GARDINER &THEOBALD

CO-WORKING SPACES

New ways of working

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WHAT IS CO-WORKING?

Co-working spaces, simply put, are shared workplaces. Co-working is a concept whereby those who are self-employed or working for different employers rent out space in the form of seats, desks or private offices from operators, typically on a monthly basis.

The concept, which started in 2005 in San Francisco, has seen an unprecedented rise in demand in recent years. Often referred to as flexible office space, the surge in demand has been driven by a variety of factors, outlined in the section 'Why has this developed?'.

Whilst there are various co-working business models, these shared workspaces typically offer a suite of office-like amenities such as hot-desks, private meeting rooms, kitchens, coffee points and a range of other facilities. Often, they also offer a flexible, open-source community approach to work where collaboration and networking are encouraged.

Occupants of co-working space have typically been freelancers, start-ups and small and medium enterprises (SMEs) who want to take advantage of a flexible space, renting out only what they need. Increasingly, however, more established companies are integrating co-working spaces into their workplace strategy instead of taking space on a traditional lease.

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Why has this developed?

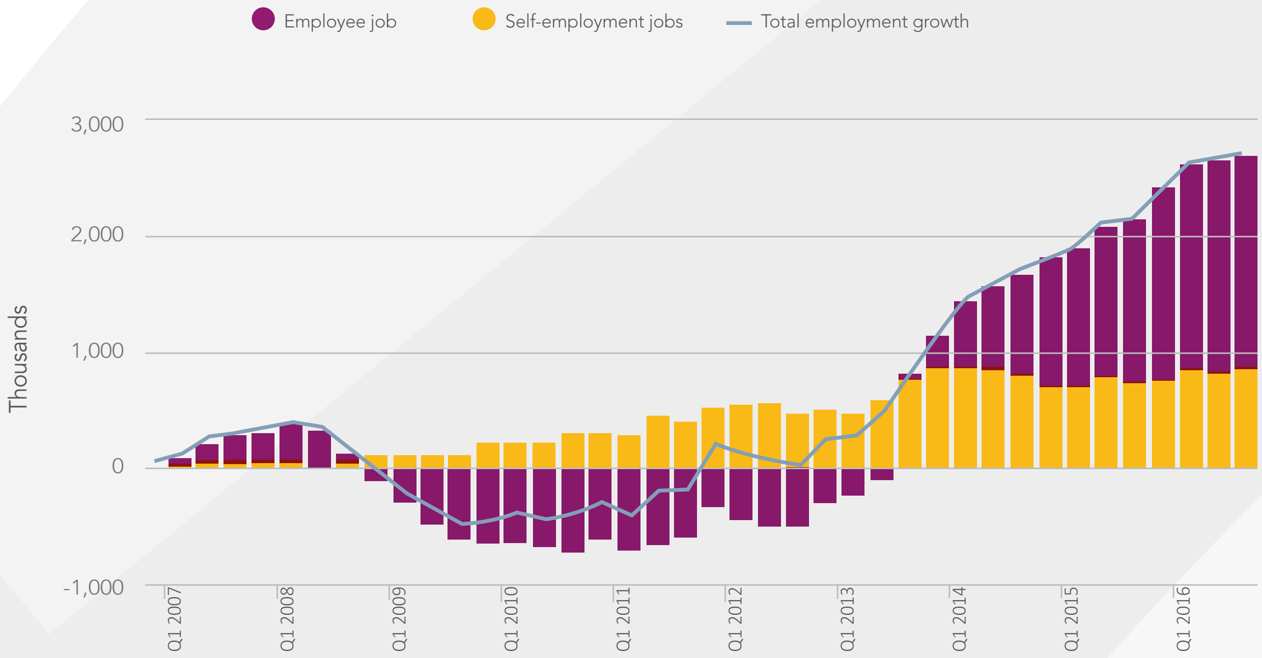
Globally, it is estimated that by 2020, 1.55 billion workers will be in roles that do not confine them to a desk[1]. Non-standard forms of employment are becoming more commonplace, with more professionals working in casualised, project-based freelance roles. For these people, co-working allows occupiers to share a workspace in an environment geared towards open collaboration.

Changes to working models and practices have been a major reason behind the growth in co-working spaces. PeoplePerHour predicts that by 2020, 50% of the UK workforce will be self-employed.

In the UK, self-employment has reportedly grown in recent years. ONS figures indicate that the number of self-employed increased from 3.3 million people (12% of the labour force) in 2001 to 4.8 million (15.1% of the labour force) in 2017. This growing segment is likely to continue to fuel demand for flexible work environments.

[1] Frost & Sullivan – The Global Future of Work

The cumulative change in employee and self-employed jobs (Q1 2007 – Q4 2016, UK)



source: ONS

NEW WAYS OF WORKING

In the UK, a rise in the number of start-ups and SMEs have also contributed towards greater demand for co-working space. In the City of London alone, the number of SMEs has increased by 41% since 2010[2].

Companies are increasingly seeking to enhance their workplace experience, primarily to attract and retain talent. Co-working appears to be a big draw to millennial talent that prefer to work in communities of like-minded people.

In a study reported in Harvard Business Review[3], researchers found that users of co-working spaces experienced greater meaning from their work, and reported higher levels of 'thriving' at work than their office based colleagues. Additionally, with many choosing to work from co-working spaces closer to home, there is a positive knock-on effect as commuting times and traffic congestion are reduced.

For small start-ups, with uncertain growth prospects, co-working provides a way to quickly adapt to the changing number of employees. Long leases and large overheads carry a high cost risk for small businesses. Even larger businesses are starting to see the advantage of avoiding long-term space commitments in a volatile economic climate. With Brexit uncertainty weighing heavily on the minds of companies, the attraction of short leases on their respective balance sheets may prove very attractive.

Growth is also being driven by changes to working practices and team structures. As agile working practices become more widespread, co-working spaces will continue to be set-up to cater for such agility and connectivity requirements.

[2] http://smallbusiness.co.uk/smes-driving-employment-levels-2539643/

[3] Harvard Business Review – Why People Thrive in Co-working Spaces

Co-working globally

The results of the latest Global Co-working Survey[4] ('the Survey') show positive, year-on-year growth of the number of co-working spaces worldwide. According to its estimates, approximately 1.69 million people will be working in approximately 18,900 co-working spaces around the world by the end of 2018.

On average (using the arithmetic mean), a co-working space today serves 159 people, or 'members' (an increase of 23.3% since 2017), and most survey respondents (86%) estimate that in the coming year there will be 'slightly more' or 'much more' members in co-working spaces worldwide.

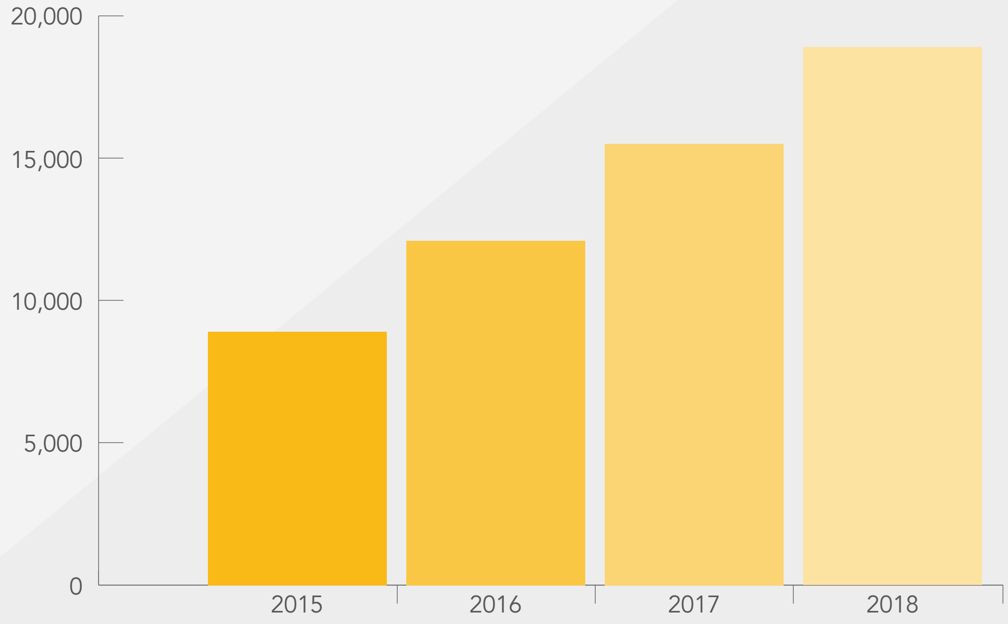
By the end of 2018, the Survey forecasts that co-working spaces with 150 or more members will represent approximately 23% of the total share of co-working spaces worldwide. Co-working spaces with 10-19 members will have the second highest share (16%) of co-working space worldwide.

It's interesting to note that the number of the very smallest co-working spaces (i.e. those with 0-9 members) has fallen significantly since 2016, where such spaces had a 23% share of all co-working space. By the end of 2018, this is expected to fall to a 10% share of all co-working spaces worldwide, indicating that the market is favouring larger spaces.

The survey respondents also noted that the biggest trend for co-working spaces in 2018 is 'more (and bigger) co-working spaces'. A large proportion of providers (37%) also commented that to achieve this, they would focus on opening additional locations rather than seek to expand their current location(s) or move from an existing location to another, larger location. Opening additional locations was also thought to be the most profitable of all the expansion approaches mentioned in the survey.

[4] DeskMag's 2018 Global Coworking Survey: the 2018 coworking forecast

Number of co-working spaces worldwide (as at 31 December of each year)



source: Global Co-working Survey: The 2018 Co-working Forecast

Co-working in London

In their 'Co-working 2018' report[5], Cushman & Wakefield estimates that flexible workplace operators currently occupy around 10.7m sq ft of space across Central London, or 4% of Central London office stock.

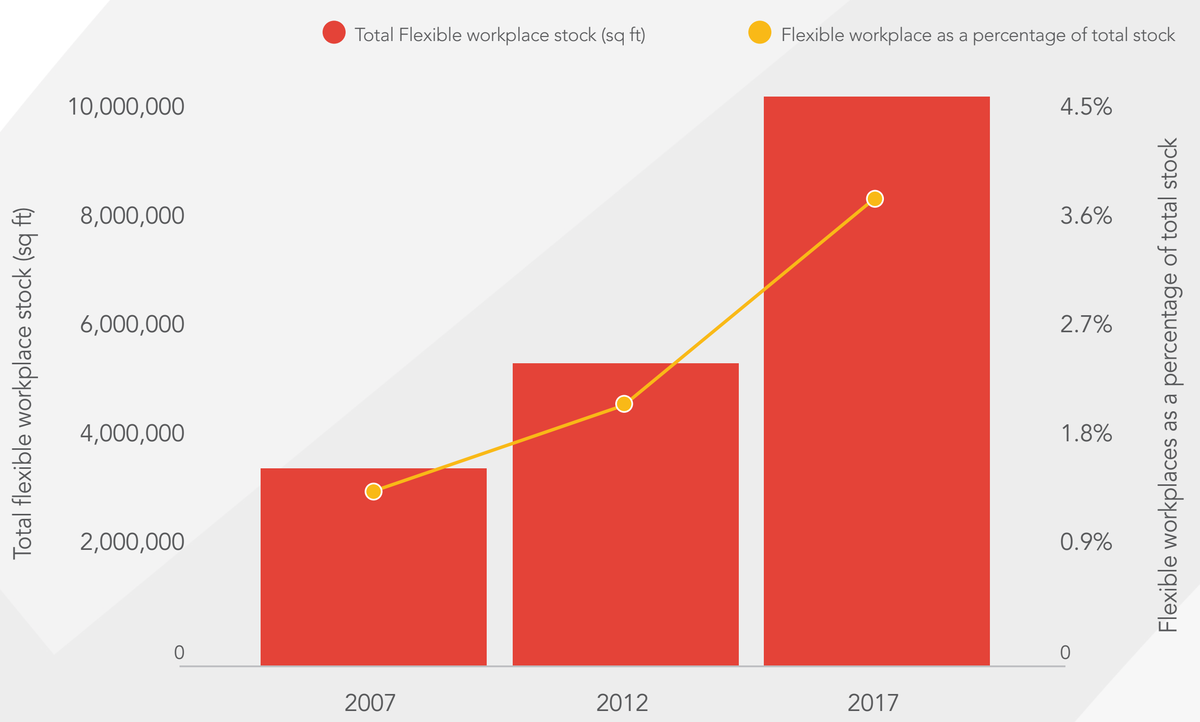
In 2017 alone, 2.5 million sq ft was leased to flexible workspace operators in Central London, more than a fifth of total office transactions in the capital. The largest stock of space occupied by flexible operators is in the City, with 26% of all flexible workspace. This is followed by the West End, with 23.2% of the total flexible workspace.

London is considered the global leader for flexible workspace in terms of both space and number of operations, surpassing the likes of New York Manhattan. Flexible workplace providers account for a substantially higher proportion of total leasing in London than Manhattan. Since 2012, flexible workplace leasing has represented an average of 2.9% in Manhattan, compared to 10.6% in London.

Cushman & Wakefield's report also notes that in 2017, the average size of a flexible workplace unit in Central London was 22,300 sq ft, a 48.7% increase from 2015, where the average size was 15,000 sq ft. The increase in the average unit size is largely due to the greater number of new operators that have entered the co-working market, all competing to gain market share. The increase in average unit size is also a result of operators that scale their business by adopting hybrid business models that can draw from multiple income streams (e.g. selling class space, ticketed events and the sale of food and drink).

[5] http://www.cushmanwakefield.co.uk/en-gb/research-and-insight/2018/coworking-2018

Change in Central London flexible workplace stock



Source: Cushman & Wakefield

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The biggest players in Central London

WeWork has been the largest taker of space in Central London between 2012-2017, but big tech companies have also taken significant amount of space. The table below shows the top five biggest takers of space in Central London:

Company	Amount of space taken (2012-2017)
WeWork	2,577,864 sq ft
Google	1,334,121 sq ft
Amazon	1,012,649 sq ft
The Office Group	853,524 sq ft
Apple	515,865 sq ft

Source: Cushman & Wakefield

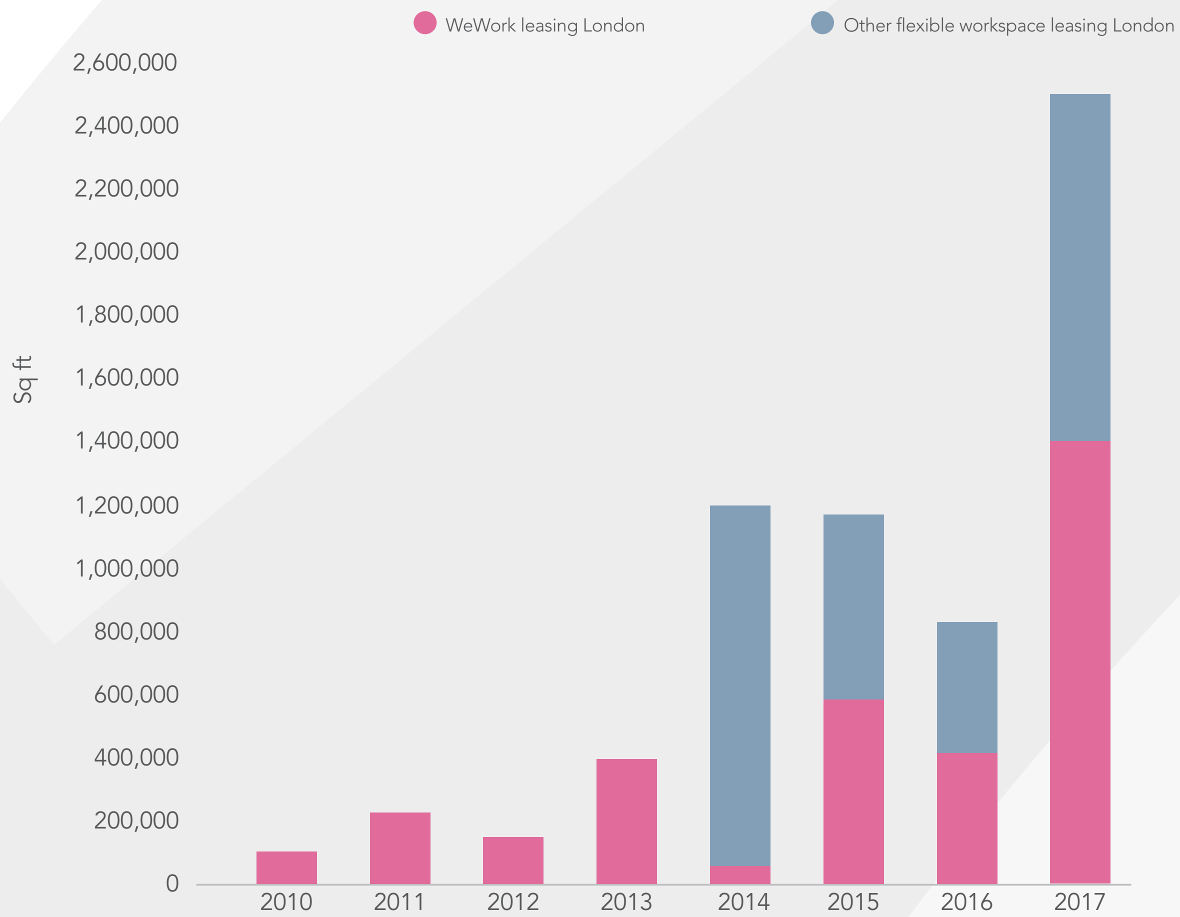
£65.50 per sq ft was the average rent paid by flexible workspace operators in 2017 in Central London, reportedly up 10% compared to the 2016 average, with operators such as WeWork targeting a density rate of 35-45 sq ft per desk for their new co-working spaces. By way of comparison, in 2017 average prime rents in the City were £70 per sq ft and in the West End prime rents were £110 per sq ft[6].

Despite the strength of the London co-working market, approximately two thirds of the UK flexible workplace market is located outside the capital, showing that many operators prefer to focus on growth outside the capital due to competitive costs.

In London, WeWork has dominated in terms of the volume of space let to flexible workplace operators in the past couple of years. In 2017, WeWork accounted for 58.8% of lettings as a proportion of total take up in the flexible workspace market in London.

[6] JLL – Central London Office Market Report (Q3 2007)

WeWork lettings as a proportion of total take-up (London)



source: Cushman & Wakefield

However, WeWork is not without competition in London. As WeWork expands, other operators and landlords are competing for space. The Office Group (controlled by US private equity fund Blackstone) was the second largest flexible workspace operator in London in terms of space taken between 2012-2017. The Office Group took 853,524 sq ft of space during the period, just under a third of the space of WeWork.

International Workplace Group (IWG), which has a wider global reach than WeWork and is still the main operator of flexible units in the US and the UK, also took a substantial amount of space in Central London between 2012-2017 (512,219 sq ft).

i2 (now rebranded as 'Landmark') has outlined plans to expand from 44 to 65 locations and double the size of its business by 2020. Landmark was the eighth largest overall taker of space between 2012-2017, and include in their range of services the option to have a fully bespoke private floor.

In 2017 British Land set up Storey, its flexible workspace brand, which aims to fill the gap for companies that have outgrown co-working space, employing between 20 and 70 people. The concept also suits larger office customers seeking project or shorter term space on top of their core requirements. As at June 2018, Storey had launched 114,000 sq ft of space and committed to a further 119,000 sq ft, demonstrating that it is keen on scaling its business model. Due to its recent success, Storey announced that it will no longer let new space to WeWork or other flexible workspace competitors. Instead, British Land will expand Storey to as much as 10% of its £9bn office portfolio, and has begun buying buildings specifically for its use.

In order to stay competitive against incumbents and the growing number of new entrants into the market, WeWork has evolved its business model to focusing on custom from bigger corporates and more traditional categories of tenant such as global banks, in order to target more reliable and consistent income streams. To aid its growth plans, WeWork recently secured a $1bn loan note investment from Japan's SoftBank which has been earmarked for overseas expansion and the building of further office space.

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How will co-working business model evolve?

Providers of co-working space are increasingly offering end-to-end solutions, from sourcing the space to managing the custom build-out and operational aspects of the office on an ongoing basis. For example, BE Offices offers its 'BESpoke' service, which provides a fully managed workspace solution for larger organisations.

Diversification of revenue streams is likely to be another key development in the coming years. By widening the scope of services and amenities, providers will be able to stay competitive. Operators are already forming partnerships to provide their occupiers with various business services in areas such as health, technology support and insurance.

Co-working is also likely to expand to non-office buildings. For example, vacant retail space is beginning to be utilised for co-working, providing landlords with a way to fill surplus or unused space. In London, Heals, the furniture and home accessories store, has already opened a café and co-working space at its store on Tottenham Court Road, with 14 desks to rent.

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Case Study: HUB

The Realtex Group, who has developed six middle-market multifamily properties in Berkeley and San Francisco's South of Market, has proposed a new kind of mixed-use project at 475 Bryant. The developer has assembled the roughly 20,000 sq ft site from two parcels currently housing a gas station and low-rise industrial building.

The developer anticipates the building to be the first large-scale self-sufficient mixed-use building where people can live and work in the same building with plenty of amenities so that they won't need to leave.

Residential units are located on the bottom half of the building, around a central core of amenities (gym, cinema, supermarket). Residents work in upper floors (designed like WeWork spaces with a mixture of private offices and desks with shared kitchen/ common areas) which allows residents to 'commute via elevator'.

This type of development may be well suited to major tech employers, with intellectual property concerns. Companies such as Facebook and Google's parent, Alphabet, are diving into developing housing on or near their campuses.

The co-working model has yet to be tested in a recession or following significant lease breaks or renewals, and it remains a possibility that such events could increase operating costs. Flexible space providers typically take out long leases on space which is then let out on a short-term basis to its members. This leaves providers exposed if those members subsequently decide to leave.

However, the co-working model is constantly evolving in an attempt to mitigate such risks. For example, WeWork's 'Powered by We' offers a turnkey solution to corporate and work space users to design and implement the fit-out of its existing space, which WeWork then manage. Powered by We enables WeWork to earn fees from members without having to take leases, and is a prime example of its ability to adapt its business model and reduce risk.

Fit-out costs

G&T research indicates that co-working space providers prefer to target iconic landmark buildings in good locations for transport nodes, but have no particular bias as to whether the buildings are new, old or refurbished.

Most co-working space providers are also likely to prefer to take space from shell in order to avoid ripping out CAT A works that will often not be in keeping with their requirements. WeWork, for example, tends to prefer exposed ceilings and so would probably target shell and core space.

Co-working fit-out costs are highly variable but the table below provides a typical range for the cost of a CAT A and CAT B fit-out.

Fit-out category	Fit-out cost range
Cat A	£50/sq ft - £60/sq ft (NIA)
Cat B	£100/sq ft - £150/sq ft (NIA)

A typical CAT A fit-out will cost £50/sq ft on NIA. If a tenant takes a CAT A space they will likely spend £15-25/sq ft adjusting the CAT A works. If they take a space from shell this will avoid the CAT A abortive works allowing them to build to their preferred layout from the start.

Providers like WeWork will typically fall towards the lower end of the CAT B fit-out cost range above (£100-£125 per sq ft) due to their massive standardisation and therefore ability to negotiate better rates with suppliers. At the higher end of the fit-out cost range (£135-£150 per sq ft), offerings tend to be more niche and incorporate amenities such as high end coffee shops, restaurants and fitness facilities.

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THE FUTURE OF CO-WORKING

Core cities in the regions are likely to see accelerated growth as the more established operators look outside of a saturated London market.

The growth rate of companies such as WeWork indicates that co-working and the flexible workplace segment is here to stay. Whilst the sector only accounts for approximately 4% of the London office market, take-up has grown year on year.

In 2017, 2.5 million sq ft of lettings completed, accounting for a market share of more than 21%. WeWork was responsible for more than half of 2017 take up. The company reportedly doubled its sales in Q1 of 2018 to $342 million and noted that occupancy of its offices rose to 82% at the end of the first quarter (up from 73% a year earlier).

WeWork's most recent funding round values the company at $20bn, but a SoftBank executive has said that the company was seeking to raise more capital which would increase its valuation even further to $35 billion. If WeWork was able to reach such a valuation, it would become the most valuable venture capital-backed private US company, surpassing the likes of Uber and Airbnb.

Scale appears to be one of the few ways to improve margins for providers of co-working space. This acts as a barrier to entry for more traditional landlords as they would likely struggle to establish the necessary supply chains in order to make such a transition profitable.

A potential inhibitor of growth in the sector is likely to come from a lack of supply, especially for larger spaces in prime locations. This is likely to lead to providers considering alternative, non-office spaces, providing that developing such spaces can be justified by sufficient levels of demand.

Another development that will impact co-working space providers in the near future is the implementation of the new lease accounting standard, IFRS 16. IFRS 16, which will apply to annual reporting periods beginning on or after 1st January 2019, provides that leases under 12 months do not have to be listed as an asset on the balance sheet. This is likely to boost demand for co-working spaces as it removes the requirement to capitalise the rental liability on the occupier's balance sheet, making the business look healthier on paper.

IFRS 16:9 also provides a new definition of a lease for accounting purposes:

"A contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration."

The wording appears to indicate that co-working spaces are likely to fall outside its scope. As co-working space providers generally don't allocate specific floor space that occupiers have the right to control the use of, it falls outside the changes to IFRS 16.

So clearly, the sector will continue to have a broad appeal to a wide range of businesses and occupiers. Operators will expand their offering in order to cater for this growing demand from a wider range of occupants, and will aim to differentiate themselves by focusing on different niches within the flexible work space environment.

If you have any questions regarding the content of this report, please contact Michael Urie or Gavin Murgatroyd in the first instance.
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