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RETHINKING WORKSPACE

UNFIT TO FLEX
HOW ALTERNATIVE OFFICE MODELS CAN DRIVE CASHFLOW

Publicly listed REITs with major office holdings are largely showing valuations below pre-pandemic levels; several showed an average of a 50% decline in share price in less than 4 years. With systemic changes to office use widely accepted as the norm, the real estate market is facing major challenges with current yields no longer offering safe and stable returns.

However, there are substantial rewards for landlords that integrate flexible space into their portfolio, including increased cashflow, positive impact on valuation and placemaking benefits. While each asset is unique, a serviced-based flexible workspace could add up to 30% returns after CapEx compared to traditional leasing over a 10-year period.

This eBook compares these two models to assess both the benefits and the risks based on real-world flexible workspace market data and revenue trends.

WHAT IS FLEXIBLE OFFICE?

A flexible office, also referred to as a flex space or flexible workspace, is an all-encompassing term for several types of workspaces including coworking spaces, hot desks, managed offices, serviced offices, and executive suites.

For this article, we are defining flexible workspace as an enclosed, multi-customer area within an asset that provides both private office and coworking facilities to occupiers including fully furnished offices, internet, meeting rooms, break-out areas, reception services, facility management, and community events all under a single monthly contract. We have assumed all contracts are under three years with an average contract length of between 8 and 12 months, and no single occupier being larger than 100 people. Such a space is the most common form of flexible space in today's market but is by no means the only flexible office solution, with the likes of Managed office spaces (a turn-key option catering to a single occupier often with bespoke fit-out requirements) seeing high growth.

WAKING UP TO A NEW REALITY

Office utilisation across global cities is stubbornly refusing to return to pre-pandemic levels. Of possibly greater importance is the realisation that pre-pandemic utilisation levels were no more than 70% (1). This combined with high vacancy rates in many major cities forecast to rise in the near future has created a real estate market that could best be described as "toxic" from an investor and lender standpoint.

Despite this, offices remain highly relevant to employers, employees, and their wider economic impact. Return-to-office policies continue to move towards increased in-person attendance (2), and employees are now reporting higher productivity levels in offices versus working from home (3). The relevance of the office is no longer being debated; instead, it is the volume, location, and type of space that raises questions for investors

REIT	Share price change 3rd January 2020 vs 3rd December 2023
BXP	-42.6%
DEA	-53.7%
BLND	-47.8%
LAND	-36%

The perceived value of office assets in today's market is probably best determined by the performance of publicly traded portfolios, of which the performance is a cause for concern. With the cost of new debt ranging from 6% to 7.25% and traditional agent research referencing office yields in London remaining around 5.5% for The City and 4.0% in the West End, traditional returns and models no longer stack up in the face of new demand trends and revised cost of capital. Why would any new investor accept these yields and take equity risk when you can generate greater returns through risk-free gilts or treasuries?

The challenge for asset owners, then, is creating a business model that allows investment into an asset that remains relevant for the market whilst generating returns that meet current financial market conditions.

CASH FLOW IS CRITICAL & REESTABLISHES CREDIBILITY

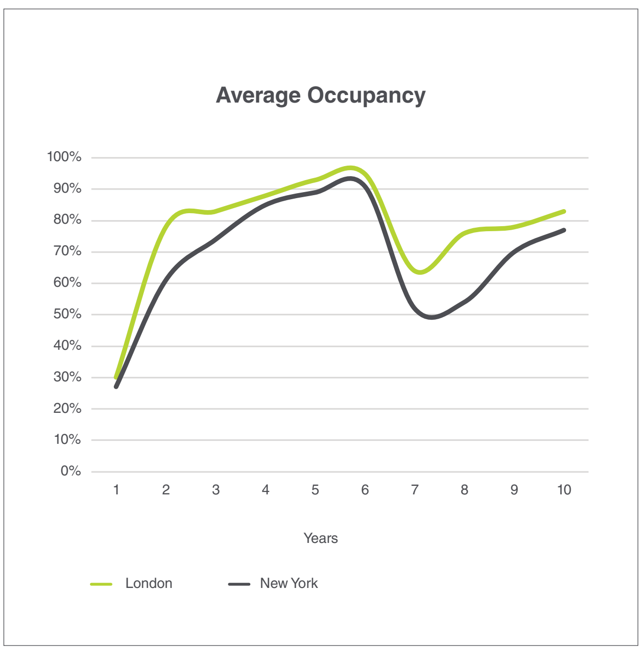
There is no guaranteed solution for this problem, but we believe that the additional operating income generated by well-run flexible spaces can mitigate some of the challenges that assets face when it comes to valuations and loan-to-debt ratios. Through the inclusion of operating services and flexible models, void periods can be reduced and additional revenue generated as shown by our analyses. Once true market conditions are factored in, asking rents are often detached from reality, a factor that investors are all too aware of. This has created a credibility challenge that cash flow generating models simply don't have and therefore can help rebuild confidence in a waning market.

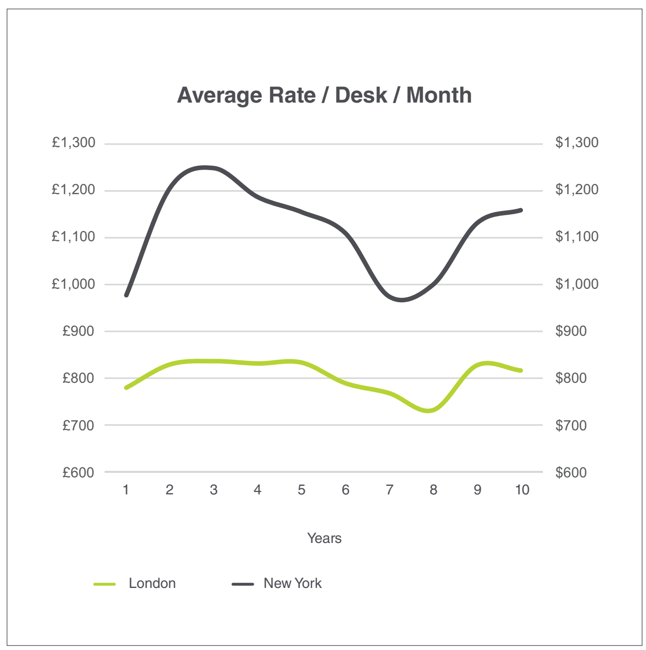
Results from the likes of GPE and HLCL show capital values far stronger than their share price performance, an indication of investor trust. Their implied yields of 2.4% and 3.8%, respectively, tell a different story and likely remain too low to be attractive to investors at less than 4%.

Critically, transparency is key. We explored two assets in London and New York using commercial real estate data from CoStar and real-time flexible workspace cost and revenue models to explore the different approaches that exist in these markets.

Given the greater levels of agility within the flexible space market, it is important to model both the upturns and downturns the market can experience. Because of the agility that flexible spaces offer, periods of economic hardship may have a faster impact on these models. Conversely, they tend to bounce back more quickly than the traditional office sector given the rising preference for agile solutions.

Our data indicates that in a market downturn, both pricing and occupancy rates are likely to decline within a flexible space as existing occupiers exit and competition for new occupiers increases. But, as we saw during the Covid-19 pandemic, pricing and occupancy rates rebounded quickly, and the declines, on average, were not as severe as many industry commentators would have expected.





Data Source: CoworkIntel

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WHAT HAVE WE LEARNT?

The first point to consider is that every space, brand, and office provider reacts to market challenges differently. Different spaces target different customer groups, operate different business models, and engage differently with their customers - all factors that can impact the "stickiness" of occupiers in tougher markets. Given the sharp declines followed by relatively rapid recovery, all of these factors can help bridge what in reality can be quite a small gap, turning a space from high risk to sustainable.

Some of the important factors include:

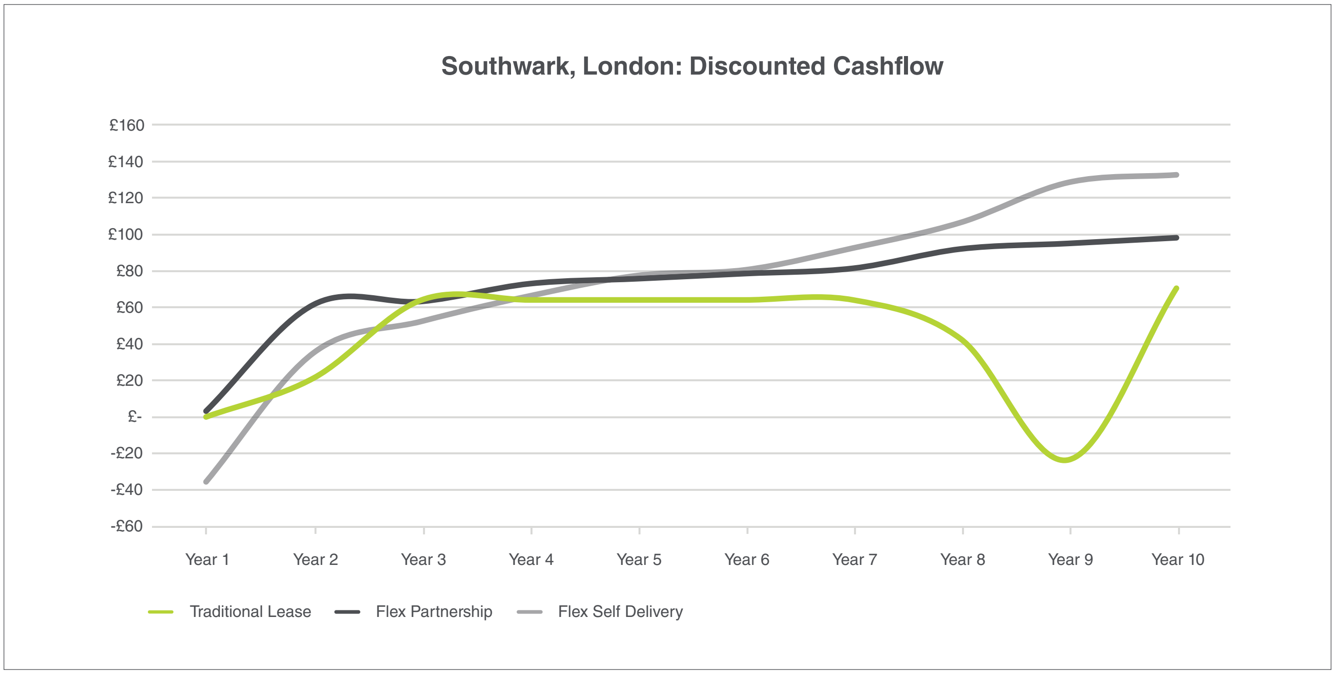
1	Percentage of private offices	2	Average occupier size
3	Average contract length	4	Office community and service level
5	Size of space	6	Brand perception with customers

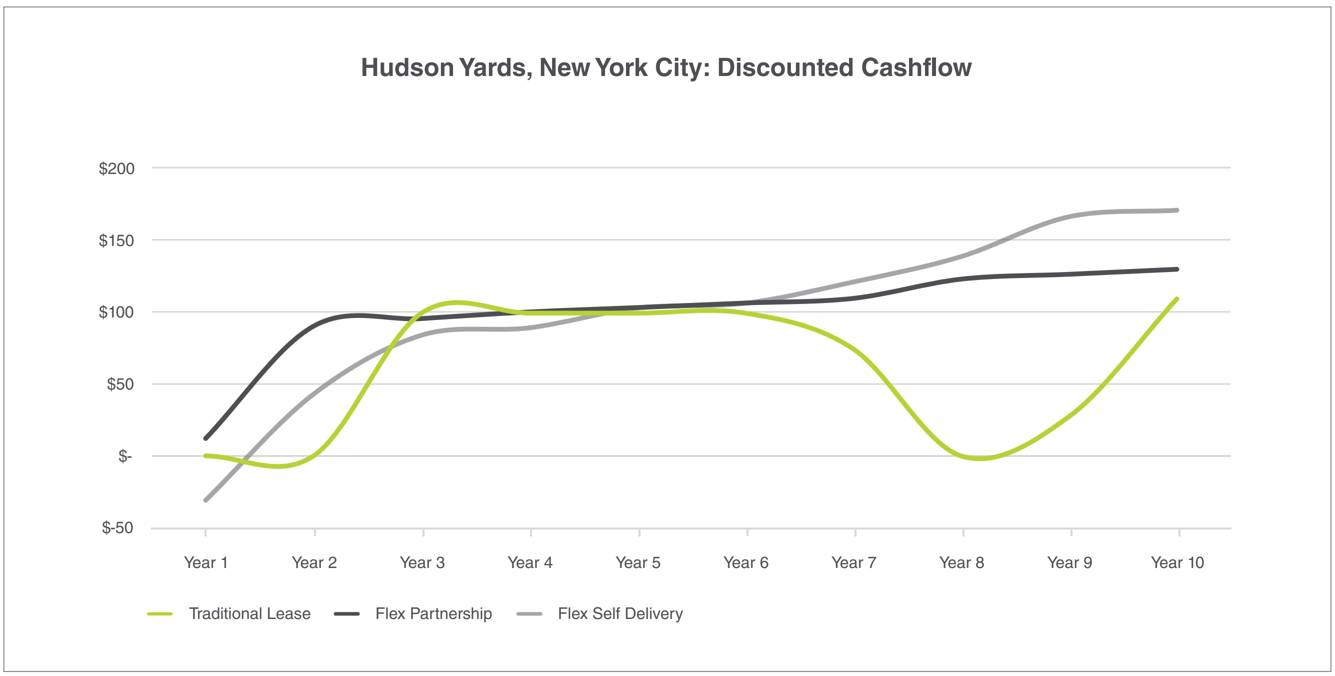
In both cases, headline rents, as published in the market, are higher than the cash flow models that flexible space delivers. But when factoring in current market conditions (i.e. discounted cashflow) for each asset, a different story emerges. In both London and New York, when assessing current market conditions, flexible workspace solutions, either self-delivered or in partnership with a third party, deliver EBITDA figures above traditional office leasing. In our London example, an asset owner can increase cashflow by up to 71% when assuming an average stable occupancy of 82%, a figure mirrored in our data, even taking into account market challenges such as Covid. In the New York example, our model shows potential cashflow increases of up to 64%, a lower percentage increase compared to the UK model due to lower stable occupancy levels across the city at just 74% and a higher degree of instability across the flexible workspace market.

Southwark, London Grade A Cashflow Models						
	Traditional Lease (current)		Flex Self Delivery		Flex Partnership	
	10 Year Average					
Size of Asset (sq. ft.)		43,300		43,300		43,300
Revenues	£	21,612,834	£	59,944,642	£	70,102,815
OpEx (including property costs) - *paid by Operating Party*	£	–	£	19,783,064	£	17,852,746
3rd Party Platform Fee	£	–	£	–	£	56,08,225
Profit Share to 3rd Party - *subject to performance*	£	–	£	–	£	78,27,764
Landlord Revenue	£	21,612,834	£	40,161,578	£	38,814,079
Landlord Revenue / sq. ft. (annual)	£	50	£	93	£	90
Capital Returns						
TI/Discount/CapEx	£	2,915,606	£	8,253,324	£	7,503,022
Average Return after CapEx (annual)	£	43	£	74	£	72

Hudson Yards, New York City, Grade A Cashflow Models						
	Traditional Lease (current)		Flex Self Delivery		Flex Partnership	
	10 Year Average					
Size of Asset (sq. ft.)		44,003		44,003		44,003
Revenues	$	31,256,431	$	77,643,270	$	91,546,470
OpEx - *paid by Operating Party*	$	–	$	22,204,448	$	18,625,820
3rd Party Platform Fee	$	–	$	–	$	7,323,718
Profit Share to 3rd Party - *subject to performance*	$	–	$	–	$	10,943,108
Landlord Revenue	$	31,256,431	$	55,438,822	$	54,653,824
Landlord Revenue / sq. ft. (annual)	$	71	$	126	$	124
Capital Returns						
TI/Discount/CapEx	$	4,574,112	$	11,969,531	$	10,881,392
Average Return after CapEx (annual)	$	61	$	99	$	99

Assumptions and data used in the above models can be found in the Appendix. Included in the Appendix is an explanation why variations in revenue and cost exist between Self Delivery and Delivery with a partner already established in the flexible workspace market.





Ultimately, the devil is in the detail. Every owner's risk profile is different, and their cost of capital will also vary. We therefore cannot comment on the impact on asset valuation but instead aim to show a different solution that can combat market perception and reestablish credibility via increased cash flow at an asset level.

One clear thing is that in many markets, a well-run flexible workspace can generate additional cash flow over traditional rental incomes. The question, therefore, becomes, what delivery model best aligns with an asset or fund profile.

FLEXIBLE WORKSPACE DELIVERY MODELS TO MEET DIFFERENT RISK PROFILES.

When it comes to fitting out and operating flexible space, there are a variety of options. We have modelled two as examples, and there are pros and cons to each. The right solution is dependent on the investor's risk profile, the asset location, and the owner's underlying motives in creating flexible space within an asset

Self-Delivery		Partnership	
Strength	**Weakness**	**Strength**	**Weakness**
Greatest cashflow generation potential to landlord	Highest risk/ investment	Experience gained from established partners leads to quicker sales cycles	In strong market conditions, less cashflow generated for the landlord
Full control of design and layout	Lack of market experience leading to long sales cycles	Lower investment is needed, and no operational team needs to be created	Lack of brand and design control
Full control of the customer profile	Lack of established brand and sales team leading to lower desk rates	Established supply chains allow time to launch be reduced	Potential for customer competition within a wider portfolio
Opportunity to develop a brand	Lack of centralised infrastructure leading to higher OPEX costs	Lower marketing expenditure thanks to networks and economies of scale	

In both models, there is a greater upside from a cash flow and risk perspective to creating a partnership, but this option is not always available. Instead, other solutions such as management agreements or white-labelled solutions can help maximise cash flow, ultimately limiting exposure while still benefiting from market experience. Every asset is different, but we recommend using market data to fully assess the risks and rewards at an asset level during every stage of the decision-making process.

MAKE DATA-DRIVEN DECISIONS

Flexible space is not a silver bullet to solve the challenges of every asset. Instead, it offers a route to drive additional revenue streams, mitigate void periods, and encourage new customer engagement. But it will not work for every asset. Asset location, size, and floor plate layout alongside current market conditions all need to be considered to make an informed decision. If indicators are strong, only then should routes of delivery be truly explored.

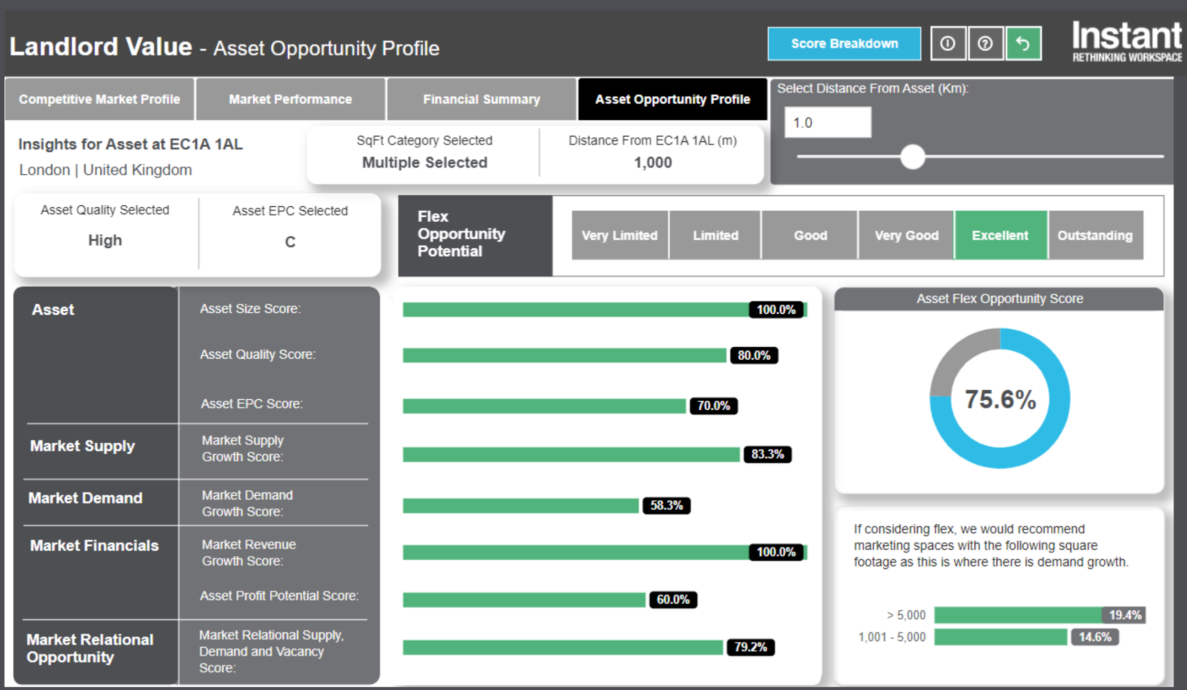
Data within the flexible workspace market has progressed significantly in the last five years, with tools now in place to enable informed decisions at an asset or portfolio level before any CAPEX is invested.

In conclusion, our models show that while each asset is unique, a serviced-based flexible workspace could **add up to 30% on returns after CapEx compared to market asking rates** over a 10-year leasing period. Service-based workspace achieves this through several features. These include:

1. Void period mitigation
2. Reduced lease discounting
3. Higher rate per square foot on primary rates
4. Unlocking of secondary revenue streams
5. Increased space efficiencies (communal use of services)

Partnerships with existing flexible workspace providers or those with proven experience in the industry offer the strongest potential for return thanks to operational experience, economies of scale, established sales channels, and brand recognition. But even self-delivery methods offer a viable option to generate higher cash flows.

In our experience, not every asset is suitable for flexible space, but the additional premiums that can be generated from an owner with a mid- to long- term viewpoint has the potential to turn many assets that are simply unfit in today's market into viable and cashflow generating assets with long term potential.



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PARTNER WITH THE INSTANT GROUP

The Instant Group is the largest global marketplace for flexible workspace. We help landlords, asset owners and investors to fill space and invest wisely in flexible workspace. We do this by driving **tenant demand** to reduce vacancies, providing **data and insights** for smart flex investments, and offering a range of **flex space products and services** to generate higher revenues.

OUR PRODUCTS AND SERVICES

OPERATOR PROCUREMENT

Procure and engage the best flex partner.

FLEX ADVISORY

Comprehensive advisory for strategic flex implementation.

FLEX POTENTIAL

In-depth evaluation of flex viability at an asset and portfolio level.

FIT FOR FLEX

Assess the viability of flex space across an asset.

MANAGED OFFICE

A turnkey solution to meet the demand profile of an asset or portfolio.

DISCOVER MORE

Partnerships@theinstantgroup.com

APPENDIX:

Southwark example:

Average lease rate = £60.20 / sq ft (4)
Average months vacant = 11.9 months (4)
Average vacancy rate = 25.6% (4)
Average lease length = 6.4yrs (5)
Flexible rents (6)
Flexible CAPEX (6)
Flexible OPEX (6)

Hudson Yard example:

Average lease rate = $103.61 / sq ft (4)
Average months vacant = 13 months (4)
Average vacancy rate = 24.9% (4)
Average lease length – 5.25 years (7)
Flexible rents (6)
Flexible CAPEX (6)
Flexible OPEX (6)

Variations between flexible workspace delivery models.

Within our models, there is a variance in both the revenues and costs associated with each flexible workspace delivery model.

Our analysis uncovered the following factors that impact each of the following areas.

Revenue:
- Established sales teams with knowledge of flexible customer behaviours.
- The ability for sales teams to cross sell from existing spaces within a portfolio.
- An established brand generating greater leads and higher conversion rates.
- Relationships with the brokerage channel delivering greater external lead flow.

Costs:
- An established supply chain allowing economies of scale and faster delivery times.
- Centralised back office and support functions allowing for lower staff costs per location.
- Experience with occupier ramp-up times and required staffing levels reducing onsite staff costs.

Rethinking Workspace.

About The Instant Group

The Instant Group is the world's largest marketplace for flexible workspace. We exist to make work smarter for everyone: employees, businesses and the planet. We provide over 250,000 organisations globally with everything they need to work smarter, whether that be office space, coworking memberships, virtual offices or meeting rooms. As well as delivering the latest data and insights on the flex market or offering expert consulting services on portfolio strategy, procurement and sustainability.

Our clients include Prudential, Booking.com, Shell, GSK and Hines, working with our 600+ experts across offices including London, Paris, New York, Hong Kong, Singapore and Sydney.

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