European Commercial - Autumn 2022

SPOTLIGHT
Savills Research

European Flex Offices

savills

● Market dynamics ● Investor sentiment ● Flex outlook

Foreword

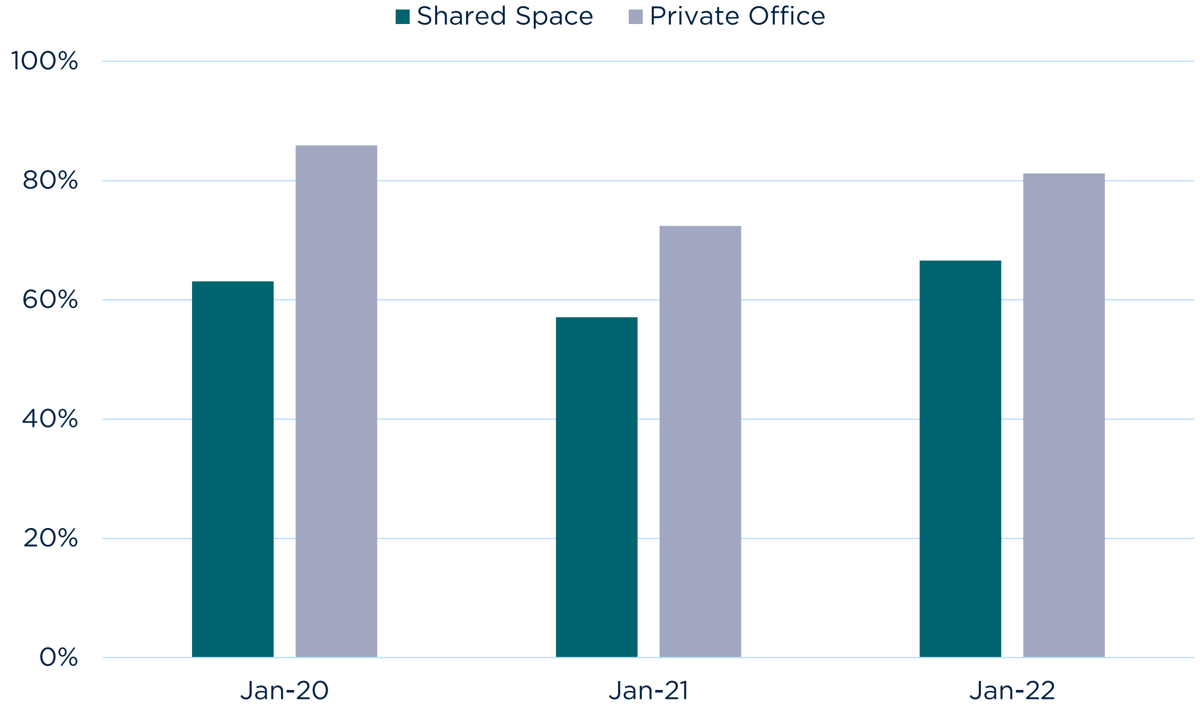
A series of global supply chain shocks continues to cloud the macroeconomic outlook, however changing occupiers demands on how office space is best used will continue to heighten the flex sector's appeal to landlords.

This recovery of the flex office sector has been most apparent by rising occupancy levels in flex space. According to the latest Flexmark report, flex contract occupancy rates are back to pre-pandemic levels of over 80% in private offices and over 65% for shared space. Meanwhile, Savills June 2022 European occupancy analysis of conventional office space reached an average of 43%. Although this marks a recovery, this is significantly down on the circa 70% levels prior to the pandemic.

Flex operators are thus able to charge higher prices for private office desks, as recorded by an average 9% increase over the past 12 months in Europe (above the 4.3% increase in conventional office rents), which has led 82% of European flex operators to report an operating profit over the same period.

After all, in a record low unemployment market, businesses must ensure that their real estate appeals in order to attract and retain staff. Employers are searching for the optimum balance in their work from home (WFH) policies with most employees seeking flexibility in terms of WFH and office days. Elon Musk has stated his expectation for all Tesla employees to return to the office full time; Apple has mandated employees to attend the office three times a week and Goldman Sachs and Morgan Stanley have instructed employees to return full time.

Chart 1: European flex office contract occupancy rates



Source: Workthere

Why opt for flex?

So why are businesses opting for flex space?

Flexible term length- First of all, flex offices provides companies and organisations with the option to sign a licence agreement for office space for a shorter amount of time and with more flexible lease terms and conditions than a traditional lease. This provides more adaptability given the current (economic) uncertain times allowing to trial different types of company policies regarding WFH and mandatory office days.

Flex growth has been particularly prominent in Central London, with flex take up eclipsing 20% of the total market prior to the pandemic, whereas in mainland Europe, we observed flex demand peak at 9% of total demand pre-pandemic. Despite conventional leases being typically signed for five years with a three year break option in mainland Europe against London's ten year term with five year break, businesses continue to seek space to scale up or down to cope with business growth or shrinkage.

Fitout costs- A flex model reduces occupiers' capex requirements on fit-outs when taking up new space, since flex offices typically come fully fitted out and ready to move in with limited adaptation needed. Given rising fitout costs and delays to fitout timescales on conventional leases, occupiers have opted for flex operators in order to increase the speed to occupation. We have observed some of the most resilient demand for flex space in countries where tenants tend to pay for fitout costs, including the Netherlands, Portugal, Spain and the UK.

Enhanced service offering- Flex offices are typically more modern with enhanced services and amenities, located in prime locations. With increased service requirements, businesses are becoming more willing to pay the additional rent for a fully serviced office offering, rather than procure their own facilities management teams.

Types of flex, and who is taking space?

Flexible offices come in different shapes and sizes. The table below shows the most common types of flex offices, ranging from the conventional office to the most flexible shared/co-working offices.

Traditionally, flex office occupiers have been smaller start-up companies in the tech sector. However, the Flexmark report showed a shift in occupier type post pandemic, with more corporations and larger scale-up companies active in the B2B and financial services now taking up flex office space. One of the explanations for this shift is that corporations and larger scale-up companies are looking to test the new way of working policies without locking themselves in with a conventional longer office lease, and collectively account for 39% of the total market. This is increasingly likely to impact conventional office demand for the 500-1,000 sq m lot sizes.

Table 1: Types of flexible workspace

Flex workspace type	Typical contract length	Indicative company size	Description
Co-working	Typically monthly rolling	1-4 people	Co-working is an open plan area that offers hot desks and dedicated desks to customers usually on the basis of a monthly rolling contract. The space will provide a shared break-out space. Co-working will quite often form a small part of a larger serviced office, where there are private suites and break-out spaces.
Serviced offices	3-24 months	1-200 people	Serviced offices usually provide a range of private office suites, ranging in size from 1 desk through to 200 desks, which are let on licence contract to customers on terms ranging from 3 to 24 months, and sometimes longer. Average term is usually 12 months. The serviced office will provide those customers with a shared amenity space, e.g. kitchen, break-out, meeting rooms, lounge space etc. A serviced office space might also include a co-working area within the space, usually 5-10% of total desk space.
Managed offices	2-5 years	25-500 people	Managed office space provides a self-contained suite for a business, which is fitted out with all furniture and meeting rooms and all include services such as IT, cleaning, utilities in one monthly contract. The suite includes a dedicated kitchen and break-out, therefore none of the space is shared with other companies. The occupier can usually customise the space to their own brand.
Plug & play	3-5 years	25-500 people	Similar to managed space in that it provides a self-contained unit that is fitted with furniture to allow for a company to move in immediately. The key difference is that the services are not always included and it is typically on a lease rather than licence contract.
Conventional offices	5 years +	25 people +	Space delivered to CAT A, where the tenant is required to fit out to their own design. They usually take a 5- or 10- year lease.

Source: Workthere

Flex growth in Europe

European flex office demand reached 193,000 sq m during H1 2022, in line with the levels recorded for the full year 2020 and 2021. Flex office demand accounted for 5% of take up across European cities during H1 2022, up from 3% during the pandemic, and remains on a gradual recovery to the 8-9% observed before the pandemic. Amsterdam, Paris CBD and Lisbon have been the most active flex markets over the last 18 months, however, the major German cities have generally seen lower levels of flex office demand in recent years, partly due to a more traditional working culture and more cellular office layouts, with a higher proportion of private offices in conventional space.

The flex office market in Barcelona continues to add new centres. Between during H1 2022, there were 10 deals registered, accumulating almost 20,000 sq m. Demand continues to be active, with an average size of between six and eight workstations, although medium-sized companies are increasingly looking to flex spaces as the centre of their corporate headquarters. This demand, which can range from 50 to 200 workstations, tends to be from international tech-related companies which value the flexibility of this market.

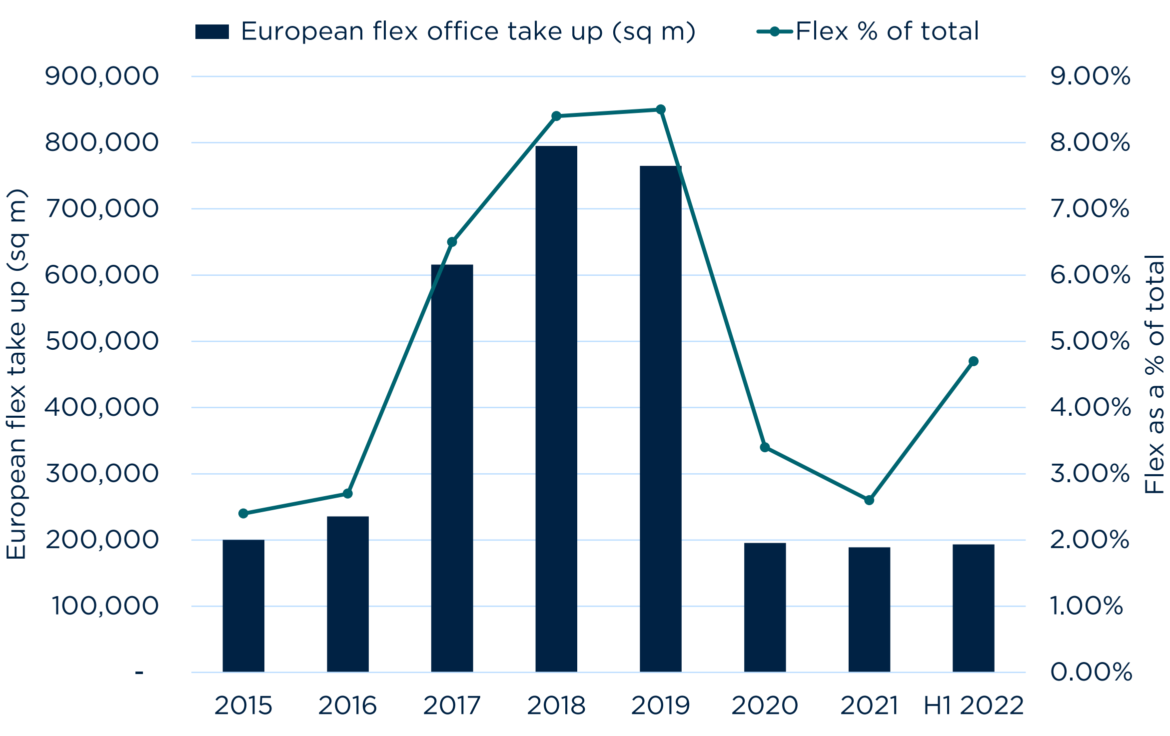
In H1 2022, flex operators already represent 5.4% of the total take-up in the Madrid office market. This is still far from the almost 11% registered in 2018 (which was the largest share in the historical series), but it is an improvement of almost one percentage point compared to 2021.

Paris CBD appears to be one of the fastest growing European hubs for flexible office operators, with 45,000 sq m of flex take up in H1 2022, 20% of the total. Deskeo, IWG and M2DG have been among the most active operators, whilst Morning have signed for five spaces so far this year in the CBD, totalling 17,000 sq m. However, over the next couple of years, we expect to see new flexible office locations in the French regional cities following a rise in new requirements.

London West End recorded no flexible office deals during H1 2022, although activity picked up in Q3 2022, with Landmark Space, X+Why and Huckletree signing for space. In the City, flex offices accounted for 7% of total activity as occupancy levels continue to recover.

In Warsaw, the increase in demand among flexible space operators during H1 2022 is clear, with deals from Brain Embassy and Loftmill. Demand

Chart 2: European flex office take up (sq m) and proportion (%)



Source: Savills Research

through the end of June was 140% higher than for the whole of last year, reaching 15,700 sq m. Furthermore, six transactions were signed, compared to seven for whole 2021. The Russia/ Ukraine conflict continues to increase business uncertainty across CEE, with many companies relocating to Poland and seeking office space on more flexible terms. Modern coworking space in Poland, despite its numerous operators, is mainly concentrated around a few major providers and the five largest operators account for 44% of the total space offered.

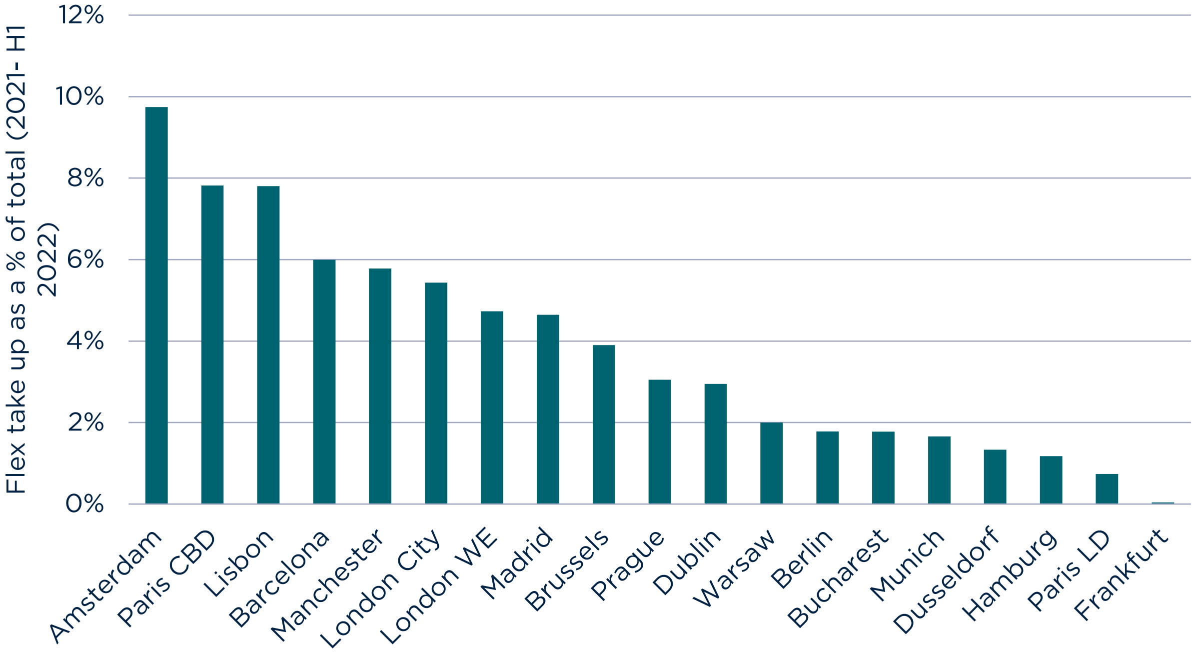
Although operators have not been as active in Prague in 2022, the landlord, Penta has implemented fitted space into their offices (branded as FLEKSI). Flex demand has not observed a significant recovery to the same speed across the major German cities, though Mindspace is set to open its sixth Berlin flex office, signing for 4,100 sq m by renovating a former department store, and will expand into Dusseldorf in 2023.

In Amsterdam, flex operator Tribes has recently signed a lease contract for 2,266 sq. m. in the FOZ building at the South-Axis district, Amsterdam, marking their eight location in the city. New requirements from operators remain strong and we anticipate positive momentum to continue.

In Stockholm, Covendum is currently the largest co-working operator, and recently signed for 7,600 sq m on Kungsgatan on a 12 year lease, whilst emerging operators including 7A now account for 32,000 sq m of flex space in the city.

In Brussels, flexible office demand exceeded 10% prior to the pandemic before slowing driven by Spaces, Fosbury & Sons and Silverquare, although in 2021, while new take-up has been more limited. Dublin's flex office demand has recovered to 7% of total take up in H1 2022, with Glandore and Regus signing leases in the city.

Chart 3: Flex as a % of take up by city (Q1 2021- Q2 2022)



Source: Savills Research

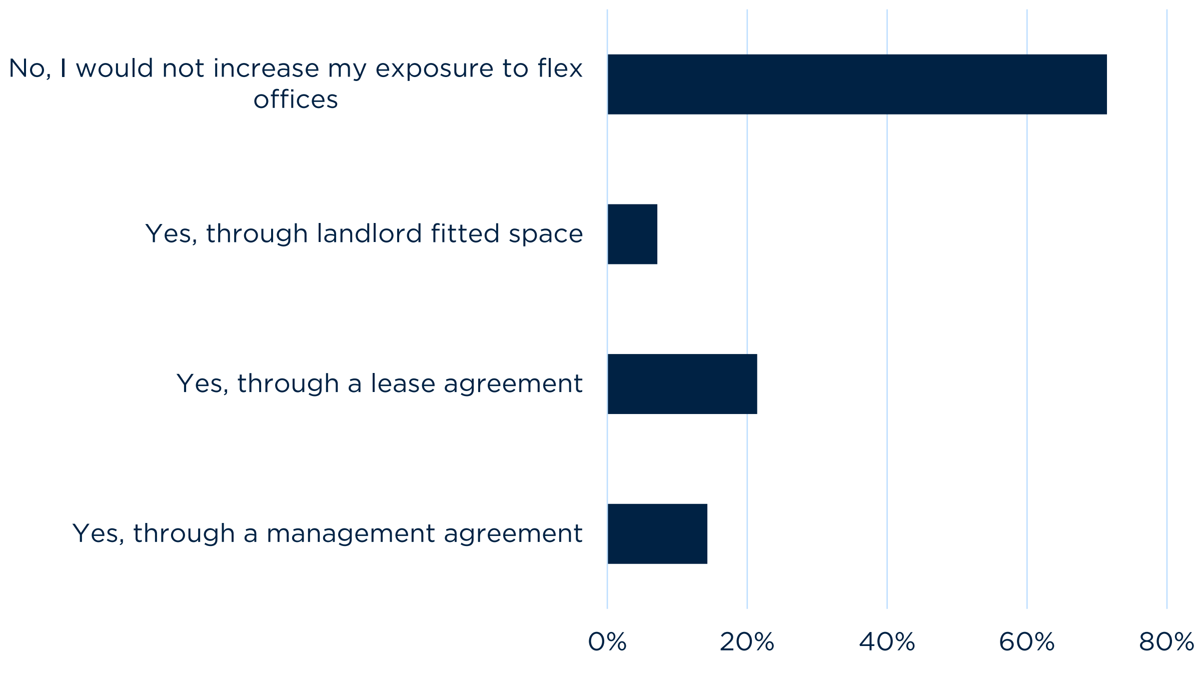
Investor sentiment to flex

Investor sentiment towards the flexible office sector remains buoyant. Savills EME Investor Sentiment Survey, Autumn 2022 indicates that 29% of investors would increase their exposure to flexible offices over the next 12 months. Landlords remain cautious regarding the increased construction and fitout costs, with only 7% looking to increase exposure through fitted space. However, 14% would register through a management agreement, and 21% through a lease agreement with an operator.

As it stands currently, only 4% of Europe's flexible office operators have a management agreement in place with the landlord, significantly below the 16% observed in the UK, according to the Flexmark.

Given the capital that is required to setup a flexible office, many providers look set to partner with landlords to reduce their risk, while landlords are able to achieve rental income at a premium to the market rate if spaces are successful. As occupancy levels have risen and operational profits rising, we anticipate more of Europe's landlords will follow the UK in adopting management agreements over the next 12 months.

Chart 4: European Investors: Would you increase your exposure to flex offices over the next 12 months?



Source: Savills EME Investor Sentiment Survey, Autumn 2022

How must flex offices adjust?

Further mainstream corporate adoption has driven a demand for greater privacy in flexible offices. Workthere's Flexmark data indicates the top five most in-demand features from flexible office **members** in Europe are phone booths (22%), internal meeting rooms (21%), extra passes for office space (15%), standing desks (11%) and collaboration space (10%). Additionally, 4% of Europe's respondents reported a need for additional vehicle charging points, a higher proportion than any other region.

Over the next five years, European flexible office **operators** expect the booking of space through online platforms as the biggest change. In order to be truly flexible, members must have the ability to book space through a platform on as close to a live basis as possible. Operators also anticipate an increase in management agreements, which have begun to gather pace, but this will only continue to grow as landlords develop more of an understanding of the nuance of these agreements and how they can benefit them. Finally in third was zero-carbon spaces, many European cities have made large commitments to reducing energy emissions and are generally further ahead than other regions in that regard. Given record high gas prices in Europe, this could also encourage workers back into offices as they try to reduce heating and powering their own homes through the winter months.

Looking forward, if employer hiring sentiment weakens, and unemployment rates begin to rise, this may reduce the total quantum of office space required. However, economic uncertainty will both help fuel demand for more flexible lease terms, and the shift to additional amenity and a widening range of working forms will support further demand for flex space. Coupled with the rising cost and timescale of fitting-out own premises, Savills anticipate flexible office take up will account for 5% of European office take up in 2023, and 6% in 2024. Over the longer term, we anticipate flex office stock will reach circa 20% of total stock, although this will vary significantly by location and working culture, as the definition of what is considered "flex" broadens.

> "Rising gas prices in Europe could also accelerate office workers back into offices as they try to reduce heating and powering their own homes through the winter months." Ed Bouterse, Head of Workthere, Europe.

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