Aligning landlords and operators to unlock occupier demand

Introduction

2023 can best be described as a mixed picture. Healthy occupier demand for flex space was set against more moderate expansion in operators' footprints as the focus was firmly on maximising occupancy rather than network growth. Despite this, the broader situation in the flex market is clear. Occupiers want more flex space in their portfolios – whether for short and responsive lease terms, encouraging employees back to amenity-rich spaces or to outsource the management of part of their estate. Yet occupiers are looking for these features in a supply-constrained market, in which operators are struggling to do the right deals to enable them to expand and satisfy the pool of occupier demand.

Increasingly, the deals that operators want to do typically involve management agreements or hybrid leases with landlords. With some notable exceptions, landlords are viewing this issue with caution. This is based on concerns around valuation impacts, operator performance, business continuity in downturns, and the uncertainty of transforming traditional office space to flex space, and hence relatively predictable long-term income streams into variable short-term ones. It's becoming clear that, to provide the product occupiers want to pay for at the scale they would like to purchase it, relative risk sharing needs to be addressed in a way that is acceptable for all parties.

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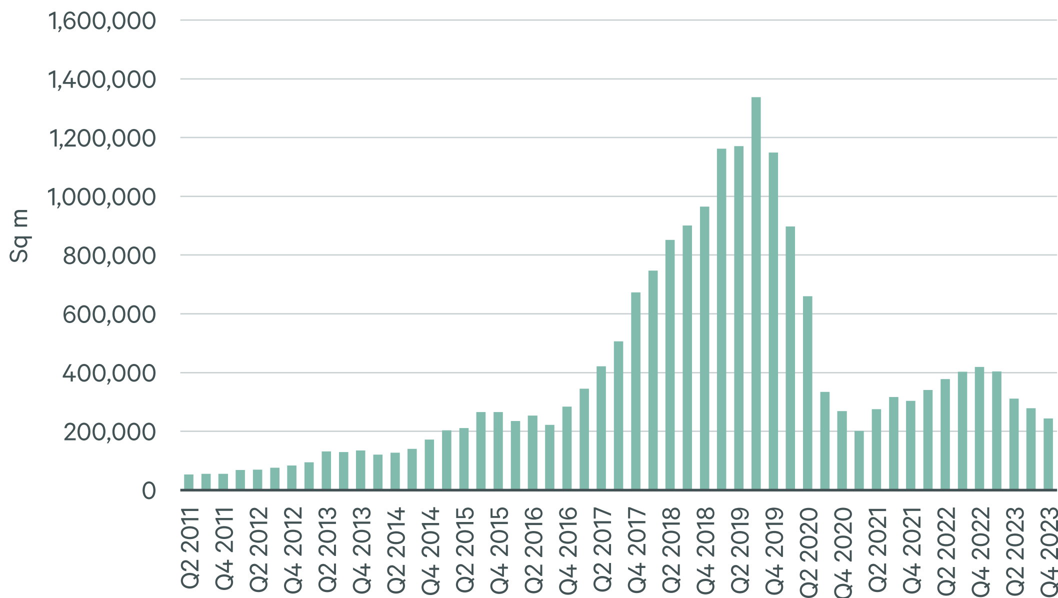
Operator Sentiment

Leasing patterns

The economic headwinds affecting European office markets in 2023 also affected the flex sector. Take-up of traditional office space was down 14% year-on-year in 2023, while flex take-up by third-party operators was down 42% over the same period (See Figure 1). Central & Eastern Europe (+21% YoY) had a better 2023 than Western Europe (-46% YoY), though Western Europe remains by far the larger market. On top of operator run take-up, landlord owned and operated space is becoming an increasingly important feature of the market, and conversion to flex space would not contribute to 'new' take-up, but is bolstering flex stock.

FIGURE 1: Operator take-up of space, Europe, 2011-2023 (Rolling 4Q aggregates)

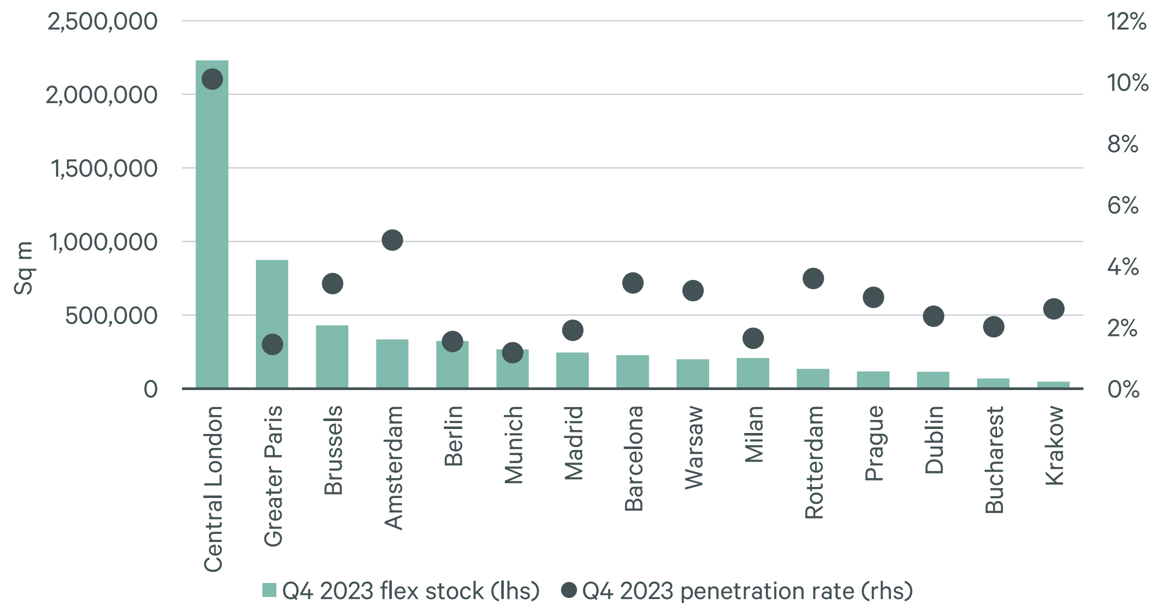


Source: CBRE Research

Market penetration rates leave occupier demand untapped

The amount of flex space across Europe grew by just under 4% in 2023, with around 300,000 sq m of flex stock added to the market. This leaves the flex market steady in relation to the traditional office market at around 2.5% of total European office stock (See Figure 2). This low rate of supply growth in flex space is leaving potential occupiers with severely limited options to execute their space plans and increase the amount of flex they have in their CRE portfolios.

FIGURE 2: Flex stock and penetration rates



Source: CBRE Research

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Occupier Sector

In our 2023 Office Occupier Sentiment Survey, our clients predicted that they would continue to shift the weighting of their real estate portfolios to flexible leasing products (defined by CBRE as less than three-year commitment, typically turnkey fit-out, and managed by a third party).

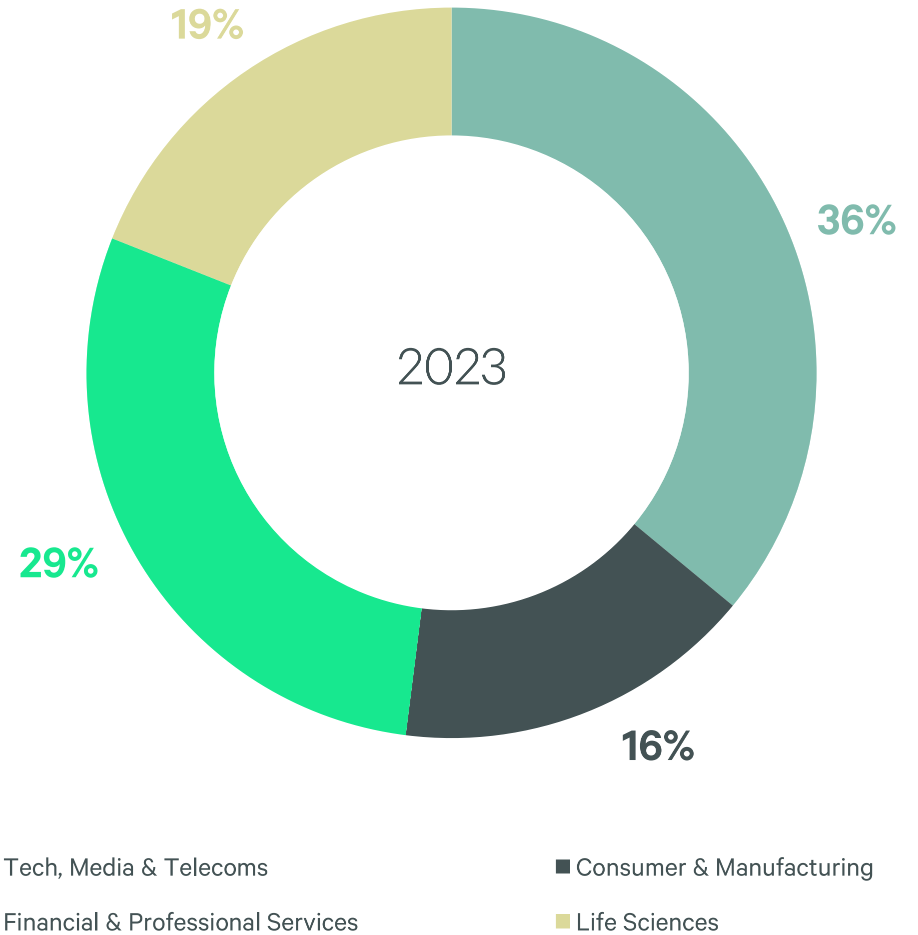
CBRE Flex's European brokerage activity reflected this prediction with total transactions 14% up and desk volumes 22% up compared to 2022. This was against a backdrop of subdued activity in the traditional leasing market, highlighting the dichotomy between the two markets.

The TMT sector remains the most active in driving demand for flex space, albeit less dominant as a proportion of overall deals transacted. It accounted for just over a half of all deals in 2022, dropping to 36% in 2023 (See Figure 3).

This is partly due to the slowdown in the tech sector but also due to an increase in activity in other sectors, most notably financial & professional services which rose from 21% of deals done to 29%. This reflects increased comfort among financial occupiers with the flex concept, as some of the previous operational barriers are overcome.

Continuing the trend of last year, clients are increasingly taking a programmatic approach; with CBRE regularly engaged to plan portfolios of flex space rather than individual deals.

FIGURE 3: Proportion of flex deals transacted by CBRE by sector, 2023



Source: CBRE Flex

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Occupier Sector

In terms of overall desks, TMT still dominates, with 58% of all desks being transacted by this sector (See Figure 5). The disparity between deals and desks is driven by a number of tech clients taking significant enterprise deals with hundreds, and in some cases 1000s, of workstations being taken in one go.

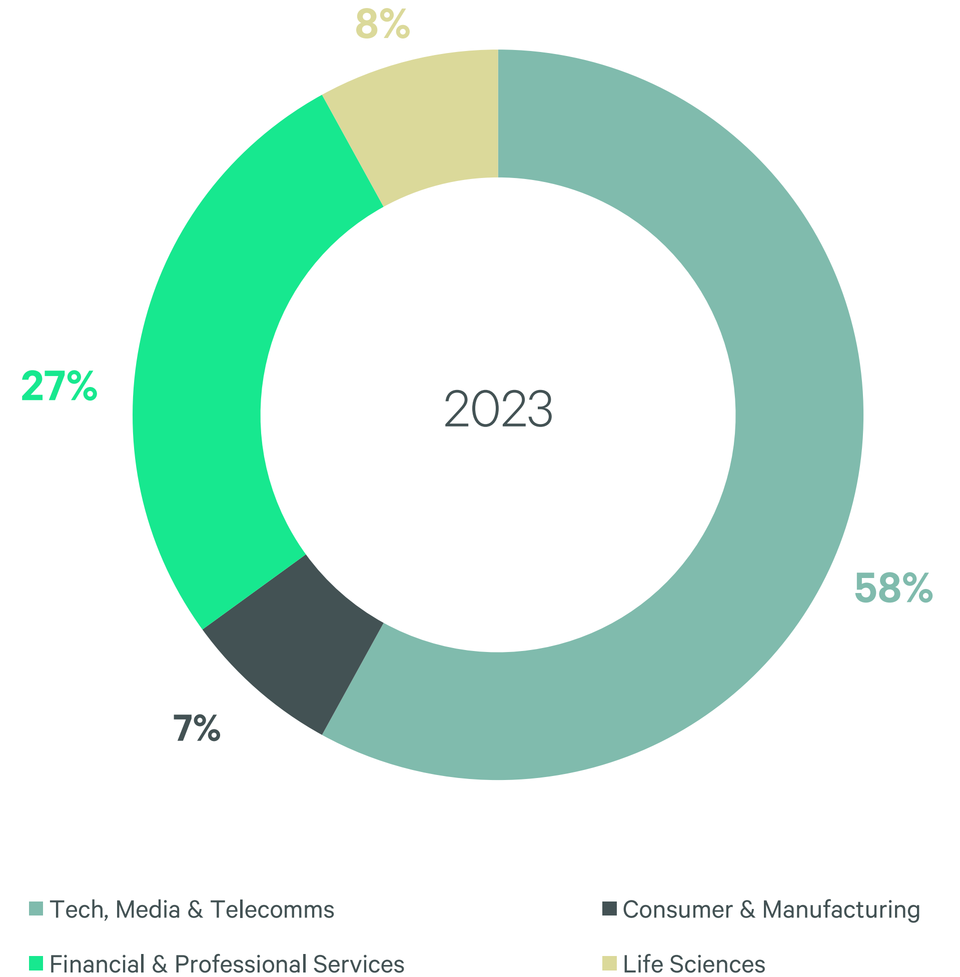
With the exception of a few large financial service sector transactions, TMT still dominates this form of enterprise deal. However, there is increasing interest from all sectors for larger flex space including managed office deals (purpose-acquired and built space for mid to long-term requirements).

FIGURE 4: Deal size by desks, 2023

Sector	Average deal size by sector (desks)
Consumer & Manufacturing	20
Financial & Professional Services	42
Life Sciences & Energy	22
Tech, Media & Telecoms	47

Source: CBRE Flex

FIGURE 5: Proportion of flex desks transacted by CBRE by sector



Source: CBRE Flex

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Management Agreements

The flex market is facing something of a paradox at present. Occupiers indicate that they want more flexibility in their portfolios and operators want to provide this space but, given a desire to reduce balance sheet impact, are also looking to minimise capital outlay. Increasingly this raises the attractiveness of Management Agreements (MAs) or hybrid agreements with rental liability apportioned into part-committed and part turnover-based elements. Some major operators see this model as their only path to growth, keeping long leases off balance sheets and mitigating downturn risk.

Some landlords and investors have existing concerns – namely covenant uncertainty and variable occupancy – about leasing space to flex operators even under conventional leases. These concerns are heightened by the structure of MAs and hybrids; and reinforced by traditional approaches to asset valuation.

Traditional building valuation approaches will mostly ascribe higher values to income streams that are longer and relatively certain than to those that are shorter and variable. Clear evidence on investment transaction pricing for flex space, or on underlying occupancy patterns, might provide a counterweight – but both are currently scarce. As a result, conventional models struggle to evaluate non-committed income (which may deliver superior returns) and amenity. The effect of this may be to understate the potentially value-enhancing characteristics of flex space to investors, and hence inhibit further portfolio growth for operators.

There could be ways forward through this impasse, and data transparency is key to unlocking a solution. As in the hotel industry, greater insight into occupancy and income patterns for operator businesses could help strengthen the argument for flex. In addition, a greater acceptance of the balancing of risk between operators, landlords and occupiers could drive more innovation as shown in the following example.

> Despite investor concerns, a successful partnership has the potential to deliver more stable returns over time, avoiding the ‘new lease’ peak and ‘end of lease’ trough in values often seen in traditional lettings.
>
> Jonathan White
>
> Executive Director, Valuation & Advisory Services, CBRE

FIGURE 6: Pricing levels, selected European markets, Q4 2023*

City	Price per desk per month, range
Amsterdam	€450 – €1200
Barcelona	€325 – €500
Berlin	€600 – €900
Birmingham	£350 – £600
Brussels	€400 – €700
Dublin	€700 – €800
London	£500 – £1500
Madrid	€325 – €500
Milan	€250 – €1000
Munich	€600 – €900
Paris	€500 – €1700
Prague	€300 – €400
Warsaw	€330 – €650

Source: CBRE Flex

*Note: Flex desk pricing is determined by a broad range of factors, including sub-location, building quality, size of requirement, operator desk density, amenity, length of commitment, etc. Therefore, pricing can vary significantly within a market, reflected in large ranges.

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Management Agreement Innovation

Ingenuity House

The landlord of Ingenuity House, an office development near Birmingham Airport, faced a challenge when the tenant on an institutional lease became insolvent in 2021. The space was fitted to their requirements and proved challenging to lease post-lockdown with changing market dynamics.

TSB were looking for space in the market to replace one of their end-of-life corporate offices but wanted a high-quality, turn-key flexible solution to accommodate their workspace requirements. Nothing was available that matched their brief.

A transaction was structured by CBRE Flex between TSB, Orega Serviced Offices, and the landlord to accommodate the requirement. Orega took 30,000 sq ft of space under a 10-year management agreement with the bank partially underwriting the space by taking a dedicated suite of 180 desks and associated space on a four-year term.

By attracting TSB to the Orega space, the landlord has underwritten an element of the management agreement risk while also instructing Orega to activate the amenity space in the building, thereby providing a more attractive offer to other potential tenants. Orega have subsequently pre-agreed terms with a number of other parties prior to opening, indicating the potential of these structures.

> "As the flex office market continues to evolve in the Corporate Real Estate sector, we are thrilled to be able to deliver an intelligent flex office solution for both occupier and Landlord at Ingenuity House. A clever tripartite deal that will activate the amenity offering and kick start the letting campaign for the building. Thanks to CBRE for helping us execute it.
>
> **Ben Hutchen**
> Orega

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Predictions for 2024
Billy Hodges, EMEA Flex Advisory & Brokerage

01

Back to office initiatives will drive flex activity with occupier clients that have cut back on core space, and in some cases now do not have enough space to accommodate short-term peaks in demand.

02

Occupiers will further explore **core-flex initiatives**. CBRE Flex are representing a number of clients exploring these innovative deals that provide future insurance against demand uncertainty. These deals have been talked about for some time but with few executed to date. 2024 will be the year that these start to be delivered meaningfully.

03

Managed office momentum – Occupiers seeking capital-light solutions will partner with landlords or operators to provide managed turn-key solutions, bridging the gap between fully flexible serviced offices and long-term lease commitments, ideal for mid-sized, mid-term requirements.

04

All focus on WeWork – the Chapter 11 process should complete with the outcome of the initial submission decided by Q2. If successful, the new WeWork will be smaller and more modest in ambition but still offering a global network and brand that will continue to appeal to many multi-national and local occupiers.

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