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Real Estate

The London Business Footprint
The growth of serviced offices

A Deloitte Insight report 2015

Contents

Research definitions

Occupier data: Central London office occupiers in units of 5,000 sq ft and over as at 1st July in 2004, 2009 and 2014, comprising around 18,000 records. Data supplied by EGi. Pre-lets are included at the point where the lease was agreed. Business sectors and market areas as defined by the Deloitte Real Estate research team.

Transaction data: Deloitte Real Estate database of office space transactions from 2004. Data includes office deals of all sizes and pre-let leases. Business sectors and market areas as defined by the Deloitte Real Estate research team.

Crane Survey data: Biannual survey of all new central London office developments. It is the most accurate indicator of current office construction. For the purpose of analysis, Q3 survey period in 2014 was used.

Serviced offices:

Serviced office space is space that is leased to an operator which is subsequently rented to businesses part or whole on a contract that covers running and service costs. The data covers serviced office operators that have leased office space. It does not include the customers of the operators.

Central London market areas:

City – EC1, EC2, EC3, EC4 (excluding western fringe captured in Midtown below)
Docklands – E14
East Fringe – E1
Midtown – WC1, WC2, EC4A, EC4Y, EC1N
North Fringe – N1
Southbank – SE1
West End – W1, SW1, NW1, W2

Introduction

A growing base of operators

The London Business Footprint series is a comprehensive study of office occupation in central London from 2004 to 2014. The database Deloitte Real Estate has used for this research records more than 18,000 businesses and the office space that they use. This database has enabled us to analyse the changes in the business footprint over time.

The first report in this series highlighted the macro movements in office occupation over the past decade. These encompassed changes in the type, quality and location of office space in the central London office market. Our second report, 'The evolving financial sector' looked specifically at the industry that continues to account for the largest share of office space in central London. In both reports our analysis has identified some important trends and enabled us to consider future changes, and any impact that they may have on real estate.

This report, the third in the series, focuses on a part of the market that has seen significant growth since 2004: the serviced office sector.

The report identifies a 67% increase in the share of floorspace dedicated to serviced offices, with a growing base of operators. A number of new players who are offering a different menu of options, are now making inroads into the market.

Our research analyses this space by location, the current market dynamics and how it is likely to develop over the coming years. A number of key themes have emerged, including:

- the mature but still evolving market is becoming more acceptable for all types of businesses;
- serviced offices have become a natural choice for first-time tenants, no longer a letting of last resort;
- the changing market share of geographic locations: the City and fringe locations, like E1 have grown, while the West End market share is shrinking;
- operator concentration remains high, dominated by just ten operators;
- the growth in entrepreneurial trends and the rise of the virtual office, which lead us to predict that demand for serviced offices will continue;
- a greater understanding and acceptance of co-working space, which is expected to become the first choice for many small companies; and
- the evolution of the offering from a simple desk solution to an innovative flexible workspace, giving rise to a new breed of operators and opportunities.

Ultimately, a sector that was once seen by some as a stop-gap solution for small businesses has demonstrated that it increasingly appeals to a wide range of firms, who are attracted by the flexibility, quality of buildings and unique working environments that serviced offices can offer.

Understanding serviced offices

The world of serviced offices is complex. The following Deloitte Real Estate research aims to examine the key characteristics of the sector, how the market has evolved during the past decade and how it is likely to change over the coming ten years.

The serviced office range widens

Since its inception, the serviced office has developed both in terms of the type of space offered as well as the location. While the commonly-held definition of serviced offices as being a 'ready-to-go' space for tenants prevails, operators are now responding to changes in technology and the wider business culture by offering a very broad range of different types of space.

For the purpose of this report however, it is important to focus not so much on the differences between the types of serviced offices but on the flexibility and choice that can be gained from non-traditional leases. The term 'serviced offices' as used throughout this report encompasses three types: serviced/flexible offices, co-working space, and virtual offices. The different terminology used both within and outside the industry highlights the range of spaces and services now being offered to meet changing business needs.

Cost: serviced office vs. traditional lease

There is a misconception among some parts of the market that the comparative cost of serviced office space is much higher than a traditional office lease. Indeed, on a pure price per square foot basis, serviced offices are often more expensive; however a business that uses serviced offices to gain more flexibility in terms of size of space and length of contract could benefit from a lower overall cost under a traditional lease.

"The landscape has shifted now in that flexible offices, with one single cost, offer a value proposition as businesses focus on their space needs within their individual offices. Businesses can be more efficient in their use of space within the office they are paying an all-inclusive rent for, and then share all of the facilities that are within their building but outside of their office, such as meeting rooms, kitchens, lounges, roof gardens and of course shared working/co-working areas."

Charlie Green
Co-CEO, The Office Group

Under serviced offices it is possible to lease space for a set number of employees only, and by not adding meeting rooms, kitchens or reception areas, to reduce the overall size requirement and, in turn, the total rent.

One fee covers all

Serviced office fees also cover those additional costs that would normally be paid on top of a traditional rent, such as security, a reception area, cleaning, and internet access. Moreover, serviced office tenants avoid the potential cost of reinstatement at the end of a traditional lease. The transparency of serviced office fees allows businesses to understand their costs and outgoings clearly, while avoiding capital expenditure exposure from fit-outs and reinstatement costs.

Serviced/flexible office	Co-working space	Virtual office
This is the most common type of space. Fully equipped and managed, office space is taken on a desk-by-desk basis. The benefits can include the use of facilities within the building from breakout areas to meeting rooms. An all inclusive rental basis can provide space and flexibility to businesses of all sizes. It is particularly attractive to the large corporates who take space as project/overflow space.	Co-working space, run on a membership basis with a monthly fee giving access to the office space, a desk, meeting rooms, Wi-Fi, and access to networking events with other co-workers. Generally the customer can access a number of different office locations, providing greater flexibility. Typically used by freelancers, entrepreneurs, start-ups and small and medium enterprises looking for a collaborative open plan space to work.	The use of a location provided by the operator with dedicated phone lines and postal address, also allowing the customer to use the facilities ad-hoc creates the image of a working office to users' clients. Meeting rooms can be booked when needed. Typically used by start-up companies with few employees.

Building a business ecosystem

For serviced office tenants there are many benefits to having a diverse range of firms working right next to each other. For example, a fledgling business could take advantage of an accountant located in the same building, while a media business that could help redesign their website and a legal firm that could offer them advice. In some cases operators work hard to bring together such a mix and often host networking events. This collective or co-operative environment provides a valuable network of contacts not easily obtained when in a traditional leased space.

Project space

While occupiers of serviced offices tend to be small to medium-size businesses, larger organisations are increasingly using this space for short-term expansion either for projects or confidential client work. Businesses trying to accommodate 50 or more people should factor in the length of contract to ensure that it remains the most effective way of taking office space. Cost efficiencies are generally achieved on terms of one year or less, and subsequent extensions may not always offer the best value for businesses with a large amount of space. The challenge for organisations is knowing if a project or space requirement will extend beyond a year.

Flexibility

An overriding reason for the use of serviced office space is the flexibility it offers. A typical serviced office can provide a fully functional office within a matter of days or even hours to meet the demands of the customer. Serviced office operators tend to run their centres at around 70-80% occupancy. This affords them the flexibility to let businesses move in quickly and/or grow or cutback as needed.

While small and medium-sized firms benefit from flexible office space and being part of a community, larger organisations can have a more utilitarian approach to serviced offices. For them, serviced offices enable them to run distinct projects on a bigger scale away from their main offices. Such space also enables them to use the offices for subsequent projects during the term of the contract. The choice of the type of space, location and facilities depend on the reason for the space. A potential challenge for this type of occupier is finding the right space and layout. For Deloitte UK its key objective is ensuring flexibility for its projects team. Traditional leases are often more restrictive and the ability to secure flexible space quickly is an essential part of Deloitte's property needs.

"Our needs during just one project could range from 25-80 desks during any lease term and can range from a year lease up to two or three years."

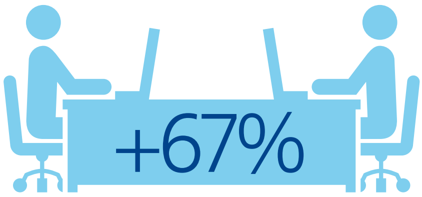
Siobhan Smith, Property & Corporate Services, Deloitte UK

Key reasons for taking serviced office space

Flexibility The ability to expand or contract the size of operations	**Temporary space** A stop-gap between permanent locations	**Lack of cashflow** Low covenant strength less of an issue	**Space requirements decline** Current office space under-utilised resulting in resource wastage
Project space Additional space requirements borne out of short-term/ confidential projects	**Cost** Short-term letting could be cost effective vs. traditional lease	**Avoid CapEx** Traditional leases could lead to expensive fit-outs and reinstatement costs	**Location** An economic way to gain presence in costly locations

The serviced office footprint

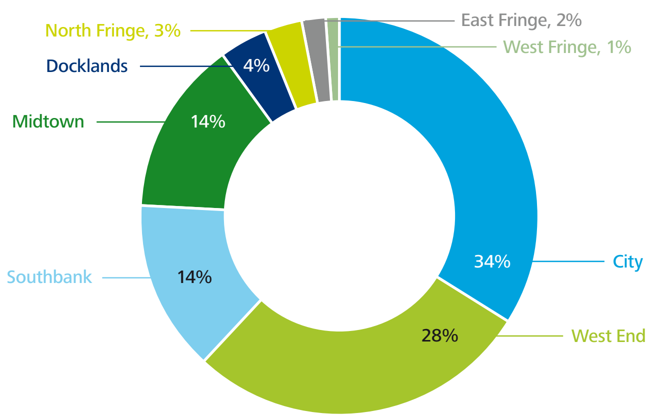
Growth of serviced offices' share of central London floorspace, 2004-14



Our analysis shows that the office footprint of serviced office operators within central London is relatively low at 3.4% of total office floorspace. However, it is growing rapidly, having increased its share of floorspace by 67% between 2004 and 2014.

This highlights how important this type of real estate offering has become, not just with occupiers but within the wider real estate market. Sometimes seen as a risky option for landlords, and a quick-fix solution for businesses, the growth of the serviced office market, despite the recent recession, has benefitted from a reinvention of the product. This is in contrast to many traditional occupier sectors, such as professional and government, whose actual share of floorspace has declined.

Share of serviced office floorspace by location (%), 2014



Source: Deloitte Real Estate

"The serviced office market has certainly grown and matured over the last ten years, and we are constantly adapting our services and strategy to meet the needs of a wide range of clients."

Simon Hempsall, Director, Instant Offices

From the core to the fringes

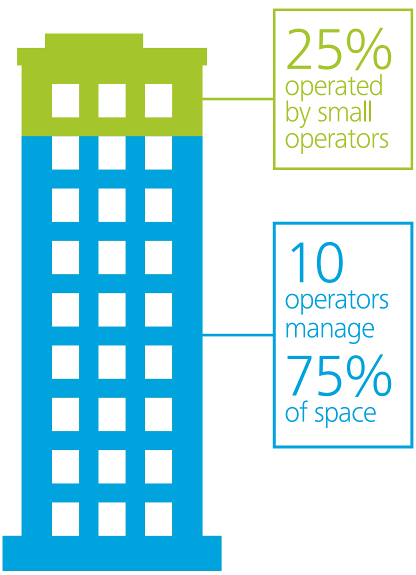
In 2004, serviced offices were chiefly located in the West End (34%) and the City (28%), accounting for 62% of all serviced office floorspace in central London. Ten years on, these two districts continue to dominate the market, yet their positions have reversed, with the City now holding the greater share following a 21% rise. While actual volumes of floorspace recorded have increased across the board, the change in share between submarkets is due to particularly rapid growth in locations such as Docklands and East Fringe.

In E1, immediately to the east of the City of London, this reflects the emergence of a tech-hub in Aldgate, home to the start-ups and small firms that are a key driver of the sector. Further east again, in the Docklands, vacant office space left over from the recent downturn has now been resurrected as serviced office space. Landlords are keen to nurture these small businesses so as to retain them as traditional tenants in the longer term. For tenants, the attraction is being located in bright, modern, often iconic buildings, while enjoying the flexibility and benefits of a serviced office agreement. Much of London's tech activity is concentrated in financial technology, and these locations offer the additional benefit of proximity to clients and friends.

The appeal of non-traditional locations is not just the preserve of businesses looking for serviced office space. Businesses taking traditional leases have also become more footloose. Ten years ago, over three-quarters of West End occupiers taking new office space stayed within the submarket. In contrast, the Winter 2014 Deloitte Real Estate London Office Crane Survey showed that just 30% stayed loyal to the West End. By contrast, the City had a larger number of tenants moving within the submarket, rather than out of it: 86% of City occupiers that moved during the latest survey took new space elsewhere in the City.

Operator competition increases with new entrants

Our research shows that since 2004 the number of operators offering serviced office space in central London has grown by a quarter (26%). The top ten operators today account for 75% of space, but this is down on 80% recorded ten years ago. The impact of increasing competition is that new players are vying for business at the smaller end of the operator market.



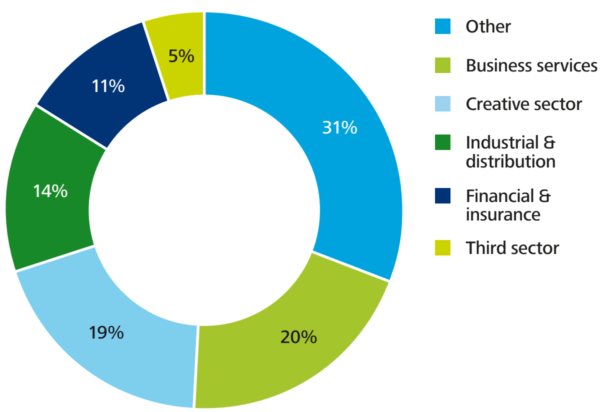
Ten of the smallest operators in terms of floorspace are new entrants into the London market since 2004. While some of them operate just a single building or floor, our research demonstrates that the appetite to enter this market has increased. Notably, no less than 75% of these new entrants are UK-owned operators, suggesting that at this scale it is too small to appeal widely to foreign based operators.

Creative and business services support growth

No business sector stands out as the typical serviced office customer, according to a number of operators and brokers we interviewed. Indeed, a recent report from the Business Centre Association (BCA) shows that there is a broad mix of business types that take serviced office space across the UK, dispelling the suggestion that it is just technology and media firms that are attracted to this offering. The BCA research shows that nearly 40% of customers are classified as business service firms or those from the creative industries.

It is the range of businesses, including financial and third sector (voluntary/social sector) firms, that makes the occupier base for serviced office so diverse and, in turn, appealing to many operators and subsequent investors.

Occupier business by sector, UK



Source: BCA, The UK Business Centre Market, 2014

Drivers of future change

The serviced office model has continually sought to serve a changing workplace for a number of decades, responding to the desire for flexibility and simpler leasing arrangements. During the recent downturn, operators were able to meet the needs of businesses that were otherwise limited in their property choices. The rise in serviced offices across central London during this time confirms the growing acceptance of this type of leasing method. However, as economic growth gains momentum, will the serviced office sector also continue to grow?

Our first report in the London Business Footprint series highlighted a number of factors that will shape the office market over the next decade, including the evolution of the office, the growth in technology, media and telecoms (TMT) businesses and the ability to harness new technologies. Additional factors will influence the serviced office sector:

Small to medium-size firms expected to drive demand

The growth in self-employment and new start-ups is expected to increase over the next few years. Indeed, the recent Deloitte UK Fast Technology 50 report that tracks the fastest growing technology firms highlights that technology businesses are in a period of hyper-growth, with the top 50 recording an average five year growth rate of 1,695%.[1] Nurturing these entrepreneurial businesses as they expand could provide a good customer base for operators.

Figures from Oxford Economics and the Office for National Statistics show that out of the 390,000+ businesses based in London, 86% of them employ ten people or fewer, with 97% of companies having fewer than 50 employees (based on the long-term average). This tenant demographic represents the core of a serviced office operator's customer pool.

Our research and interviews with operators suggest that the average number of employees for a customer taking serviced office space is 10-12 people. Therefore this anticipated growth in employment and business creation is likely to help fuel further demand for the sector.

Customers' requirements from serviced offices expected to grow

Through our research and customer interviews we expect businesses' demand for good-quality space to increase over the next few years. With a lack of small good-quality offices currently available and with a growing willingness from landlords to take serviced office operators as tenants, it is likely that Grade A serviced office options will increase.

We have already seen a number of high-profile recent developments, such as The Shard and 20 Fenchurch Street, take on serviced office tenants, allowing these prominent addresses to be used by their customers. This is something we expect to continue to see over the coming years. However, our research suggests that the current low volume of new office space being built in London will limit overall growth opportunities for serviced office operators. According to our long-term forecast, the London office pipeline is set to remain constrained until the next wave of development starts to complete during 2017-19.

In addition to wanting new Grade A space, the list of demands from businesses will continue to grow and is likely to include smarter technology, greater focus on location and transport links to attract the best talent, proximity to complementary types of businesses and equally as important, continued affordability.

1 Deloitte UK Fast 50 Defining fast tech growth, 2014, Deloitte LLP

Millennials to drive demand for co-working space

The arrival of the millennial generation in the workplace could contribute as much, if not more, to the change in working culture and practices as the baby boomers did in the 1980s and 1990s. Recent Deloitte Millennial Surveys have shown that the upcoming workforce is looking towards organisations that foster innovative thinking, encourage creativity and actively participate in society.[2] These are all elements than can be facilitated by co-working space.

Co-working space offers flexibility and potential to provide a network of contacts and resources to encourage innovation. Co-working spaces will see the breaking down of traditional barriers such as the fixed desks with the designated 100 sq ft per person ratio and whole departments hidden from view. Interaction is the key. How this type of space can work for businesses will become more apparent over the next few years.

Developers' willingness to provide such space is also expected to increase. Some large developers are already tentatively incorporating co-working and flexible office space into their large mixed-use buildings. By doing so they hope to attract tech start-ups in an innovative environment, with the aim that when these smaller companies grow they will stay within their current building and move into bigger premises. By incorporating this kind of working environment developers can help attract and support younger talent to an area. We expect more developers will take this approach with their projects over the coming years wherever suitable.

Management agreements to become more prevalent for operators and landlords

The occupier market is still dominated by traditional leasing and will continue to be. However, the growth in the serviced office market and its appeal to a wide range of businesses are likely to start to alter landlords' disinclination to lease to serviced office operators, which have sometimes been seen as risky tenants with weak covenants. In our view, the increasing acceptance of serviced offices will result in the growth of management agreements with landlords.

A management agreement will mean that the operator will not pay the landlord a set rental income, but instead will give the landlord a percentage of its profit. For the operator, this could mean access to more desirable buildings, increased flexibility to adapt to the peaks and troughs of the market as well as no fit-out costs. Despite less certainty regarding the income the building will produce, the landlord could benefit from higher revenues than fixed rental income would provide. Our research suggests that a management agreement with a serviced office provider on a hypothetical building could provide up to twice the revenue compared with a traditional leasing model. While not yet a common practice, such agreements are starting to appear and are expected to grow as both landlords and operators increasingly understand the potential mutual benefits.

2 Deloitte Millennial Survey, 2014 & 2015, Deloitte LLP

Serviced offices to attract investors

While the serviced office market is a mature player in the real estate industry, it is not yet favoured as an asset class. However, we believe this could change. As discussed earlier, the sector is expected to grow, as businesses take advantage of the flexible working environment on offer to them. And as interest increases, so too will the competition for the right space, ultimately leading to higher rents and/or membership fees. With investor interest likely to grow, and the current pool of operators fairly small, we expect more investment scrutiny over the next few years. Institutional investors could also be attracted, which could in turn create a supply/demand imbalance, leading to compression of yields on buildings that specifically offer serviced office space.

Operators to become owners

While it has not been common practice for operators to own their own space, this model does exist for some of the well-established operators, with ownerships ranging from their entire portfolio to just one building. It can often be profitable for an operator to own buildings and we expect this to increase.

However, there will always be barriers in acquiring the right property, especially in London, where operators compete against hotel and office investors, as well as residential developers. With yield levels currently low and a lack of stock to meet demand, buying any building is currently a highly competitive process.

If the operator-ownership model gains momentum, fringe locations are likely to become more attractive. Potential stock is more readily available in such locations and investor interest in secondhand buildings, which are cheaper to buy, is growing.

Landlords could also become operators themselves. Realising the potential returns of serviced office space, landlords could turn some or all of a building into serviced offices, adding a further dynamic to this market.

"Serviced offices are highly cash generative providing investors with a high but resilient income yield and the opportunity to benefit from yield compression and hence increasing value as the sector matures."

Matthew Condren, Real Estate Advisory, Deloitte Real Estate

The rise of M&A activity

Although we do not foresee any 'super-sized operators' emerging on a global scale over the next few years (where large operators join forces with other larger operators), we do anticipate a number of mergers and acquisitions. Some of the small operators with favourable locations and/or attractive client lists could become the focus of some corporate activity.

In addition, we could see the arrival of both investors and operators from overseas. While setting up new operations in the UK is not to be discounted, it is more likely that they will acquire existing players. For serviced office customers, an expanding operator base is a positive outcome as it should bring more choice at a time when there is a shortage of good quality office space.

"Flexible workspace is becoming the norm for businesses who seek to deliver agility to their staff through office space. The ability to take short-term, highly collaborative spaces in well located, quality buildings has helped to reposition this sector."

Chris Lewis, Director, Head of Tenant Representation, Deloitte Real Estate

The evolution of serviced offices over the past ten years has already seen a shift in the footprint eastwards, locating within the growing tech-hubs and the financial districts of London. Fuelled by an increase in the number of operators and the expansion of office floorspace by existing players, the heightened level of competition will see the product and geography continue to evolve.

Flexibility will remain central to the serviced office product offering. While the dynamics of both the operating and property ownership models for some providers may change, the provision of flexible space will be key in attracting new customers, especially those from the millennial generation of workers whose approach is expected to be different.

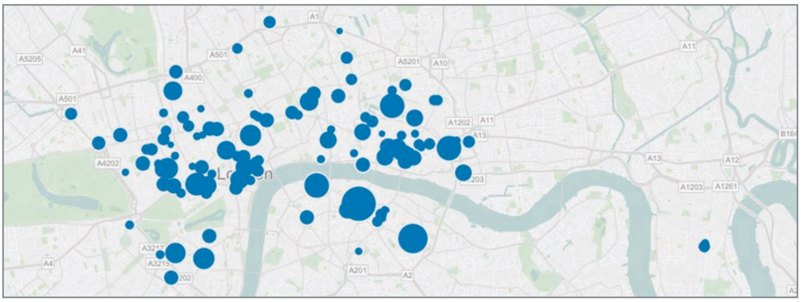
Meanwhile, the change in customer attitudes towards serviced offices could well force a re-think by landlords and investors. Sparking interest in developing the serviced office concept on a larger scale will only serve to benefit the customer.

The outlook for serviced offices, whether it be for conventional serviced space or co-working space, is one of change. An operator’s ability to respond to the needs of both existing and new businesses will be key to ensuring continued success and growth.

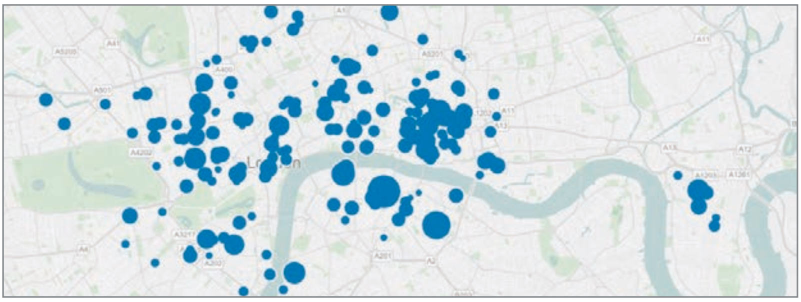
Central London serviced office market profile

Central London serviced office market profile

Serviced offices occupier location (relative size) 2004



Serviced offices occupier location (relative size) 2014

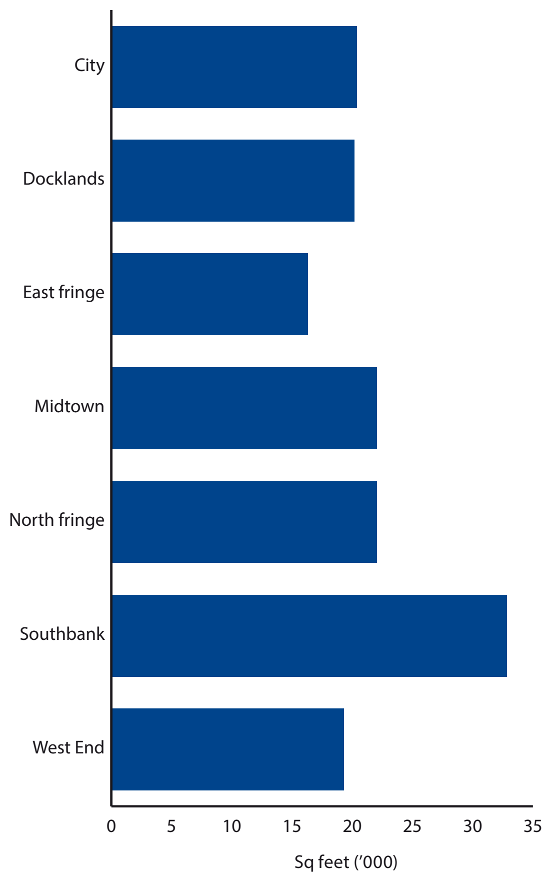


Percentage share of operators leasing an entire building

10 year movement of serviced office market (% share of floorspace)

	2004-2009	2009-2014
City	▲	▲
Docklands	▲	▲
East fringe	▲	▲
Midtown	▼	▼
North fringe	▲	▼
Southwark	–	▼
West End	▼	▼

Average size of space leased by a serviced operator by location



Notes

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