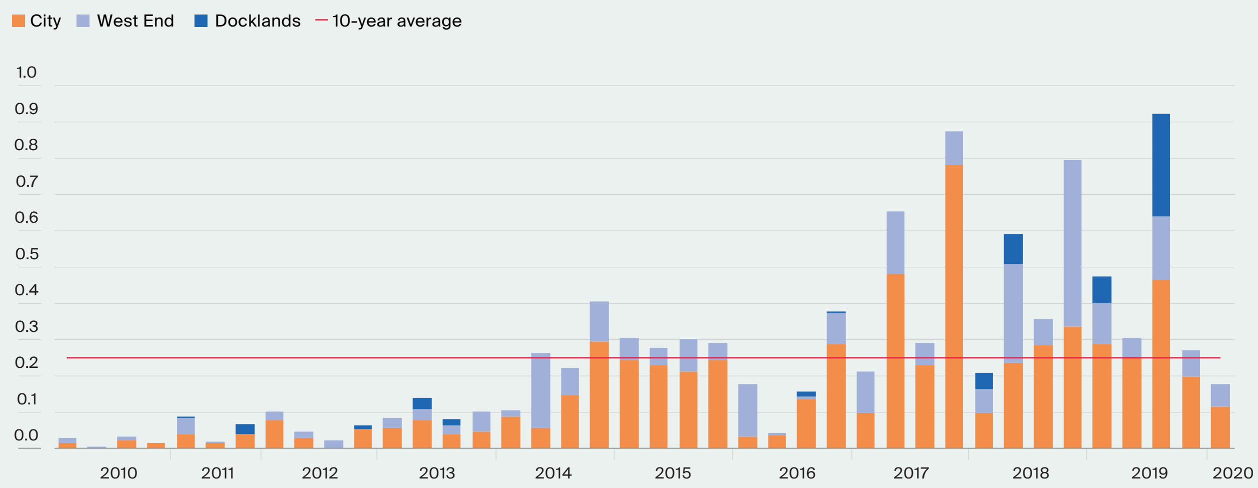
Flexible providers have a vital role to play in providing short-term solutions

When looking at restrictions around lockdown easing and businesses beginning the transition back to the workplace, we anticipate that flexible offices have a vital role to play in providing short-term solutions to those occupiers who are caught out by construction and fit-out delays since development activity has all but come to a standstill due to the pandemic.

They are likely to offer a vital stop gap solution and, in fact, our Flexible Office Solutions team has already experienced a rise in such queries. Furthermore, like some markets in Asia, flexible offices can offer a short-term remedy to businesses looking at their staff density ratios in the wake of COVID-19, as social distancing rules become part of the new normal.

We know that some businesses in the APAC region are returning to "normal";

Fig 4. London flexible office take-up
million sq ft



Source: Knight Frank

however, they are operating with shadow teams, meaning half the workforce is continuing to work remotely, while others are attending offices – this is being done on a rota system.

For now, we are seeing smaller businesses in London let leases expire whilst staff are working remotely, with the view that they will take serviced office space whilst they regroup, establish what their post COVID-19 office requirement is, search the market for suitable options, undertake viewings (which they cannot do currently), agree terms, conclude lease negotiations and fit out their new office.

Impact on vacancy rates from relinquished flexible space

With a London portfolio of approximately 3.8m sq ft, WeWork would have the largest impact on London office vacancy rates should it decide to offload any of its existing portfolio. Its existing office portfolio extends across 12 submarkets with the heaviest weighting in the City Core (28%), followed by Southbank (15%) and Clerkenwell/ Farringdon (14%).

That said, the submarkets that would incur the largest impact on vacancy rates would be Paddington, Canary Wharf and the City Core. The full impact across all submarkets where WeWork holds stock is illustrated in Fig 5.

Fig 6 illustrates the impact WeWork stock would have to existing availability levels across all submarkets in which it holds space.

In the unlikely event that all WeWork stock is returned to the market, there would be an immediate impact to London's office vacancy rate: this would rise to 7.3%, from 5.7% at present. The long run average is 6.7%. While at first glance, this does not appear to

WEWORK HAS A PORTFOLIO OF

3.8m

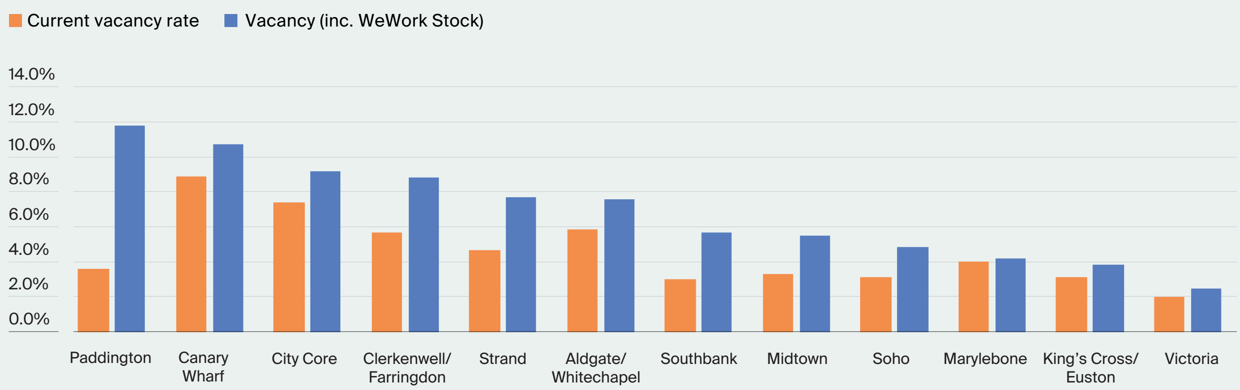
SQ FT

TABLE 2. WEWORK'S IMPACT ON LONDON VACANCY RATES

MARKET	CURRENT VACANCY RATES	VACANCY INCLUDING WEWORK STOCK
West End	4.40%	5.40%
City	5.70%	7.90%
Canary Wharf	8.90%	10.70%
London	**5.70%**	**7.30%**

Source: Knight Frank

Fig 5. London vacancy rate impact
Vacancy rate %



Source: Knight Frank

be a significant change, the impact on market sentiment could be far more harmful, not least because of the ensuing glut of space in many submarkets.

In fact, in the 12 submarkets where WeWork has a presence, all but three (King's Cross/Euston, Soho and Victoria) would take over a year to absorb the ensuing supply release, assuming average levels of take-up. Assuming a deterioration in take-up to levels not seen since the depths of the GFC in 2009, Canary Wharf would be most adversely impacted as illustrated in Table 3.

As social distancing requirements are not expected to ease in the near term and given the current economic backdrop, businesses will be unlikely to readily increase their office footprints to accommodate their workforces, so whilst they reassess their occupational density strategies, the flexible office market may end up seeing a boost in demand.

The flexible office sector is likely to provide a vital bridge in the medium-term and we may also see increased demand for flexible offices in commuter towns, as employees look to capitalise on increased flexible and agile working arrangements whilst realising that their home office set-up is not adequate in the long-term. In parallel, businesses may look to manage headcount costs through the establishment of satellite hubs (near-shoring) to compliment any London headquarters, at least temporarily.

Fig 6. London availability impact

million sq ft

Source: Knight Frank

TABLE 3. IMPACT OF THE RETURN OF WEWORK STOCK TO LONDON'S SUBMARKETS

SUBMARKET	SUPPLY (Q1 2020)	VACANCY RATE	WEWORK STOCK (Q1 2020) (SQ FT)	VACANCY RATE (INC. WEWORK STOCK)	SUPPLY (INCL. WEWORK STOCK) (SQ FT)	AVERAGE ANNUAL TAKE-UP (SQ FT)	TIME TO ABSORB ALL STOCK INCL. WEWORK STOCK (MONTHS)	2009 TAKE-UP RATE (SQ FT)	TIME TO ABSORB ALL STOCK AT 2009* TAKE-UP RATE INCL. WEWORK STOCK (MONTHS)
Paddington	118,286	3.60%	265,983	11.80%	384,269	211,926	21.8	201,147	22.9
Covent Garden	421,868	4.70%	271,518	7.70%	693,386	546,853	15.2	383,408	21.7
King's Cross/Euston	302,277	3.10%	64,891	3.80%	367,168	719,927	6.1	114,177	38.6
Soho	227,501	3.10%	125,469	4.90%	352,970	362,189	11.7	63,550	66.7
Victoria	337,359	2.00%	79,655	2.50%	417,014	619,354	8.1	332,936	15.0
Marylebone	249,664	4.00%	9,782	4.20%	259,446	105,475	29.5	336,994	9.2
West End total	**3,752,965**	**4.40%**	**817,298**	**5.40%**	**4,570,263**	**4,856,767**	**11.3**	**3,250,035**	**16.9**
City Core	4,448,773	7.40%	1,050,168	9.20%	5,498,941	3,935,336	16.8	3,423,043	19.3
Midtown	636,915	3.30%	431,757	5.50%	1,068,672	873,009	14.7	771,654	16.6
Clerkenwell/Farringdon	966,232	5.70%	537,331	8.90%	1,503,563	1,055,947	17.1	773,012	23.3
Aldgate/Whitechapel	470,318	5.90%	135,320	7.60%	605,638	473,340	15.4	432,250	16.8
Southbank	633,694	3.00%	559,462	5.70%	1,193,156	902,003	15.9	401,810	35.6
City total	**7,155,932**	**5.70%**	**2,714,038**	**7.90%**	**9,869,970**	**6,337,633**	**18.7**	**5,815,614**	**20.4**
Canary Wharf total	**1,374,452**	**8.90%**	**282,838**	**10.70%**	**1,657,290**	**814,316**	**24.4**	**230,574**	**86.3**
London total	**13,172,491**	**5.70%**	**3,814,174**	**7.30%**	**16,986,665**	**13,154,063**	**15.5**	**9,388,931**	**21.7**

Source: Knight Frank *chosen to mirror GFC take-up scenario

EMPLOYEE DENSIFICATION IN LONDON

As social distancing beds in and becomes part of the new normal, even in markets emerging on the other side of the COVID-19 pandemic, we investigate how space allocated to every desk based employee in London has evolved over time. The West End emerges as the most generous market, with an almost consistent 160 sq ft apportioned to staff over the last five years, enabling the safe enforcement of social distancing, which requires 135 sq ft of space per person. This is of course reflective of the nature of occupiers in this part of London, which typically tend to have lower occupational densities, such as hedge funds.

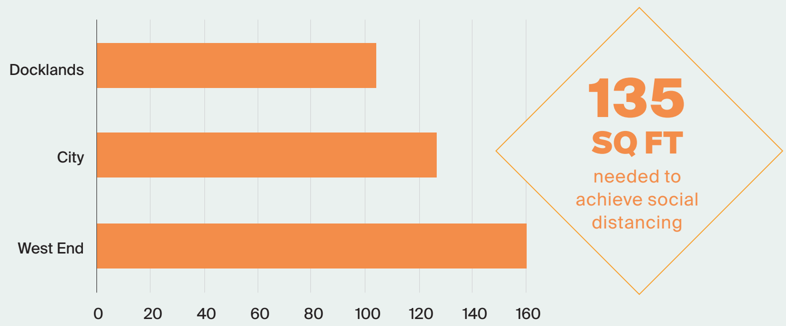
For markets like the City and Docklands, rapid growth in employment over the last five years, has resulted in higher staff densities.

This is in part due to the chronic shortage of space in the market. The City, at 126 sq ft per employee outperforms the Docklands, where the staff density ratio stands at 104 sq ft per person, 23% below the minimum threshold to maintain social distancing. This has been underpinned by densification stemming from banking and back office operations homing in on this submarket.

Notwithstanding any current inertia around expanding office footprints in the current economic climate, occupiers may eventually start to think about longer term ways to house their staff and this could involve leasing additional space. In theory, this would suggest that the City needs another 8.3m sq ft of office space to allow for social distancing, while the Docklands would require 4.9 million sq ft. Factoring in stock due for delivery this year, which is not already spoken for, this would equate to another 6.1m sq ft and 4.4m sq ft, respectively.

Rather than committing to new space to accommodate their workforces, it is likely that businesses will instead turn to the flexible office market as a stop-gap solution due to the short term nature of commitments. Furthermore, the design and layout of offices will need to be revisited as businesses reassess how best to house their staff in safe and secure environments.

Fig 7. Desk based employee density in London in 2019
sq ft



Source: Knight Frank

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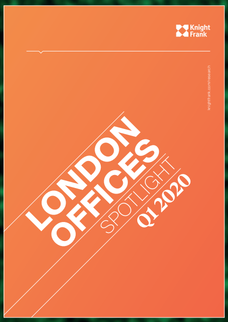

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