The Rapid Growth of the Flexible Office

LANDLORD-TENANT RELATIONSHIPS ARE CHANGING, RISK SHARING IS RISING

SECOND QUARTER, 2019
Flexible office arrangements are a growing trend in office markets around the world. Office owners have not historically embraced innovation preferring the stability of the traditional office leasing model over the income generation potential of alternative leasing models.

Relatively new entrants to the flexible office market like WeWork, and others, emerged first as tenants of office owners and later as operators and partners with owners. As a group, they are disrupting the status quo of office markets and are becoming intermediaries between building owners and workspace users. Much has already been written about the flexible office movement; but very few of these reports describe the investor’s perspective. That is our focus here.

To maintain asset values, owners will need to respond to this new competition for office occupants. In some cases, owners will need to embrace less certain income streams in the flexible office market for the potential of greater income—either through higher rental rates, risk-sharing leases that optimize net versus gross income, or higher long-term average occupancy rates from positive spillover effects. In other cases, office owners may avoid the complexities of flexible office tenancy and hold out for lower-risk traditional office leases, even if the net operating income is slightly lower because greater income certainty could do more to drive a higher asset value. Finding the right balance between stability and income that enhances, rather than diminishes, office asset values should guide how investors react to flexible office trends.

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<tr>
<th>Flexible Office Economic Model</th>
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| **ASSET VALUE**  
Cash Flows divided by Discount Rate |
| **CASH FLOW**  
A function of rental level, occupancy level, capital expenditure, expenses |
| **DISCOUNT RATE**  
A function of certainty of future cash flows |

<table>
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<tr>
<th>FLEXIBLE OFFICE IMPACTS</th>
<th>CASH FLOW</th>
<th>DISCOUNT RATE</th>
<th>ASSET VALUE</th>
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<td>Shorter Leases</td>
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<td>Lower Tenant Credit</td>
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1 See tables on p.12 for a list of leading global flexible office operators and some of the largest single market operators.
Flexible office growth is driven by a growing business need to be nimble, attract talent, and adapt to changing work styles. Businesses are looking for flexible lease terms, space sizes, and space configurations. However, there are implementation challenges, and the long-term economics of flexible offices are not well-established. The trade-off of cash flow certainty and income levels will drive office market evolution. We expect additional segmentation of the flexible office market and greater direct owner involvement in the flexible office market. Office owners who ignore the impact of flexible arrangements and their ripple effects on the broader office market are making a mistake. Similarly, those making long-term commitments without careful evaluation of the economic trade-offs do so at their own peril. Owners should be discerning as to where and when to engage with flexible office tenants, based on the asset and market context, as well as the risk-return strategy. The length of the holding period and exit strategy should also be a factor when determining the extent of engagement.

In this note, we evaluate the flexible office trade-off between income and stability. We describe the drivers of flexible office growth, segmentations emerging within the flexible office market, the impact it is having on office investment, our expectations for the evolution of office space, and conclude with strategy recommendations for office owners.

What is Flexible Office?

A variety of terms are used to describe the provision of office space outside of the historic market norms (which vary around the world). The most commonly used term is “coworking,” but this implies different firms occupying a shared space, and in more and more cases, this is not accurate. Several brokerage firms have adopted the term “flexible office,” which sometimes applies to how firms use office space within the confines of a traditional lease (e.g., movable furniture or walls). Taking an owner’s point of view, we focus on how the economic structure and lease terms of work spaces are changing. In this paper, we use both “flexible office” and “coworking” to refer to these changes and sometimes disintermediation in the economic relationship between the building owner and the occupant of the office space.

Drivers of Growth

Our analysis suggests that flexible office space demand is not a fad, but is supported by structural economic, behavioral, financial, and government shifts.

Drivers of Growth

Our analysis suggests that flexible office space demand is not a fad, but is supported by structural economic, behavioral, financial, and government shifts. Looking across these four drivers we see a strong case that demand for Flexible Office will continue to grow and it will take share from traditional tenant-owner lease arrangements.

Economic Drivers

Growth of Small Firms: Small- and medium-sized businesses typically account for 60%-80% of jobs within an economy. Small business creation has increased in the last 10-15 years, far

The rising demand for coworking office space is an example of how many parts of the real estate market are migrating to a model that provides a more complete experience to tenants than just physical space. In the highest performing sectors of the economy, firms are no longer satisfied with space in a generic building. Instead, they are seeking amenities (in the neighborhood and in the building), services (concierge, tech support, food preparation, wellness programs, events), and community (meeting other tenants, forming business or personal connections, self-image associated with being around like-minded people).

Building owners who address these demands can create value from more loyal and profitable tenants (higher cash flows). Of course, there are costs associated with expanding services. The economics of providing these Amenities, Services, and Community-building activities (A+S+C) is not yet proven, and we expect the provision of these services will often be out-sourced. Flexible offices or coworking spaces represent a blended space/service model for work environments; examples can also be found in other property sectors, including rental apartments, shopping centers, and healthcare facilities. There are also emerging service operators, such as JLL’s Curae (and numerous other offerings by other property managers), which will provide a package of services to all tenants in a building.

Owners who can capitalize on these trends in a cost-effective manner should generate a higher income stream and outperform market trends. Those who continue using an old strategy of just providing space will lag the overall market. Others will over-reach and pursue business plans that do not make long-term economic sense. This economic challenge applies to both coworking operators and landlords. From an investor’s perspective, owners need to underwrite coworking tenants to ensure their business models are economically sustainable, and that their presence in a building is accretive to the value of the building.
The Rapid Growth of the Flexible Office

surpassing the growth of larger firms. The forecasts for major economies are for this trend to accelerate over the next decade. Technology is a major catalyst of this growth, reducing barriers to market entry and allowing small businesses access to a wide range of markets. In-line with the structure of major economies, 60%-80% of demand for flexible offices comes from small occupiers. Small, fast-growing firms are also less likely to want to commit to a 5-year lease for a fixed amount of space. Their space needs could swing up and down, and many are willing to pay extra for this flexibility.

Growth of Key Industries: While there is a lack of systematic data on the users of flexible offices, we know from a City of London survey\(^2\) that the finance, business services, and information and communications sectors are the key occupiers of flexible office space in London. Office-based employment projections indicate that these sectors will grow twice as fast as other sectors, as we see continued growth in knowledge-based sectors. This growth will support the trends we see in flexible offices. Project-based work in other industries is also growing, where teams come together and then dissolve when the project is done.

Our analysis of the media/entertainment industry in Los Angeles suggests that creative teams working on new content also prefer the flexible office model.

Financial Drivers

Cost Efficient for Certain Users: Cost may drive small businesses to occupy flexible office space rather than investing in the build-out and operation of a stand-alone office. For start-ups, cash flow may prohibit office renovation when there are other more important capital necessities. And in situations where the long-term outlook is uncertain, flexible offices allow occupiers to avoid being locked into longer-term leases that are unlikely to meet their future needs.

Changing Accounting Standards: New international accounting standards that go into effect in 2019 will make flexible leases more desirable as they allow the removal of leases shorter than 12 months from balance sheets. This will reduce liabilities and enhance the financial profile of those looking to raise capital from the markets.

Behavior Drivers

Changing Business Practices: Technology is increasing firms' geographical reach, thus their client base is more likely to be geographically diverse. While it is costly to have permanent offices in multiple locations, membership-based flexible office space allows even small companies to have a "home base" close to clients.

Changing Employee Needs: Younger employees are increasingly footloose, and frequently demand work arrangements that are flexible and accommodating of their varied lifestyles. Businesses that need access to these workers need to offer a range of work venues that appeal to their work-life balance. Flexible offices allow smaller firms to meet this need in various locations.

Cost may drive small businesses to occupy flexible office space rather than investing in the build-out and operation of a stand-alone office.

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2 "Serviced offices: A new asset class" A 2016 publication by Capital Economics
Government Drivers

Government intervention, particularly in the Asia Pacific region, has been a catalyst for the growth of flexible offices. In Australia and Singapore, the public sector is developing or supporting the construction of flexible space. In Japan, the government has been pushing “work-style reform” to encourage companies to explore more flexible ways of working. Both approaches are driven by concerns around productivity, work-life balance, and improving the participation of women. In several countries, business incubators or accelerators have been subsidized by local governments that are eager to attract technology firms to their cities.

Data Availability and Transparency in the Coworking Market

One of the challenges to evaluating the impact of flexible offices on the broader office market is the lack of good data. The available data are mainly focused on leasing by coworking operators (e.g., 4% of office space in London and 3.6% of office space in New York City is currently leased by coworking operators). However, these estimates do not include the space offered by landlords or through management agreements.

Another consideration is that just because space is leased by a flexible office provider does not mean it is occupied by tenants. Coworking firms act as intermediaries who transfer space from the direct lease market to the flexible office market. A lot of effort is still needed to procure tenants. There is little information available on flexible office occupancy or capacity utilization, let alone the associated rental rates, which compounds the challenge of understanding the economics of supply and demand.

Typically, analysis of the flexible space market is based on assumptions and anecdotes. Brokerage research shows that coworking operators are leasing large amounts of space, leading to explosive growth in the supply of coworking space. In real estate markets, a growth in supply typically leads to concerns about future occupancy and the sustainability of rent levels. The fact that coworking offerings are increasing so quickly could mean the economics are very attractive to providers and eventually the market will reach a level where there will be lower marginal rent levels charged to members as more supply of coworking options are introduced into the market. An alternative view is that the economics for flexible offices are not strong but because so much capital is flowing to coworking companies, flexible office providers are deploying capital with limited consideration of the long-term economics. Individual coworking firm valuations are predicated on rapid growth, so they have every incentive to try to establish a “first mover advantage.” But, can they all succeed at once? Many may be hoping their financials will improve when they reach a certain scale. The question is whether this time frame aligns with the time horizon of a real estate investor.

Another element of traditional market analysis that can be applied to the coworking space is the signal of increasing tenant incentives. Some operators are paying brokers increasing commissions to put tenants into coworking spaces. “Buying” tenants can be an indication of landlord weakness, not strength and is a potential warning sign regarding the fundamentals in the coworking space. Neither signal is clear, but in the absence of solid data on the fundamentals, investors may rely on these weak signals to inform decisions. The lack of data is a risk and an opportunity. For investors, it suggests careful due diligence and possibly higher returns are required when investing in buildings where the economics of the coworking tenants are difficult to figure out.

Flexible Office: Operating Models

The growth of flexible office demand, combined with the still uncertain economics of the space is leading landlords to consider a variety of ways to participate in the market. These approaches broadly fit into three models: Leasing, Partnership/Management, and Platform.

Leasing: This is currently the predominant model, where the landlord leases space to a flexible space/coworking operator. Large office spaces are leased to operators at market rents (or higher depending on landlord contributions and credit) for long terms (typically 5-15 years depending on the country). These flexible office operators in turn sublet space to members or companies, using a variety of economic arrangements. In this model, the landlord does not take on additional operating risks, but there is the assumption the flexible office operator will have a sustainable business and make scheduled lease payments. In a standard pro forma model, this does not increase the risk profile of an asset, but owners should ask about the sustainability of the flexible office cash flow if the operator’s business does not perform as expected. A revenue or profit-sharing lease, where the space is leased for a discounted base rent and payments to the landlord increase if the operation exceeds pre-defined benchmarks, is an emerging variant to this structure. This is similar to some retail leases, which are known as percentage rent leases or turnover leases.

Partnership/Management: In this model, the flexible space operator does not sign a lease but is contracted to manage the space on behalf of the building owner. This is like the management agreements used in hotel operations. The operator assumes responsibility for managing the flexible office operation and the revenues and expenses are shared between the operator and the building owner. This approach limits the owner’s operating risk as they are leveraging the strengths of the operator’s experience and network. However, there is more financial risk as the landlord is liable for the fit-out cost of the flexible office component. Operators typically are paid a percentage of the revenue of the coworking operation, as well as an incentive fee based on a percentage of the gross operating profit. There is no industry standard for implementation of this arrangement, leading to significant negotiation when structuring these agreements. Determining a fair split that keeps the operator engaged and allows the location to compete with the other locations in the operator’s system is a challenge.

Platform: In this model, the landlord engages directly with the occupier community and internally manages the flexible office operation. Having a large portfolio provides support for the business platform and allows the office owner to work with tenants in traditional and flexible offices to expand or contract their footprint efficiently. The variability in income plus the requirement to accept operational risk has led to these assets attracting higher capitalization rates.

PERSPECTIVES FROM LASALLE’S GLOBAL ASSET AND FUND MANAGERS

“Adding coworking space can make our asset more competitive”
Amy Xu, Asset Manager, US/Los Angeles

“I am skeptical of how viable flexible office becomes in an economic downturn”
Ty Spearing, Asset Manager, US/Chicago

“There is value in leasing a small part of a building to flexible office, but I am concerned how a large flexible office operator might compete for tenants on the direct side”

“Increasing brokerage commissions paid by Flexible Office is just the natural evolution of increasing scale for coworking operators. As they have more space to fill they need more people to secure tenants to fill it”
Simon Howard, Head of Asset Management, Australia

“[Flexible Office] can improve the building offering to other tenants”
Lauren Robertson, Asset Manager, UK/London

“[Flexible Office] can improve the building offering to other tenants”

“[Flexible Office operators] default then certain aspects of the fit out are fairly re-usable”

“Some operators are also offering front of house to buildings... The hotel concierge experience on a building entry is gold-dust”
Paul Till, Head of National Business Space, Asset Management, UK/London

“The key concern is where operator’s cash flow turns negative in a downturn”
Kaity Morioka, Fund Management, Japan

“The rise of the flexible office is a reflection of and response to the way the world has changed...Landlords shouldn’t perceive this as a threat, but rather an opportunity”

“Flex is here to stay and on a big scheme, part of the amenity of a building”
Each of these three operating models has a different mix of upside opportunities on income and risk associated with the cash flows. The risk and return associated with each model is depicted in the figure entitled “Distribution of Outcomes from Flexible Space is Wider Than a Traditional Lease.” In a traditional office lease, there is a high level of certainty around a specific outcome (the landlord receives the contractual lease amount). This lowers the asset risk and boosts the valuation of the property. For other models, there is more uncertainty around the cash flow from the space, which is both a potential positive and negative. Even if the average outcome is the same, the wider distribution of outcomes is viewed as risk, and this lack of certainty should be reflected in lower property valuations.

Segmentation of Flexible Offices from a User’s Perspective

When engaging in the flexible office market, an owner should consider the style and amount of space, as well as the economic arrangement. The owner needs to evaluate how those choices are a fit for the asset, location, and market, along with how it impacts the trade-off between income stability and income growth. Below are four model examples for flexible office occupation and how they have evolved over time:

Serviced Offices: This is the legacy flexible office model most widely implemented by firms like Regus and Premier Business Centers. Office suites of varying sizes can be leased on short-term tenancies; the space is practical but unexciting. The benefit for occupants is their ability to have their workforce in one place, with the added convenience of access to basic refreshments, Wi-Fi, printers, meeting spaces, etc. This option generally appeals to more traditional office-using industries. This space may also be a temporary location as firms establish operations and transition into a traditional leased space elsewhere. The ratio of private space to communal space is usually much higher in the serviced office model compared to coworking environments.

Coworking: This model, pioneered by WeWork, has seen significant growth over the last few years. Coworking offices cater to millennials and technology start-ups who desire a more engaging and flexible working environment. By fostering a community among tenants, coworking space is tailored towards smaller enterprises. A variety of economic arrangements are possible, including memberships allowing access to a variety of locations and day-to-day desk rentals. Space is designed to be collaborative (within businesses as well as inter-business), with more open floor plan designed for high density. However, the lack of privacy and often loud environment is not suitable for many types of business. The space is almost always offered on a short-term basis, but may have the potential to be customized into a long-term space if needed.
Hybrid: Hybrid operations bring together the best features of the traditional (i.e., clear business identity) and coworking (i.e., collaborative space) models. More operators are moving towards hybrid (e.g., WeWork) flexible space as they and members begin to better understand each other’s requirements. The optionality that hybrid space affords to members is one of the reasons it is a desirable format for potential occupiers.

Enterprise: The increase in large corporates taking full floors or entire buildings from flexible office operators highlights that large-scale flexible offices may be an option for some large businesses. As discussed in the sidebar entitled Experience in Flexible Offices (LaSalle’s experience), the occupation of businesses within flexible space has the potential to dilute a brand’s identity/impact. Such solutions are likely to be more attractive to firms with an existing headquarters who are looking to expand into flexible space.

Impact of an Economic Downturn on Flexible Office Operators

A key question of investors regarding flexible office operators is how a downturn will impact them. There is a lot of uncertainty about the economic sustainability of this market as many of its elements have not been cycle tested. There are also market dynamics to consider, as well as the alignment of incentives, or the lack thereof, to keep operating when cash flow turns from positive to negative.

The fixed-lease model theoretically places the impact of cash flow volatility on the flexible office operator, not the landlord. However, many operators set up special purpose vehicles (SPVs) to carry this risk and do not put the full faith and credit of the parent company behind each lease. This leaves the SPV with a long-term lease obligation to the landlord and the short-term obligation of the user to occupy space. If flexible office cash flows go negative, operators with an SPV on the lease may default with limited consequence to the parent except the loss of a money losing part of their business, or they can use the threat of default to renegotiate the lease. In either case, the lease income stream to the landlord of a flexible office is more at risk than with a traditional tenant.

The cash flow risk for operators is reduced in the management and platform models where owners share the upside and downside associated with short-term tenant commitments. As long as the flexible office income is part of a diversified set of revenues and the overall tenant base is stable, a temporary decline in cash flow from a flexible office should not put the landlord in a distressed position.

Experience in Flexible Offices

It can be difficult to disentangle hype from the fundamentals when it comes to the flexible office trend. To better understand the strengths and weaknesses of these new office options, a group from LaSalle’s London office decided to experience the formats first-hand. Here we share their key takeaways.

Within the flexible office formats visited, the group noticed a distinct lack of business identity. From the perspective of a start-up this was clearly not a concern as they fully embraced the shared community mantra. However, as businesses mature and develop, particularly those where interactions with people are important, brand identity could become more critical and this is difficult to achieve in many coworking operations.

The role of breakout areas also proved to be an interesting discussion point amongst the group. There is a novelty factor associated with having access to more informal communal areas. However, the noise and general commotion can be overwhelming particularly where games such as table tennis are being played. It would be a difficult environment for a critical client meeting and while meeting rooms are the obvious solution, there may not be enough of these to meet peak demand.

One main strength of the flexible office environment is the wide-range of opportunities to collaborate with colleagues. The lack of computer monitors and room dividers makes it easier to have conversations, while the enclosed booths or desks are great for a quick conference call or if you want some heads down work time. Ultimately the group felt that people did not need to be in a flexible office to achieve the same outcome as a slightly different build-out on traditional space could achieve it.

Many elements of flexible offices are appealing, but ultimately the nature of a business will dictate its office space requirements. Whether it has to do with the level of branding or personalization, for many, there will be a flexible office solution to meet their needs. Medium- to large-sized businesses with more formal structures and requirements will likely prefer the control of a traditional lease. Currently, that this is a large portion of the demand pool, thus it is difficult to see flexible offices completely replacing traditional structures that provide privacy, quiet, and company identity.
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In an economic downturn, a few dynamics will impact the flexible office market. This is part of the risk of doing direct leases to coworking operators and should be considered carefully. Specifically:

- During an economic downturn, occupants will try to eliminate some obligations and search for less expensive alternatives. Firms with diversified portfolios may find coworking spaces expendable even if they occupy a preferred space. Smaller companies may find short-term, direct leases (which landlords will be more amenable to when markets are unfavorable) to be a cost-effective alternative.

- During a period of economic uncertainty, the demand for flexible workspaces with leases that can be canceled in 30 days, becomes more attractive. A good example of this situation is found in London, where firms are unsure of what the implications of the Brexit referendum are on their long-term space needs. In such circumstances, the demand for flexible office space can rise, as long as the economy is not also contracting.

- The flexible office market has low barriers to entry. The figure entitled U.S. CBD Office Market Rent and Flexible Office Rent shows the strong relationship between office rents and coworking membership costs across U.S. markets using JLL data. We expect this relationship will exist across time, and lower-cost flexible office options will be available when direct office rents decline. A downturn will make the opportunity cost of offering flexible office space lower and lead to less expensive coworking places that could take market share from legacy operators with higher cost operations.

The durability of offices with coworking operators on the rent roll, is going to be different than traditional office. One comparison that might be valid is the cyclical durability of service-oriented retail properties. Like coworking operators, fitness centers and other service-oriented retailers have long term liabilities and short-term cashflows. They often set up SPVs and do not put their parent company’s credit on the lease. Just like coworking operators service-oriented these retail operators care about access, footfall, and micro-locations, and both are providing a space/service mix that cannot be reproduced on the internet. What remains to be determined is how much coworking revenues dip in downturn relative to service-oriented retail.

Impact of Flexible Office on Valuation

While we believe flexible office tenancy decreases the certainty around cash flows, which should reduce asset values, the question is how is the market viewing this today. There is some evidence of flexible office discounts around the world, but the evidence is relatively limited. Anecdotal evidence suggests that investors discount office assets that are heavily dependent on flexible offices. Investors reportedly tolerate up to around 30% of an asset that is exposed to flexible offices (mostly based on the lease model). As the flexible office share of an asset increases beyond 30%, estimates of the discount range from 10% to 20% compared to an asset leased to traditional tenants. Given the predominance of the lease model, this is as much a statement on the credit worthiness of flexible office operators as the outlook for flexible offices overall. An example is the comparison of two assets in the Seattle CBD that sold in 2018. Both had long-term leases on 100% of the building: one to Amazon and the other to WeWork. In this case, the WeWork asset traded at a 75 bps capitalization rate premium to the Amazon leased asset, which implies a 17% asset value discount. A similar example in Tokyo was a 25 bps premium, which implied a 7% asset value discount. As more flexible office assets trade with a variety of economic models, there will be more data on how investors view the long-term cash flow profile of flexible offices, giving them more targeted information on which to base their investment decisions.

![U.S. CBD Office Market Rent and Flexible Office Rent](image-url)

Source: JLL, LaSalle Investment Management. Data as of Q3 2018
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Pros and Cons for Office Owners

Flexible office is often framed as a binary decision: Should an owner lease to a coworking operator or not? We see advantages and disadvantages for an owner engaging in the flexible office market and their relative importance depends on the situation. We do not see a universal answer to the question of whether an owner should engage in the market, or for that matter how they should engage and with what assets.

**Advantages**

- **Ability to Quickly Increase Occupancy**: Flexible office operators are willing to lease large blocks and quickly get it open and rent paying in advance of having occupants lined up. This is a positive for landlords looking to quickly boost the income of an asset with low occupancy.

- **Avenue to Reposition a Building**: Many flexible office operators have an image which enhances the overall building’s image to other tenants. This is a slightly longer-term boost to an assets occupancy and income generation.

- **Source of Tenant Lead Generation**: The occupants of flexible space sometimes grow to the point that they can become direct tenants. This is another longer-term avenue to income growth.

- **Ability to Charge Higher Rents**: Flexible space rents at a premium to the traditional office market. This enables an asset to increase cash flow.

- **Ability to Retain Tenants for Longer**: Providing existing tenants with flexible solutions, particularly in larger buildings can lead them to use that space as spillover, avoiding the need to move elsewhere. This will help to support an assets cash flow.

**Disadvantages**

- **Credit of Operators**: Since the coworking market is fairly new, there is limited evidence around the long-term durability of the business. This risk is showing up as a discount to asset value in some cases.

- **Increased Volatility of Cash Flows**: If a landlord pursues a management model, it exposes the asset to greater upside and downside volatility of cash flows throughout the business cycle. It is unclear how this volatility and uncertainty will be priced in the transaction market.

- **High Incentives**: In order to secure flexible office operators through a lease, landlords are usually required to provide large upfront capital contributions as well as sizable rent-free periods. The majority of the risk rests with the landlord, particularly if the operator were to collapse.

- **Fit with Certain Tenants**: Flexible office space (and the more casual tenants) may be negatively viewed by some tenants such as law firms, financial services firms, and security-conscious users.

- **Opacity of Coworking Market**: If a flexible office operator ceases operations, it will be the dynamics of the coworking space market that will determine the ability to keep occupants in place and cash flowing. However, the lack of market data makes it hard to understand the ability to and relative economics of releasing to another operator or retaining tenants if the space shifted to a management model.

- **Long-term Economics**: Flexible office is in its infancy, so the long-term costs associated with it are unknown. There is also uncertainty around the ongoing cost of occupant acquisition and the durability of capital investments.

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4 This financial uncertainty is illustrated in WeWork’s self-reported 2018 results which revealed a net loss of $1.9 BN, while they also reported a 28% gross margin based on “community adjusted” earnings before interest, taxes, depreciation, and amortization.
The balance of these advantages and disadvantages is linked to the asset’s situation and the investors’ strategy with the asset. This means there are situations when engaging with coworking tenants makes more sense than others and the extent and risk in that engagement will vary. The key factors in determining this are both a function of the asset, the investors’ strategy, the potential coworking operator, and the nature of the lease or operating agreement with this operator. This includes the building’s leasing situation, current building image, building capital improvement plan, share of building to be dedicated to coworking, capital market receptivity to the coworking operator, intended hold-period, credit profile of the coworking operator, and match of the coworking tenant with the building’s current tenants.

Advice for Office Investors

The sources of demand, stability of cash flows, and methods of competing for tenants in the office market are being challenged by the shift to flexible offices. There is value to offering potential occupiers new models of using and leasing office space. Currently, it is unclear whether providing flexible office space creates value for landlords and is economically sustainable in its current structure. The negative value impact of greater uncertainty surrounding short duration cash flows needs to be compensated for with higher levels of cash flow. The companies leading the disruption have not yet proven their economic models are profitable in the short-term or the long-term.

Given this uncertainty, investors should proceed carefully into the flexible office market. There are short-term value creation opportunities, but also long-term risks. Investors need to consider the short-term and long-term potential of each property on a case by case basis. LaSalle’s advice is to develop a flexible office market strategy that includes the following:

**ACTION ITEMS FOR OFFICE INVESTORS**

1. Incorporate flexible office when suitable to the risk-return objectives of the specific asset and the wider portfolio.

2. Be mindful of the impact that flexible office competition can have on assets based on market position and tenant base.

3. Consider the costs and the benefits of the lease versus shared-risk operator model.

4. Consider the impact on valuation, as well as cash flow.

5. Negotiate for as much corporate guarantee of the lease by the Flexible office operator as possible.

6. Track exposure at the asset and the portfolio level of a coworking lease failure.

7. Determine whether a “do it yourself” approach makes sense for a specific building, but also be realistic about how much effort it takes to “curate” a coworking space.

Finding the right balance between cash flow growth and income stability in order to enhance asset values will remain the primary guide for office owners. Data to help guide the analysis this trade-off will become more available as coworking operators mature and evolve. And as the overall market evolves LaSalle will adjust strategy and recommendations accordingly.
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LARGEST GLOBAL FLEX OFFICE OPERATORS

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<td>41</td>
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<td>38</td>
<td>2</td>
<td>2015, Shanghai, China</td>
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<tr>
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<td>35</td>
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<td>2016, Singapore</td>
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</table>

Source: Operator websites and secondary sources. As of Q2, 2019, LaSalle Investment Management.

LARGEST SINGLE COUNTRY FLEX OFFICE OPERATORS

<table>
<thead>
<tr>
<th>TOTAL CITIES</th>
<th>TOTAL LOCATIONS</th>
<th># OF COUNTRIES</th>
<th>YEAR FOUNDED</th>
<th>HQ CITY</th>
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<td>awfis</td>
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Source: Operator websites and secondary sources. As of Q2, 2019, LaSalle Investment Management.

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