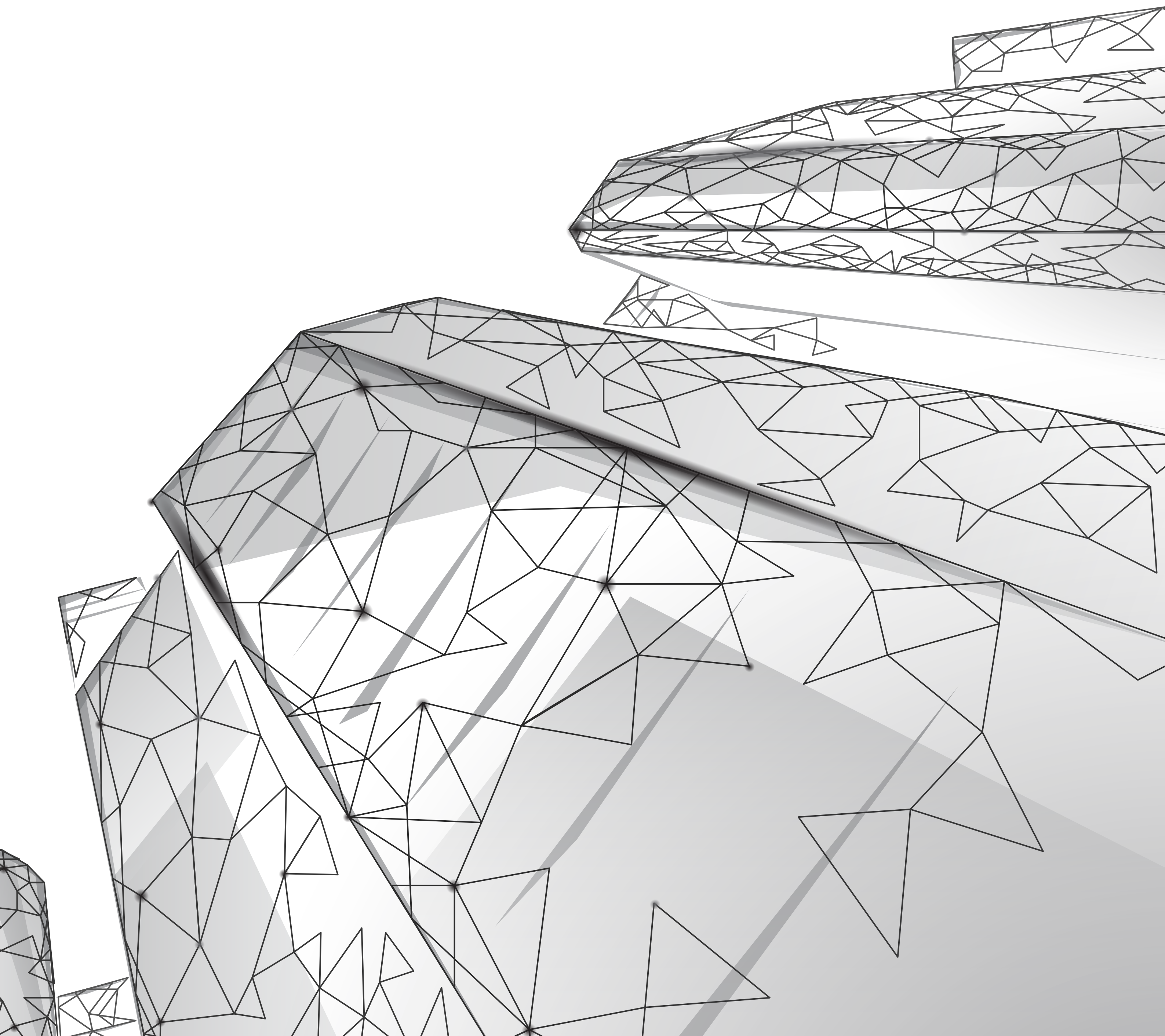
trowers & hamlins

THE FUTURE OF WORKPLACE INVESTMENT

How innovative investors are seizing the opportunities



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"I don't know what the future of work looks like over the next ten years, but I am here to find out and to facilitate the revolution"

Enrico Sanna, Fora

Foreword

In the past, investors have been able to put their money in safe commercial stock and expect a solid return. The rise in profile of co-working and flexible workspaces, and occupier demand for more fluidity, means landlords are having to do more to keep up with the competition.

Forward-thinking investors are seeing the value in taking greater risks and managing their assets creatively, through innovative design, better amenity, services and connectivity, flexible leasing and branding buildings to attract the best occupiers – who can then win and keep the best talent.

What do you need to do to keep pace with the workplace revolution? Will our existing office stock get left behind? Where are the opportunities for investors? Paul Norman, Editor of CoStar, chaired a gathering of leaders from the world of real estate to discuss The Future of Offices. This report captures some of the highlights, along with data from CoStar to set the scene and viewpoints from the coalface.

If you are an investor, developer, operator or innovator in the world of workplaces, and would like to be involved in future events and discussions, please get in touch.

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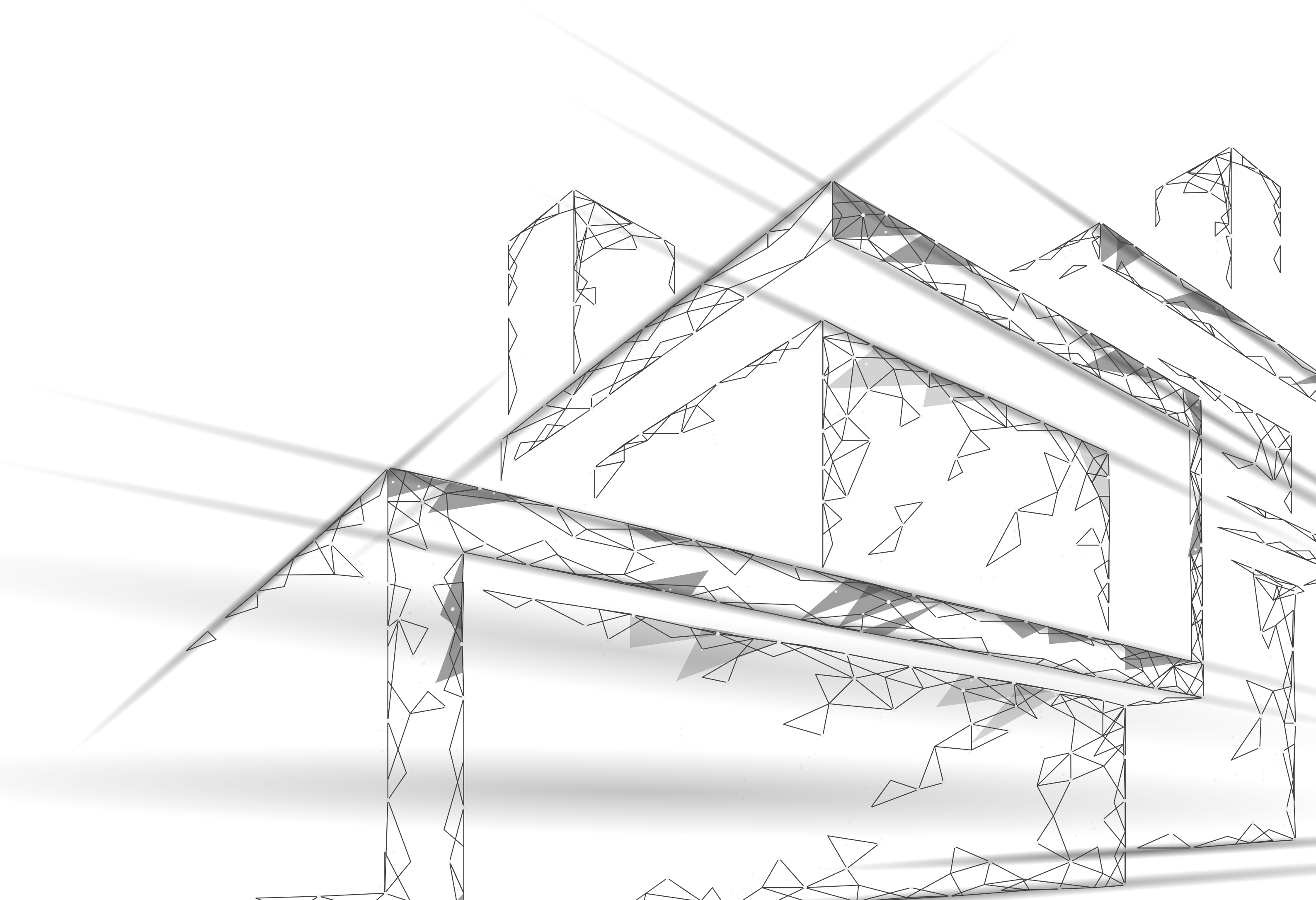


CoStar data forecast 2019

To set the scene at a national level, this is the story in terms of supply, demand and vacancy across the whole of UK offices. It's a really positive story if you're a holder of a UK office asset. National vacancies have plummeted to cyclical lows, standing at just under 6% at the end of 2018, following another strong year of demand and a fairly weak supply. If we look at the forecast, supply is expected to ramp up, but vacancies are expected to remain fairly low compared to historic levels and it's worth noting that most of the supply set to deliver this year is in London. In fact, it will be London's busiest year for new supply since 2003.

Drilling down to a market level, there has been strong demand for prime space driving net absorption in the big cities. Figure 1 ranks UK markets by the amount of four and five Star (prime) office space that has been absorbed over the last 12 months. It has been a very strong year for London, but also for Leeds, Manchester, Berkshire and North Hampshire, Birmingham and Glasgow, where tenants have taken the opportunity to upgrade or expand into some of the new space that has been delivered.

A couple of other themes have stood out. Net absorption, especially in London, continues to be driven by the Technology, Media and Telecom (TMT) sector. And of course a standout theme in London has been the meteoric rise of co-working (or serviced offices). Although serviced office leasing did fall in 2018 from 2017's record high, at more than 2 million square feet it was still the second-strongest year on record. Despite WeWork taking less space than in 2017, the firm have still cemented their position as the top holder of office space in London at just over 3 million square feet, with more deals likely in 2019.

There are the knock-on impacts to this burgeoning trend that we have noticed in our data. One is a rise in vacancy in smaller buildings, with many SMEs and start-ups (particularly in the TMT sector) gravitating towards WeWork-type space at the expense of signing more conventional deals in smaller buildings, which they may have done five or ten years ago. Figure 2 looks at availability rates in buildings of less than 20,000 sq ft in central London (about 80% of buildings by number), so there are lots of landlords being impacted. Since WeWork first took space at the end of 2014 the availability rate has nearly doubled. Whilst still fairly low, this is something for landlords and owners of these buildings to monitor – customer care and flexible lease terms will increasingly be the way forward.

Figure 1. Prime space in-demand in London, Leeds and Manchester

Annual Net Absorption Rankings by Market (4 & 5 Star)										
Market	Asset Value	Vacancy Rate	Availability Rate	Market Rent/ sq ft	Annual Rent Growth	Inventory sq ft	12 Month Delivered sq ft	Under Construction sq ft	Under Construction % of Inventory	12 Month Net Absorption sq ft ↓
London	£251 b	6.70%	10.4%	£55.85	-2.3%	211 m	4.7 m	13.6 m	6.5%	5.4 m
Leeds	£1.6 b	10.0%	14.4%	£24.55	-1.8%	5.3 m	265 k	552 k	10.4%	774 k
Manchester	£5.7 b	11.6%	23.1%	£25.51	1.3%	12.8 m	359 k	2 m	15.3%	701 k
Berkshire & North Hampshire	£4.6 b	15.1%	19.9%	£29.20	4.1%	12.7 m	160 k	19.2 k	0.2%	674 k
Birmingham	£3.8 b	8.0%	17.7%	£23.95	1.1%	11 m	236 k	1.5 m	13.7%	612 k
Glasgow	£3.1b	16.1%	16.7%	£20.01	-3.4%	8.7 m	186 k	780 k	9.0%	597 k
Surrey	£2.3 b	12.5%	16.4%	£29.85	0.9%	5.6 m	227 k	86.9 k	1.5%	435 k
Cardiff	£1.1 b	7.1%	10.3%	£19.60	7.4%	3.5 m	404 k	363 k	10.3%	340 k
Hertfordshire	£967 m	2.3%	3.7%	£25.31	2.3%	3.1 m	32.2 k	0	0%	185 k
Shropshire & Staffordshire	£256 m	5.7%	7.6%	£12.31	-2.8%	1.4 m	0	0	0%	150 k
Oxford	£455 m	8.4%	9.0%	£28.72	0.1%	1.3 m	199 k	0	0%	132 k

Figure 2. Serviced office leasing in London

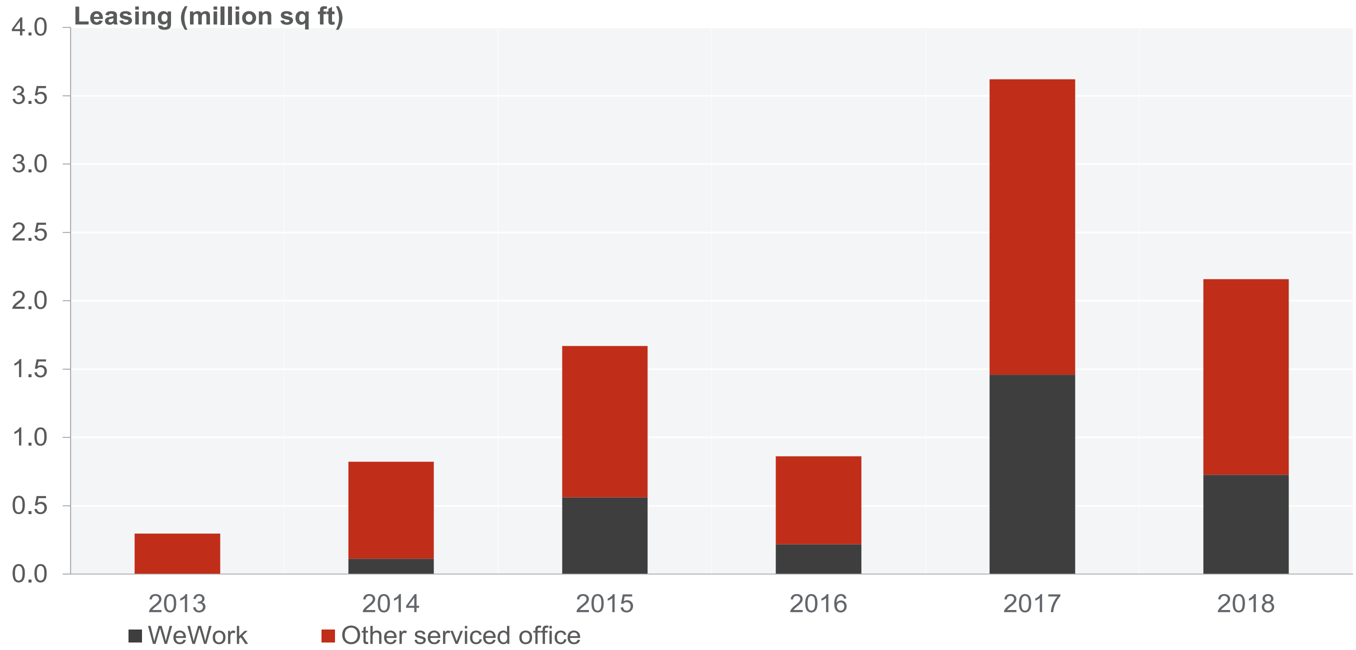
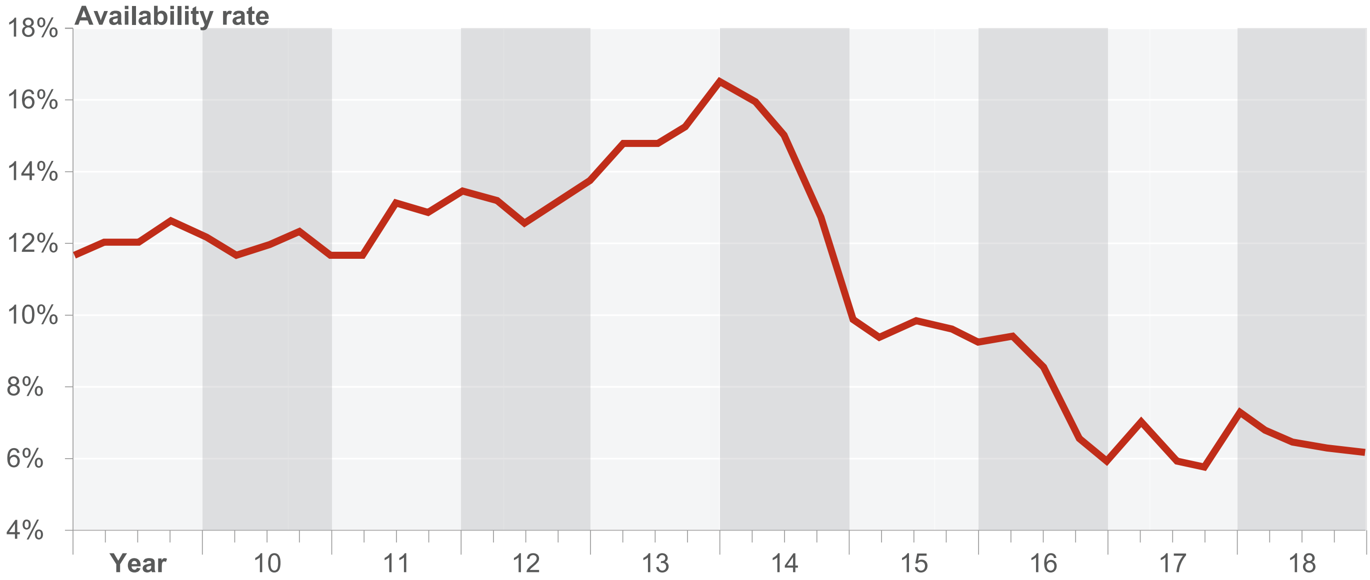
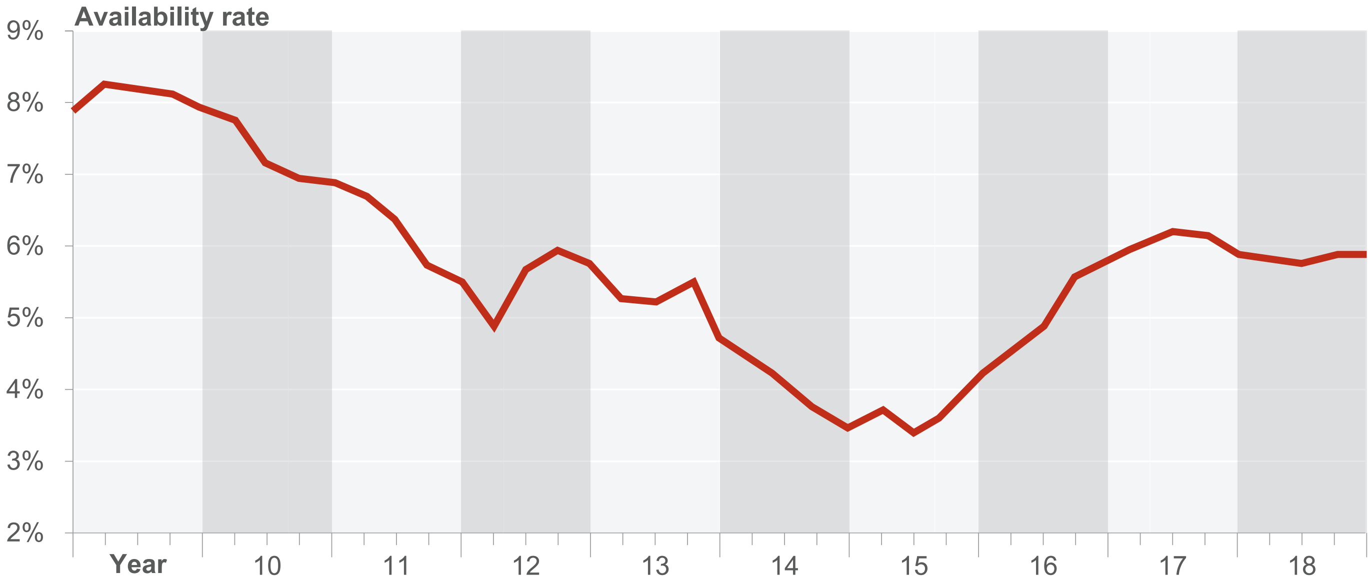


Figure 3. Central Manchester office availability rate in buildings < 20,000 sq ft



Moving out to the regions, serviced office take-up fell in London last year but it held up well in the regions, with around 0.5 million sq ft matching the levels recorded in 2017. Serviced office leasing in the regions as a proportion of all UK serviced office leasing rose sharply in 2018, to just above 25%. Manchester has been a key target. WeWork took the first two spaces outside of London in Manchester towards the end of 2017, with many other providers also in expansion mode. Spaces signed one of Manchester's largest lease deals last year, taking just over 80,000 sq ft at Peter House. Spaces is also expanding into other big cities like Birmingham, Glasgow and Aberdeen. However, the vacancy impact on smaller buildings that we have seen in London has not yet been visible in Manchester. The availability rate has not increased within this subset, so perhaps the abundance of tech firms has not yet reached that critical mass to have an impact on the wider market there.

Figure 4. Central London office availability rate in buildings < 20,000 sq ft



Source: CoStar UK

Key themes

The three overarching conclusions from the Towers & Hamlins Future of Offices round table were:

- The need to adapt to change – in particular the way properties are valued.
- No one size fits all – whether you are an occupier, investor or operator.
- The difficulty of predicting the future of the workplace in an age of fast-changing technology.

The language in the market, meanwhile, has evolved. Office space has become ‘workspace’, and tenants are ‘customers’.

A fresh lens for valuation

- The valuation matrix needs to change; it is still biased towards a long lease to the institutional investor.
- Switch your mindset as to what strength of covenant looks like. For example, 19 years ago Google would not have been seen as having strength of covenant.

Workspace as a people business

- Take care of all your customers’ employees; not just the decision makers. The workspace market is a people business.
- Keep up with trends, as trends “change hearts”. All trends – property, business, technology, environmental, social and consumer.
- Change your business model to allow your customers’ business to thrive.
- A full understanding of your customers’ needs requires extra resources – both money and people.

New boundaries for workspace

- With the advance of AI and automation, space will increasingly be about providing employees with an environment to be creative and insightful.
- A creative working environment requires high capital expenditure, to bring a fresh, on-trend look and feel.
- It’s all about offering a high level of service and a flexible space – a space that creates a feeling of community and wellbeing.
- What else does the customer need? Privacy and confidentiality? Room to express their corporate identity?
- Ask yourself, how can I use building performance data for the benefit of my customer’s business? And for my business?
- As the market grows, co-working operators are specialising. For example, with the offer of women-only workspaces.

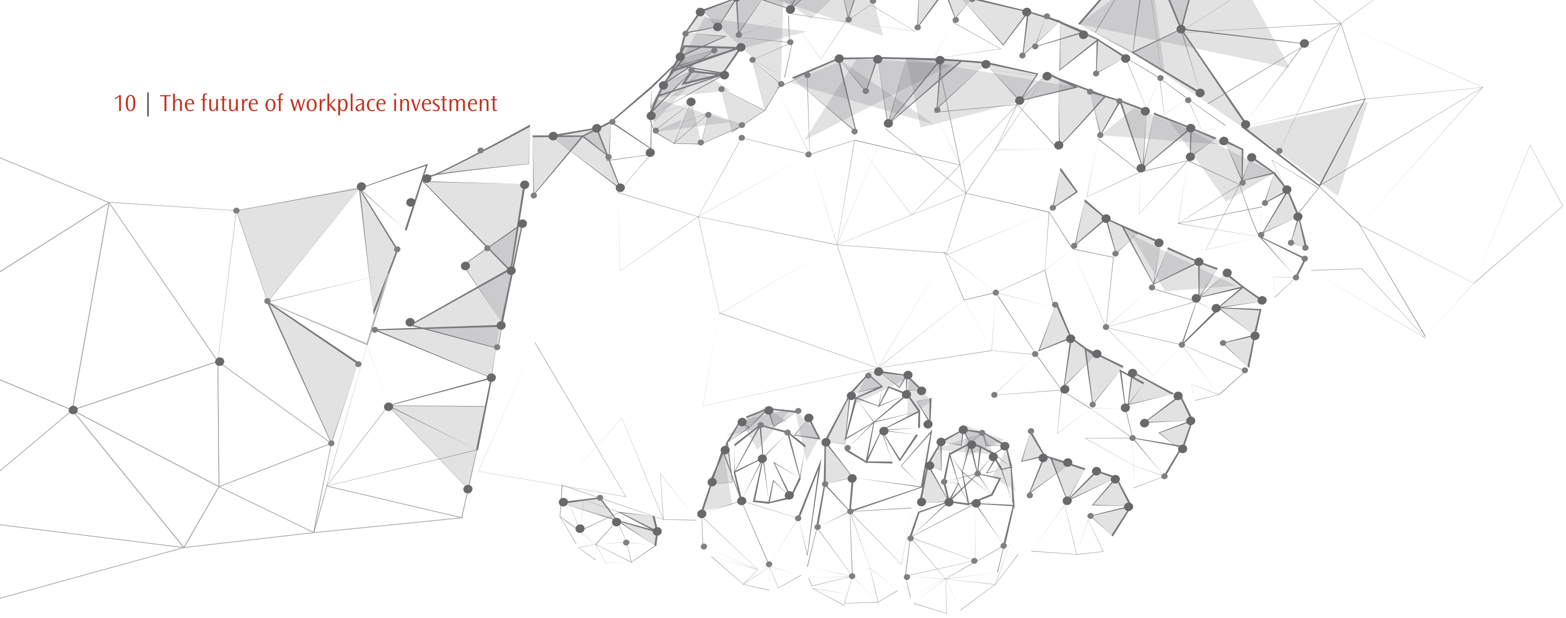
Other takeaways included:

The centre of gravity is shifting across the UK

- The regions accounted for a quarter of co-working space take-up in the UK last year, according to CoStar.
- Apart from London, the big five markets for 2018 were Leeds, Manchester, Berkshire/North Hampshire, Birmingham and Glasgow.

Do I partner with a co-working operator or do I do it myself?

- Consider setting up a partnership with a co-working operator. They have the experience and the reputation.
- If you decide that you have the scale to set up your own operator team, look at transferring in-house skills and expertise, such as from residential and hospitality teams.
- Remember, no one size fits all.



The Future of Offices roundtable

Attendees

CoStar	Paul Norman – Editor (Chair)
Trowers & Hamlins	Sara Bailey – Partner, Head of Real Estate Yvette Bryan – Partner Adrian Leavey – Partner, Head of Commercial Real Estate
Co.lab Workplace Advisory	Carissa Kilgour – Founder
Deloitte	Chris Robinson – Corporate Real Estate Adviser
Fora	Enrico Sanna – Co-Founder and CEO
The Howard de Walden Estate	Andrew Hynard – Chief Executive
Knight Frank Investment Management	Kevin Aitchison – CEO
Legal & General Investment Management	Bill Hughes – Head of Real Assets
M&G Real Estate	Sam Jones – Asset Manager
Mayfair Capital	Frances Spence – Head of Research, Investment Strategy and Risk
Oxford Properties	Chris Carter Keall – Managing Director
PGIM	Nick Kilbey – Executive Director
Tesco Pension Investment	David Russell-Smith – Fund Manager
Tuffin Ferraby Taylor LLP (TFT)	Alistair Allison – Executive Partner









Themes and ideas from the roundtable: Space for investor opportunity

You don't have to predict change, but you do need to "jump all over it", wrote legendary CEO Jack Welch back in 2000. Welch saw change as opportunity. Today, as the new technologies of the Fourth Industrial Revolution unfurl, opportunities abound – not least in the commercial property sector.

The rise of the co-working space

A key focus of the debate was the rapid rise of the 'creative' working environment – the co-working space, with its flexible leases, service levels akin to the hospitality sector, strong design of spaces, community feel, and, let it be added, higher capital expenditure.

"The rise of the co-working space opens up a huge potential for investors as returns are potentially much higher than for a traditional office building," says Sara Bailey, Partner and Head of Real Estate, Trowers & Hamlins.

Such working styles have also coined their own lexicon. Office space becomes 'workspace'; tenants become 'customers', 'residents' or 'members'; and the work/life balance is now the work/life blend.

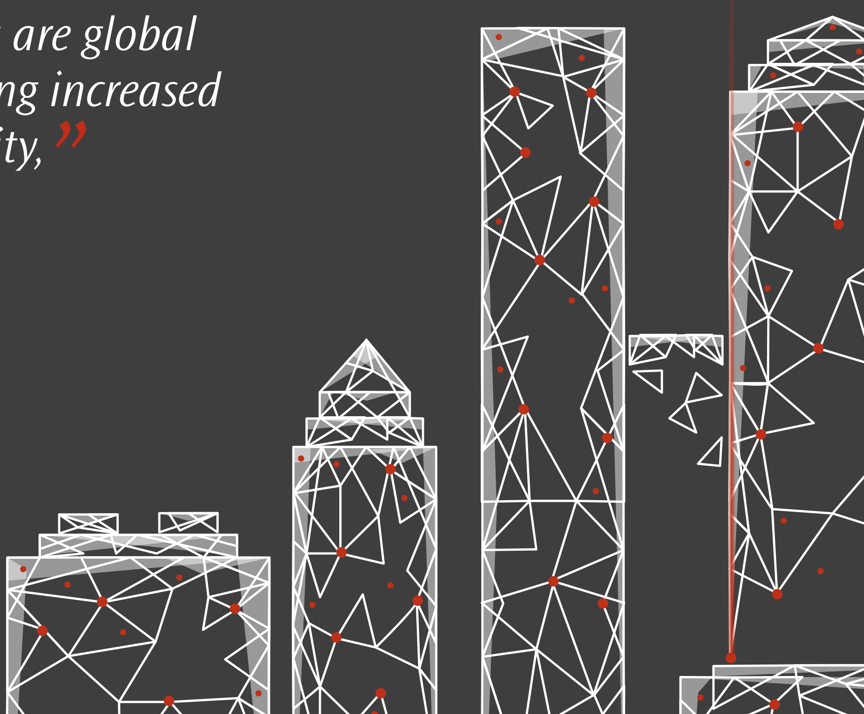
Technology and social trends are shaping space

As the more mundane roles and jobs become at risk from automation, office space will be increasingly about providing start-ups and companies of all sizes with an environment to allow for the flourishing of their employees' creativity and insight.

Carissa Kilgour, Founder, Co.lab Workplace Advisory, added that social trends on the corporate agenda, such as gender equality and workplace inclusion, were also impacting the way office space was conceived and designed.

Chris Carter Keall, Managing Director, Oxford Properties Group, summed up by saying that it was about listening to the customers, and what customers wanted was changing. He said:

> *"Over 80% of our customers are global occupiers, and they are seeking increased service and increased flexibility,"*



It all started with WeWork

Shared work spaces have existed in London in one form or another since the advent of coffee houses in the 15th century and the creation of members' clubs, but US operator WeWork – now the biggest corporate occupier in Central London – has dramatically changed the scale, nature and accessibility to these spaces.

Since opening its doors in London in 2014 WeWork has sold itself on providing 'creators' with a platform of 'space, community and services' – where lifestyle and social community meets the workplace. At the same time, the operator collects data so as to tailor its workspaces for customer demand.

Since WeWork's arrival in the UK, a whole stable of competing operators have opened up in the UK market. Manchester alone has 11 different operators, according to CoStar.

In London and the South East, a leading operator is Fora, whose CEO & Founder, Enrico Sanna, took part in The Future of Offices roundtable. Backed by Brockton Capital, Fora sees itself as a 'pro-working' operator. As Enrico explained:

> *“This is a people business: for the people, by the people.”*

Not just a London phenomenon

As the trend spreads across the UK, co-working accounted for a quarter of office take-up outside London last year, according to CoStar. Leeds had the top take-up for co-working space in 2018, followed by Manchester, Berkshire/North Hampshire, Birmingham and Glasgow, revealed data from CoStar specially collated for The Future of Offices.

> *“Just building in a town centre is not going to cut it any more. Tenants are consistently advancing the ways in which they occupy [M&G's] buildings, and we have to create a flexible and adaptable product”*
>
> Sam Jones, Asset Manager, M&G Real Estate.

What modern workspaces are all about

What does the new workspace model look like? Is it offices? It is hospitality? Is it residential? Is it a members' club? The answer is that modern workspace can feel like all four. It's a work/life blend rather than a work/life balance. The space offers:

- **Flexibility:** In terms of the lease length and the space provided.

> *“Even when taking individual leases on different floors, we are still being asked to take the very traditional institutional type leases. I might not want those floors for the next 10 or 15 years. How does that work? We are not getting those offers.”*
>
> Sara Bailey, Trowers & Hamlins

- **Communal areas:** more space given over to communal activities, whether restaurants, cafés, personal training, reading rooms, ping-pong, bike storage or outside space with benches. For example, the chef behind 1 Lombard Street has opened Borealis restaurant at Fora's Borough workspace.

> *“Over the past 5-10 years, the trend in office design has been towards maximising the occupational density. We are now seeing larger areas of offices given over to activity-based space, such as for collaboration, creativity, concentration, while traditional desking arrangements are reduced due to agile working and the need to provide amenities for a diverse workforce where talent is key.”*
>
> Alistair Allison, TFT

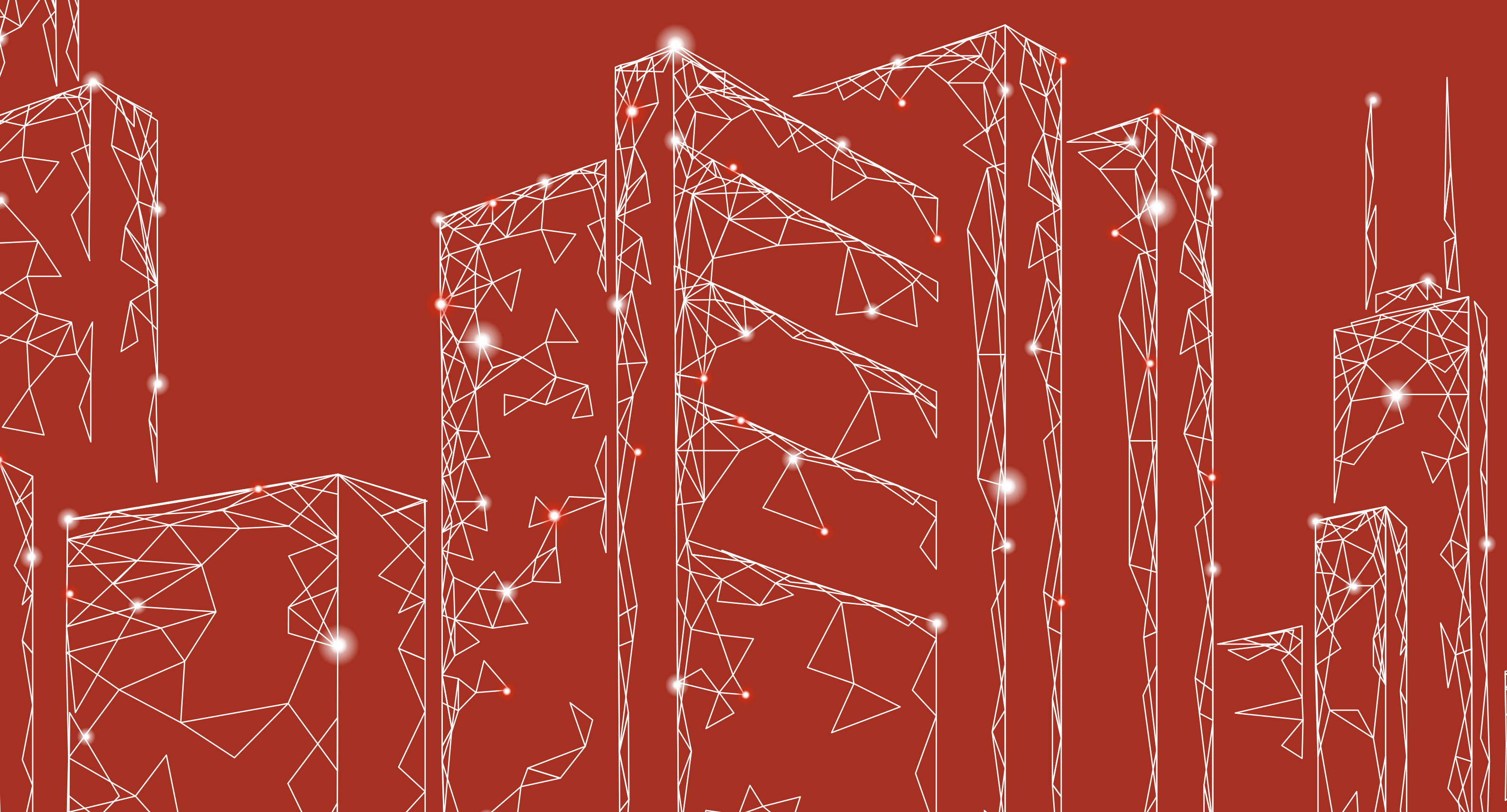
- **Customer service:** for all employees, not just the decision-makers. "Today, the employees have a vote, which was not the case in the past. They need to be taken care of just as much as the decision makers," explained Enrico Sanna of Fora.
- **Data:** the use of building performance data, such as energy performance, for the benefit of the customers' business and the business of the operator/investor.
- **Capital expenditure:** top customer service, on-trend fixtures and fittings, and a home-to-home environment require high capital expenditure.
- **Community and wellbeing:** it's all about enhancing the social and physical sense of wellbeing, whether through community activities and networks, or the building's performance.

"Community is a really important word. We are looking at what we can do to build a community feel. How do we create an inclusive environment for people? Is it somewhere people want to go?"

Frances Spence, Mayfair Capital

"Our customers are looking to us for our ESG policy, with the 'S' in ESG standing for 'social'. That is becoming an increasingly important part of what we do – and co-working is one way of doing that."

David Russell-Smith, Tesco Pension Investment



Calls for a new valuation model

Under the current valuation system, a long lease with a strong covenant was worth a lot more than the flexible, short leases of co-working, said Kevin Aitchison, CEO, Knight Frank Investment Management. "The world is changing, and that has to be reflected in valuations," he added.

For investors, valuing income over a three-year term was very different from valuing over a 15-year term, said Nick Kilbey, Executive Director, PGIM. "The serviced office operator has an opportunity to add significant value to occupiers, which should make co-working accommodation more attractive to investors, but the investment market does not appear to be accepting this value enhancement yet."

> *"The revolution that we are seeing at the moment is a reaction to the fact that [the market] had become totally inert for so long, standing behind the traditional lease"*
>
> Bill Hughes, Legal & General Investment Management

In terms of financing, Nick Kilbey, Executive Director, PGIM, said: "The next few years will be very, very interesting for financing. You have so many more co-working players coming into the market. The big question is how quickly the trend will move in tandem with how we are working, and how operators will shape their offering to make the financing proposition more attractive and secure for lenders."

The benefits of workplace transformation

Yvette Bryan, Partner, Towers & Hamlins, referred to an Asian investor client who acquired a high-value City of London office let under an institutional lease to a single tenant law firm. "The law firm unfortunately became insolvent, effectively forcing our client to radically change its approach and to embark on an ambitious refurbishment programme to make the building suitable for multi-let," said Yvette.

The refurbishment has now been completed, along with a rebranding; a new gym; shower, cycle and storage facilities; a new food and beverage outlet; and the implementation of an intelligent online platform for tenants.

"It was not an asset that the client would have looked at two years ago," Yvette added. "Now the building competes so much better in the market than if it had been left and then re-let down the line. This highlights the opportunity for investors who are not yet active asset managers, and who are starting to see potential opportunities that before were not available."

> *"As an industry, we need to start to better articulate and, importantly, quantify the benefits of workplace transformation"*
>
> Chris Robinson, Deloitte

To partner or not to partner? The big question

What scale do you need to have your own operator team? That was the big question around the table.

Reference was made to British Land as a best-practice example of a landlord offering an attractive and inclusive 'placemaking' approach to its asset management service for office occupiers – yes, British Land calls them 'occupiers' (not 'customers') and their office schemes are 'campuses'.

Being an operator in co-working space requires a different set of skills and expertise than the traditional office let. Fora team members, for example, train at L'École Hôtelière de Lausanne, one of the most famous hospitality schools in the world. At the Howard de Walden Estate, Andrew Hynard pointed out that they were using some of the customer engagement skills from their residential team in their operating model for office occupiers.

Chris Carter Keall, Managing Director, Oxford Properties Group, pointed out: "Our key challenge at the moment is how we put 'service' alongside the relationships we have with our customers. Fundamentally we are investors. Our customers are seeking services and we're not necessarily operators that can deliver all those services. What we really need is joint ventures, with partners who can deliver service, without losing those relationships with our customers."

"The power is with the occupier. Today, occupiers have more choices of how, when and where they use space. We are all letting the constraints of the traditional industry hold us back. Landlords have an opportunity to add more value to their customers – but they have to move across the line, and they have to start building out spaces in their entirety for their customers" – Carissa Kilgour, Co.lab Workplace Advisory

An increasingly diverse market

As the co-working market expands, operators are starting to diversify their offer. Fora, for example, has female-only workspaces. Not all occupiers, meanwhile, want to work in a glass bowl or in open plan. Some 'customers' look for privacy; others, with a strong corporate identity, want a space that they can make their own.

Currently, the market is still relatively small, accounting for around 5-6% of all office stock in London. "But over time," says Enrico Sanna of Fora, "if the capital markets sustain us, we will become very large."

No one size fits all

There was agreement around the table that there would always be a demand for the traditional, long lease, especially for the larger occupier with a strong corporate identity, and a need for privacy and confidentiality.

"It is about retention; if we are good at what we do, we effectively turn a short lease into a long lease" – Bill Hughes, Legal & General Investment Management

What we don't know is where the Fourth Industrial Revolution and the world of work will take us. In a report released last summer, PwC predicts that automation will create as many jobs as it displaces in the UK by boosting economic growth. That is yet to be seen.

"What cannot be denied," says Sara Bailey of Trowers & Hamlins, "is how the likes of WeWork have come in and disrupted the market. We now need to be prepared to see where the world of work will take us next."

To finish with a few words from Jack Welch, legendary Chairman and CEO of General Electric: "When the rate of change inside an institution becomes slower than the rate of change outside, the end is near." The one thing certain is the need for change!

The investor viewpoint

Sam Jones, Asset Manager, M&G Investments

As institutional landlords, we must not lose sight of supplying the best possible product to our core customers – occupiers seeking long term real estate solutions.

Flexible workspace accounts for a relatively small share of the total office market despite the strong recent shift towards flexibility and optionality and the fact that occupier needs are clearly changing.

Our focus at M&G Real Estate is to ensure that our investments are resilient to these changes in demand across sectors and that property, as our product, is appropriately and innovatively designed and managed.

Our role at M&G Real Estate is to provide office space that helps occupiers retain staff – a major concern for many companies with unemployment at a record low. We can achieve this through building specifications and design, but also by providing high quality amenities and service levels. No longer will tenants accept an uninteresting, poorly considered office space in which to operate – we consider ourselves partners in delivering the right space for their workforce.

Creating a sense of place and a belonging in buildings helps enormously, however it is important to acknowledge that the majority of our occupiers have a strong desire for a building to enhance their brand – not to dilute it.

By providing desirable workplaces with appropriate amenities and a high level of service, we will keep occupancy voids at a minimum in today's competitive marketplace.

Central Square, the largest speculative office scheme to open in Leeds, is part of our 7.8 million sq ft UK office portfolio and is a prime example of the modern, flexible and amenity-rich accommodation that we seek to provide. A public square and an internal winter garden provide informal environments to work, rest and meet. These spaces are utilised collaboratively by the occupier community with activities such as yoga and running clubs on offer. This provision has clearly appealed to the market and the building is now fully let.

Fast-changing technology certainly makes it challenging to predict and prepare for the future of the workplace. New technology needs to prove itself over time, and there needs to be the market demand for it. Keeping a close eye on technological advances and the opportunities they present is a key part of what we do. In five to ten years' time, I am confident that we will see technological advances in construction and property management as we continue to meet occupier demands with our proactive and responsive strategy.

Ultimately, our focus must be to maintain a diverse mix of occupiers and deliver workspace that functions flexibly whilst meeting the bespoke requirements of long-term occupiers. Developing structures that are adaptable to varying needs and resilient to market changes ensures our office portfolio will remain attractive to a greater pool of potential occupiers, whilst maintaining low vacancy rates.

Fora offices, Borough

The operator viewpoint

Enrico Sanna, CEO and co-founder of Fora

My view is there are two customers in this sector. There is the guy that everybody tends to refer to in the real estate world – the decision-maker, who is going to take the lead and the responsibility for the office lease along with everything else. This is usually the head of real estate, or in some cases human resources, or the CEO, depending on the type of company. Then there are the employees who, unlike in the past, have a real vote today. I see this as a big misconception of the workspace world as these people, the employees, must be valued just as much as the decision-makers. I worked in investment banking for 10 years, so I have spent quite a lot of time with operating assets and the hotel industry in particular, and I see a lot of similarities with the office industry.

Fundamentally, I do not think that anyone knows how the workplace will be in 10 years, yet Fora is looking to lead these conversations to create the best possible work environment for our Residents (our clients who occupy Fora). We lead by working much harder in order to anticipate the needs of our customers. Not only the needs of the decision maker but the needs of all employees. The difference between a co-working operator like Fora and a traditional landlord is that we do not have the luxury of five-year rental reviews and long-term leases. We have to be on top of our game and show value to our customer every day, or they won't see the value in our proposition and will ultimately leave us. Today, it is about more than a base product and the added amenities, the amenity card has already been played. It is not just about flexibility either, as Regus has been around for 30 years and we have already seen an element of flexibility in the market, so it is much more about understanding the actual day-to-day experience in a workspace. Investing in this kind of understanding requires tools and analysis, first-hand experience, and a real appreciation of customer service. However, the real key to success is our people. Our business is a people business. It is for the people (our Residents), by the people (our employees).

It is not something you achieve by just putting a welcoming concierge at the front desk, although this is also important. You have got to spend the effort and time to figure out what it is that makes people appreciate your space. This takes time, resources, and great people. This has been our approach and it is an evolving issue. Communal areas, amenities and other physical elements are important but there is so much more. For example, how do you help the community come together and feel comfortable in a shared space? At Fora we spend a lot of time thinking about this, and as a result we have a very appreciative customer base. Fora's Net Promoter Score (NPS) is way above anything that I have seen when working in the hotel industry. We take care of everybody as a client, not just the guy who signs the cheque at the end of the month and that focus enables us to continue to adapt. So, I don't pretend to have every answer when it comes to how the workspace will look and operate in 10 years, but we are doing everything we can to figure it out.

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