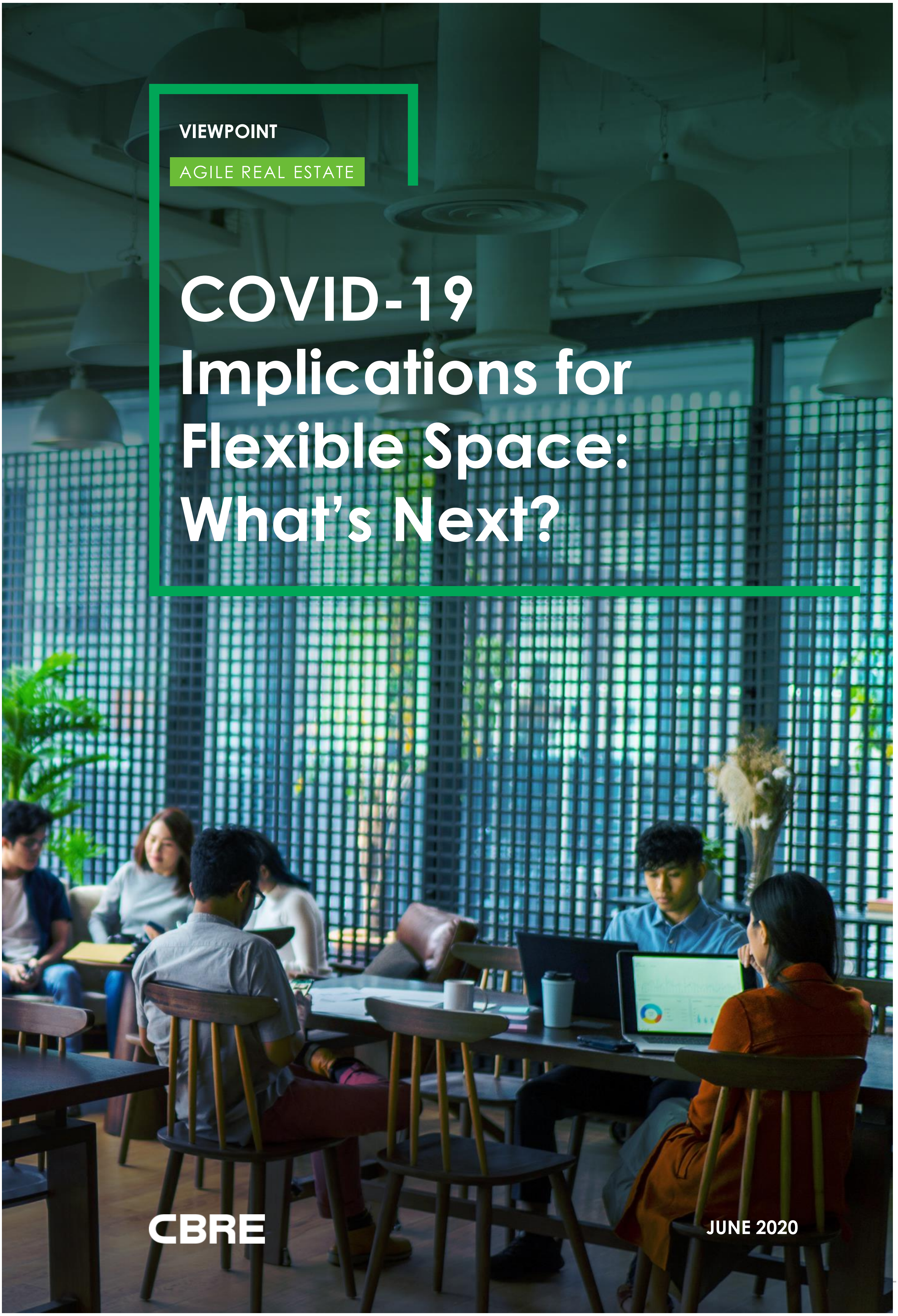
VIEWPOINT

AGILE REAL ESTATE

COVID-19 Implications for Flexible Space: What's Next?



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INTRODUCTION

COVID-19 has exerted a profound impact on the Asia Pacific office market in 2020, with effects ranging from a sharp short-term decline in new demand to the rapid adoption of remote-working. Longer-term consequences are likely to include a stronger emphasis on health and wellness and new best practices in property management.

Flexible space – which includes both coworking centres and serviced offices – has not been spared the effects of the pandemic. Attendance has been affected as lockdowns and social distancing force members to work from home; numerous operators have shortened operating hours or closed facilities temporarily; and growth in new memberships has been delayed as potential users suspend inspections and trim operational expenditure for immediate cost saving.

"While flexible space will inevitably experience some short-term pain, long-term fundamentals remain sound"

While continued turbulence in the coming months will inevitably cause considerable short-term pain, the sector's long-term fundamentals remain sound. Nevertheless, it is imperative that operators, occupiers and landlords chart a course through the current market turmoil.

This ViewPoint by CBRE explains how the flexible space sector in Asia Pacific has been impacted by the pandemic thus far; examines how operators have responded; discusses how the occupier view towards agility is evolving; and identifies strategies for landlords seeking to manage their exposure.

THE IMPACT SO FAR

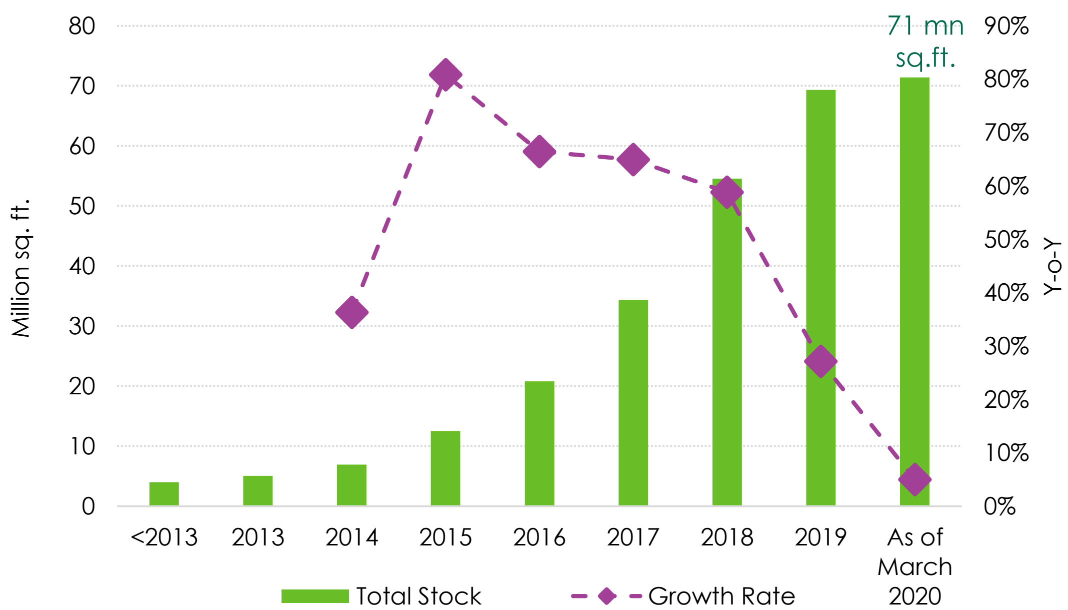
One of the most visible impacts of the COVID-19 outbreak has been an immediate drop in occupancy levels at coworking centres and serviced offices as well as a slowdown in membership growth – especially from start-ups and smaller enterprises - as potential users suspend inspections and trim operational expenditure to cut costs.

Occupancy in leading coworking centres in Greater China fell to as low as 30-40% in the first eight weeks of the outbreak[1] as users complied with strict social distancing protocols introduced by local authorities and/or avoided workplaces due to concerns about health risks resulting from high workplace density. EdgeProp reported similar figures in other Asia Pacific markets subject to lockdown measures.

As of late-May, with the number of daily new COVID-19 cases either at zero or in the low single digits, occupancy in several major coworking centres in Mainland China and Hong Kong SAR has recovered considerably – a trend expected to be replicated in other markets as restrictions are gradually lifted.

The inventory of flexible office space in Asia Pacific has risen by threefold over the past five years, supported by the shared economy boom and a flood of venture capital. Although the rate of growth slowed to 20% y-o-y in 2019, and fell further to just 5% y-o-y in Q1 2020, the total inventory of flexible space in the 18 major cities tracked by CBRE had reached 71 million sq. ft. by the end of March. This is equivalent to 4% and just under 3% of total Asia Pacific office stock and total Asia Pacific Grade A office stock, respectively.

Figure 1: Total size of flexible space market in Asia Pacific



Source: CBRE Research, June 2020
Note: Agile space includes serviced offices and co-working space located in both office and non-office space. Incubators or accelerators are not included. Includes 18 Asia Pacific markets: Beijing, Shanghai, Shenzhen, Guangzhou, Hong Kong, Taipei, Seoul, Tokyo, Singapore, HCMC, Hanoi, Bangkok, New Delhi, Bangalore, Mumbai, Sydney, Melbourne and Auckland.

1. https://allwork.space/2020/03/ucommune-coronavirus-and-the-shared-workspace-industry-in-china/

With industry competition intensifying in recent years, many flexible space operators have already begun to re-evaluate their business models and introduce new strategies to support longer term growth. However, the pandemic has added another layer of complexity for the industry and poses a challenge to how flexible space operators run their centres.

Owing to social distancing guidelines and the slow acquisition of new members, coworking centres have been unable to operate at full capacity over the past few months, negatively impacting occupancy. Several operators have also put expansion plans on hold and have furloughed or laid off staff to alleviate the rising financial pressure.

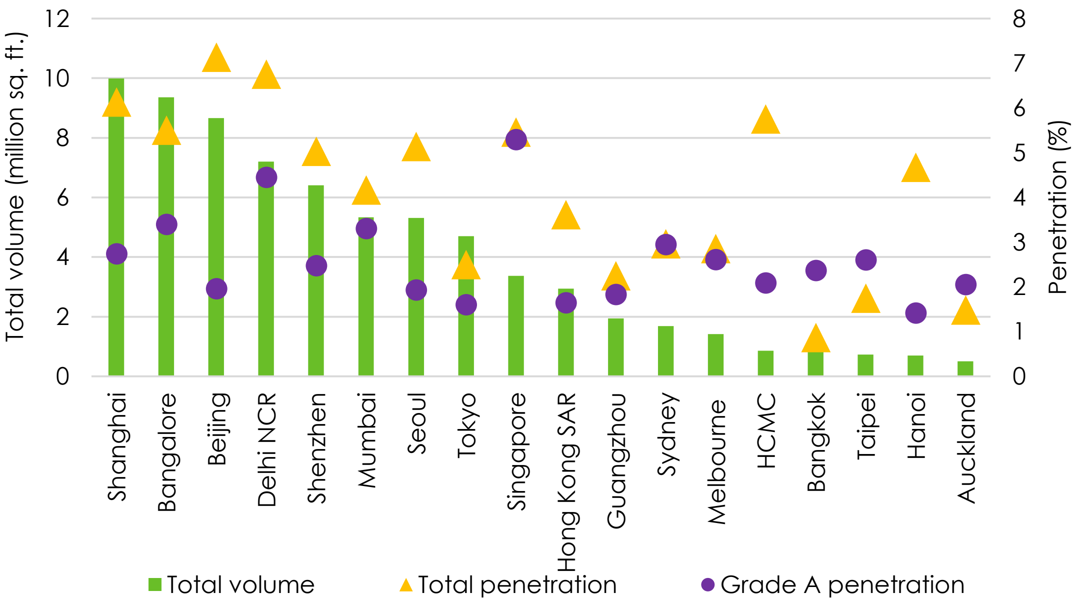
More merger and acquisition activity among operators is expected. Closures of unprofitable centres will be unavoidable but surrendered or sub-leased space is likely to be taken up by other coworking operators that are financially sound, or by tenants seeking fully fitted-out space.

Operators will seek to manage operational costs, pursue sustainable growth and exert tight control over capex. Larger operators on a relatively solid financial footing may find opportunities to increase their market share at the expense of less established platforms. CBRE expects to see instances of larger players acquiring fitted space from smaller operators as part of a broader trend of industry consolidation.

The impact of operator contraction will vary by market. Vulnerable cities include those where flexible space has been a key driver of office leasing demand and /or where there are concerns about oversupply.

These include Shanghai, where flexible space has accounted for 15-20% of total leasing demand over the past three years . Shenzhen is also susceptible due to a supply peak.

Figure 2: Penetration of flexible space industry by market



Source: CBRE Research, June 2020
Note: Agile space includes serviced offices and co-working space located in both office and non-office space. Incubators or accelerators are not included.

THE OPERATOR RESPONSE

Although there have been a few exceptions, flexible space operators have mostly kept their centres open for the duration of the pandemic, unless entire buildings have been forced to close or countrywide lockdowns have been implemented.

Most operators have introduced a range of measures to provide a safe working environment and facilitate social distancing. Steps include:

- Limiting guest accessibility
- Reconfiguring shared space and meeting rooms with staggered seating and buffer zones
- Increased sanitisation including enhanced hygiene standards, more frequent cleaning and the provision of free facial masks,
- Placement of signage informing users of capacity protocols and social distancing policies
- Cancellation of on-site conferences and events

With the rapid economic downturn placing many companies — both flexible space tenants and those in other industries —under financial strain, operators have received a wave of requests for rent relief from their members.

Following the onset of the pandemic in early February, individuals, start-ups and small and medium sized companies experiencing abrupt financial stress were quick to request relief measures from flexible space centres due to an inability to pay membership fees.

Most operators have prioritised renewals with existing customers, with some groups offering membership fee reductions; fee waivers for certain periods in exchange for contract extensions; and fee payment deferrals. A Singapore based operator recently offered 3,000 of its customers in eight different cities across the region a reduction of up to 30% on one month's membership fees[2]. Operators seeking to attract new members are expected to offer highly incentivised rates for longer lease terms.

Many operators have also started to approach landlords to renegotiate and restructure leases - many of which were signed at the market peak in 2018/2019 - and requested rent abatement and fit-out subsidies for new leases. Some operators are also understood to be pushing for a transition to revenue-sharing models or are entering into management agreements.

Flexible space operators will continue to focus on the enterprise market as large occupiers are less exposed to cashflow risk. Other opportunities may lie in providing virtual office services including phone-answering, communications and other systems.

2. https://www.justcoglobal.com/sg/wp-content/uploads/sites/23/2020/04/CEO-Message-Online-Poster.pdf

THE OCCUPIER RESPONSE

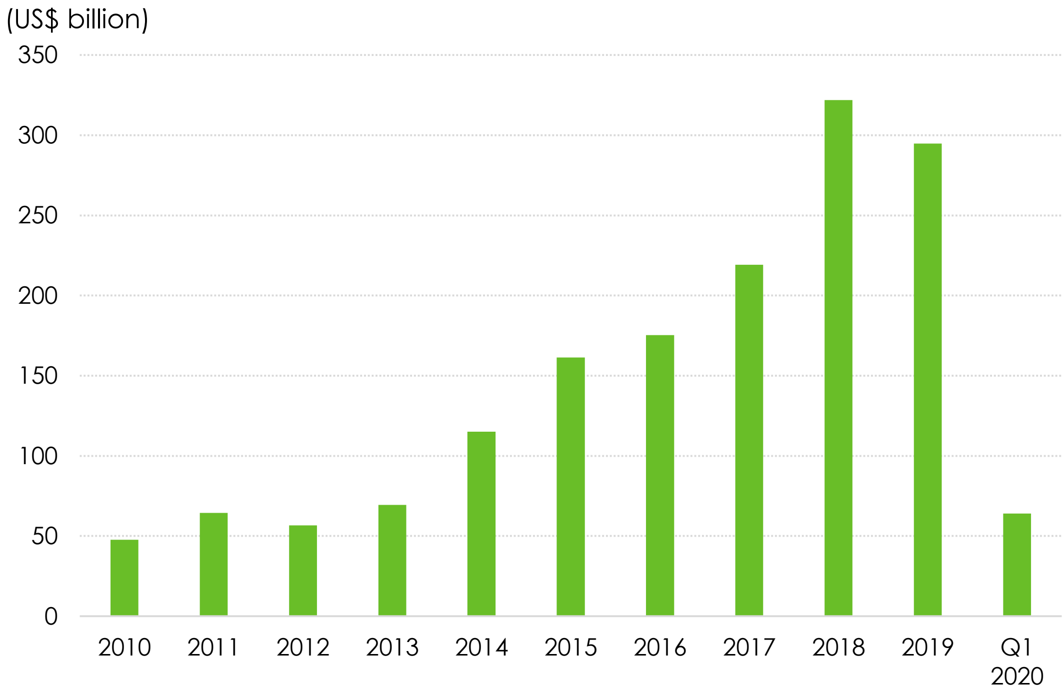
The boom in flexible space was initially powered by demand for shared services from start-ups and smaller tenants. However, start-up demand is more volatile during market downturns, and the pandemic has seen many smaller companies relocate to cheaper or home-based locations or forced them out of business entirely.

Start-ups are also having to adapt to a slowdown in global venture capital fundraising, with the total volume of new venture capital falling in 2019 after six years of robust growth. Crunchbase data show global venture capital declined by a further 8% y-o-y in Q1 2020 to US$64 billion.

However, few start-ups have defaulted on membership agreements since the pandemic, with most groups choosing to seek membership fee abatement. There have been cases of companies with contracts nearing expiry opting not to renew terms as they seek to trim operational expenditure.

Larger corporate occupiers are also evaluating more cost-effective options owing to sizable cuts in budgets for office relocations and fit-out. While some companies are pursuing deals for flex space as a cost-effective solution for short to medium-term space requirements, some firms are seeking to negotiate with landlords to obtain fit-out subsidies and/or the inclusion of options of new and long-term lease agreements.

Figure 3: Global venture capital (US$ billion)



Source: Crunchbase, June 2020

While continued turbulence in the coming months will inevitably cause considerable short-term pain, CBRE's conversations with Fortune 100 occupiers indicate that the flexible space sector's long-term fundamentals remain sound.

This is due to a variety of structural shifts including:

- **A more fluid workforce:** Flexible working will become more widespread after the pandemic. This will create a more fluid workforce and lead to greater acceptance of more varied working styles and locations.
- **Alternative options for expansion /contraction:** Flexible space will become a means to cater to headcount volatility, test growth, and access ready space on short notice.
- **Fit-out cost avoidance:** Occupiers are looking to preserve capital and evade high upfront fit-out expenses, preferring instead to utilise capital for operational expenditure. CBRE is aware of several recent deals involving large occupiers committing to long-term agreements in coworking centres in Singapore, Shanghai and Hong Kong SAR – a trend expected to solidify.
- **Workplace de-densification:** Flexible space is set to emerge as one of the solutions for large occupiers seeking to accommodate social distancing protocols in Asia Pacific's already dense office environments.
- **Risk mitigation strategies:** Some occupiers intend to make greater use of coworking space or serviced offices as Business Continuity Planning (BCP) space after the pandemic[3]. CBRE has tracked a rise in the number of enquiries from larger occupiers, especially from a BCP perspective, seeking virtual offices and touchdown locations in China, Hong Kong SAR and Singapore.

With these structural shifts and the rapidly changing external environment, the adoption of a hub-and-spoke model and greater use of flexible space in "core + flex" solutions[4] is gaining traction among occupiers as they build more flexibility into their corporate real estate portfolios.

With the situation remaining fluid and the duration of the pandemic still uncertain, occupiers are waiting-and-watching for opportune moments to obtain attractive terms for memberships and space in flexible space centres. Occupiers may wish to consider committing to agreements that allow them the usage of entire networks of centres so that they can quickly mobilise and relocate employees if needed.

Ensuring the appropriate rights and warranties are included in membership and lease agreements will offer a certain amount of legal protection in the event of an operator experiencing financial stress. Leases should also be signed with the operator's corporate entity rather than the local special purpose vehicle.

3. Asia Pacific Occupier Flash Survey April 2020
4. A "Core + Flex" solution consists of a long-term lease with a traditional landlord for core space combined with different solutions to achieve agility, such as remote working, flexible space, workplace design and optionality in lease structures.

THE LANDLORD RESPONSE

Landlord sentiment towards flexible space operators began to turn cautious in 2019 due to a range of factors including perceived over-expansion. More landlords now are balancing the optimal number of operators in their portfolios and stringently evaluating the profitability, product offering, operational health and customer feedback of individual operators before accepting them as tenants.

Nonetheless, landlords recognise that real estate agility is a long-term trend. Occupiers are increasingly seeking real estate agility by leveraging flexible space or optionality in contracts due to the uncertain operating environment and the aforementioned long term structural shifts.

As discussed in CBRE's "The Hotelisation of Office Space - New Approaches to Future-proofing Commercial Portfolios" report, this will require landlords to adopt a more proactive approach and take on a service-oriented role. The coming years will also see an increasing number of landlords entering into management agreements and hybrid-type approaches with flexible space operators.

Those landlords lacking the expertise to run these spaces could design and fit out the space themselves but then enter into fee-paying management agreements with experienced operators – thereby limiting their exposure to leasing risk.

Landlords who are reluctant to increase their short-term exposure to flexible space tenants are likely to create and operate their own flexible space platforms as an amenity and component of their overall portfolios. CBRE's conversations with a number of leading landlords in major Asia Pacific markets prior to COVID-19 indicated that a majority expect most buildings in their portfolios to have some kind of flexible office component in future. This structural change is likely to accelerate in the COVID-19 era.

CBRE's 2018 Investor Intentions Survey found that allocating around 20% of an office building to flexible space can enhance its value. While each building must be considered on a case by case basis, any proportion over this amount is likely to involve a discounted valuation – a hypothesis supported by CBRE's recent discussions with lending institutions.

Progressive landlords therefore intend to position flexible space as a core – but optimally proportioned - component of new office developments when they look to provide tenants with their desired "core + flex" solution.

CONCLUSION

Although the COVID-19 pandemic will put the brakes on aggressive operator growth and usher in a phase of consolidation in what is an already crowded marketplace, the flexible space market remains resilient.

The long-term drivers of flexible space demand are intact, with smaller users continuing to seek cost effective fully furnished space and large multinationals looking to build more agility into their office portfolio. However, there will inevitably be some failures among operators.

Larger occupiers seeking to maximise real estate portfolio agility can embed options in lease contracts, adopt a hub-and-spoke model to ensure locational dexterity and make greater use of flexible space and workplace design solutions.

Should this approach gain traction in the medium to long-term, large occupiers could end up utilising a mixture of leased space, flexible space and remote-working. This model would consist of a core office in a traditional office district combined with several satellite offices providing ‘drop in’ flex space across different business districts and fringe areas for office-based staff to use at a time of their choosing.

CBRE GLOBAL RESEARCH

This report was prepared by CBRE Asia Pacific Research Team, which forms part of CBRE Global Research – a network of preeminent researchers who collaborate to provide real estate market research and econometric forecasting to real estate investors and occupiers around the globe.

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