Can the Flexible Space Market Survive COVID-19?

22 April 2020

The coronavirus pandemic is having an unprecedented impact across all business sectors and that includes the flexible space market (FSM).

Lockdown measures and social distancing are having a particularly brutal effect on the FSM sector, which – more than other business sectors – relies on a consistent flow of new occupiers to counteract high customer turnover rates. Prior to the crisis the sector was booming, with the number of FSM centres in the UK having grown from 4,000 in 2015 to over 6,000 in 2019, with a projected growth to between 9,000 and 12,000[1] within the next four years. However, in the weeks since the outbreak began, new customer/membership levels have stalled and the occupancy of flexible spaces has plummeted. Here, we look at the detrimental impact of COVID-19 on the FSM in the UK, and consider how creative and collaborative thinking could save the main stakeholders within the sector.

The Market, Operating Models and Stakeholders

There is no "one-size fits all" in the UK FSM, which breaks down into managed, serviced, co-working and member products, with variable occupancy length and service levels. The main stakeholders within it are:

- Owners of buildings who let to FSM operators;
- FSM operators who provide flexible office space as part of their business; and
- Their end customers in actual occupation.

However, this is a market evolving all the time and, while many owners still take the traditional "passive" role, granting FRI leases to operators and having no share in the profits and no control over how the business is run in the space, an increasing number of owners are becoming more active in the FSM business. This can mean actually running the business themselves (e.g. Crown Estate and Great Portland Estates) or entering into agreements with operators under which they take a share in the business risks and profits. And, of course, there are some FSM operators (WeWork being the obvious example) which have enough capital behind them to acquire buildings themselves.

The picture for these stakeholders in the current crisis will vary widely, depending on the specific terms under which they interact. These usually fall into contractual licences or a more traditional landlord and tenant relationship (such as those enjoyed by WeWork, ServCorp, Hana). The impact on both is considered below.

Parties to Contractual Licences: How Bad Is It for You?

The picture for FSM operators and occupiers will vary significantly depending on the terms of the licence. The FSM is characterised by variety, whether that be the period of occupancy, termination provisions or the level of service included under the licence. There are, however, some common themes:

- The moratorium on landlords exercising forfeiture of commercial leases for non-payment of rent provided under the Coronavirus Act 2020 (the Act) will not assist licensees.
- Fees payable by licensee occupiers are usually inclusive of outgoings, such as service costs, insurance costs and business rates, meaning that such occupiers will not be as susceptible to such ongoing costs as the tenant under an FRI lease.
- Licences are generally short-term arrangements and, even where there is no break right, occupiers literally locked out of their office space will have a stronger case to walk away from their commitments than longer term FRI tenants, on the basis that the contract has become substantially frustrated. In any event, occupiers often have the ability to downscale memberships on a rolling basis or limit the benefits they take.

Given these factors, FSM operators will be forced to think creatively to retain their customers. What is clear is that, in the coming months, collaboration and creativity will be key to the survival of many operators.

1 Research carried out by the Instant Group and highlighted in a recent report by the Investment Property Federation.

Leases: A Different Range of Problems

For those on either side of the landlord-tenant relationship, the issues are largely those that have been highlighted in other sectors, but with particular twists.

Loss of business income – Impacting the ability to pay the rent and other outgoings. For the FSM operator the shock will have been greater and more immediate. Other office operators, such as lawyers, accountants and other service providers, can, to an extent, "keep things going" by people working from home. This is not an option for the FSM operator, whose very business is the space itself. The most vulnerable operators will be those with longer leases. Conventional lease lengths have been falling for years, and are now predominately 5 years or less. However, it is a peculiar feature of the FSM that some operators have signed much longer leases, even up to 20 and 25 years.

- **Understanding key lease provisions –** This is even more imperative for FSM operator tenants who should be scrutinising lease lengths, break options and rent suspension provisions particularly. Familiarity with the terms of business insurance cover could return welcome benefits.
- **Moratorium on landlords exercising forfeiture –** FSM operator tenants will benefit from this, which lasts initially until 30 June 2020. However, tenants will remain liable for their rent after the moratorium has expired. The Act is silent on other outgoings, such as service charge and insurance rent, and so FSM tenants will still be liable for those. The government's business rates holiday currently only benefits those in the retail, hospitality and leisure sectors and as such will not help FSM tenants.

Early engagement with landlords is vital, to explore their willingness and ability to assist tenants through the crisis. The increasing number of landlords with profit share arrangements with tenants (and so a greater than normal interest in their financial health) could mean a greater willingness to assist.

From the owner-landlord's perspective, whilst many offices have in practice closed following government guidance, landlords have not been ordered to close like those in the retail and hospitality sectors. A landlord should tread carefully if any of their FSM tenants demand access. Simply refusing might expose the landlord to claims for breach of quiet enjoyment covenants or derogation from grant.

For the FSM tenant who is locked out, there is the possibility of claiming that their lease has been "frustrated" and no longer binding. However, the courts have been reluctant to set leases aside in situations where (as hopefully will be the case in the current crisis) the inability to gain access is temporary.

Impact on the Sector

Short-term challenges are acute, but how will the current crisis affect the FSM industry medium and long term? No one really knows for sure and the duration of government measures will undoubtedly influence this. However, we can anticipate some changes, outlined below.

Consolidation

The FSM sector is highly fragmented and a consolidation had been widely anticipated, even before the current crisis. Research by the Instant Group[2] indicated that, of the circa 3,000 current operators, the largest 10 control just 3.3% of the market. In a "conventional" recession, one would expect that many in the FSM sector, characterised by diversity of occupiers and terms of occupation, would be well placed to take immediate advantage – even in a recession, people still require desk space to operate, and, as businesses struggle, the merits of flexible space could well become more appealing. With COVID-19, however, access to the traditional desk is limited, so in some respects (see above) the position of the FSM operator is worse than for other tenants.

Some commentators believe that the co-working and membership subsectors, with their greater reliance on individual and small start-up customers, will prove the most vulnerable. Whether or not that turns out to be the case, consolidation within the sector is due.

Incentivising Customers

The paramount objective for FSM operators is to maximise income as far as possible. Some operators have already taken financial measures to help their customers, including:

- Freezing memberships
- Providing rent holidays
- Deferring monthly rental payments

To compensate, they are drawing down on existing deposits, to be repaid when the position is clearer. Other operators have amended their membership offering with virtual add-ons, such as business tutorials, online exercise classes and Zoom and Slack services, to engender a sense of continuity and community.

2 Highlighted in a recent report by the Investment Property Federation.

A Bubble Ready to Burst?

Will this crisis go so far as to prick the FSM bubble altogether? One's view about that will probably be coloured by whether you see the FSM as a passing fad or a more fundamental, permanent change in the way people invest in and use real estate assets. Pre-crisis the consensus favoured the latter. We do not see the pandemic changing that. On the contrary, while the short term might prove difficult, for the FSM providers who do survive we see a move towards, not away from, businesses opting for more flexible working space over the traditional landlord and tenant model. The crisis has forced businesses to better embrace and facilitate working remotely from home, while still being liable to pay rents under leases of largely empty offices. One would expect that, at the end of the crisis, businesses will scrutinise their use of office space more rigorously and many will look more favourably at flexible office arrangements.

In sifting through the pros and cons, businesses are not likely just to focus on cost savings. For those that had already moved away from the traditional FRI landlord/tenant model, there may be a renewed enthusiasm for the sense of community and business sharing that can be engendered through FSM. Equally, even businesses which do embrace more extensive working from home will probably still need a professional address and meeting space. FSM providers who shift their focus and can evolve quickly to meet these developments might choose to allocate more amenity space and less office space to cater for these trends, arguably becoming a professional events and meeting provider.

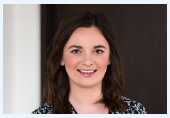
Overall, the user pool for the flexible offices sector is likely to grow, allowing those who survive the lockdown to flourish.

What Does the Future Hold?

The coming months are uncertain, but one thing is for sure – the lockdown will fundamentally change the way that businesses operate. The reality is that the longer the lockdown and social distancing measures are in place, the greater the financial impact and the bigger evolutional change will be required by FSM to maintain its place in the real estate market. Overall, however, there is reason to be optimistic.

Contacts

Patrick Ryan
Director, Real Estate
T +44 207 655 1217
E patrick.ryan@squirepb.com



Claire MacNally
Associate, Real Estate
T +44 207 655 1416
E claire.macnally@squirepb.com

Simon Watts-Morgan
Trainee, Real Estate
T +44 207 655 1041
E simon.watts-morgan@squirepb.com

The contents of this update are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations, nor should they be considered a substitute for taking legal advice.

squirepattonboggs.com

© Squire Patton Boggs. All Rights Reserved 2020

38152/04/20