Coworking and the New Corporate Office

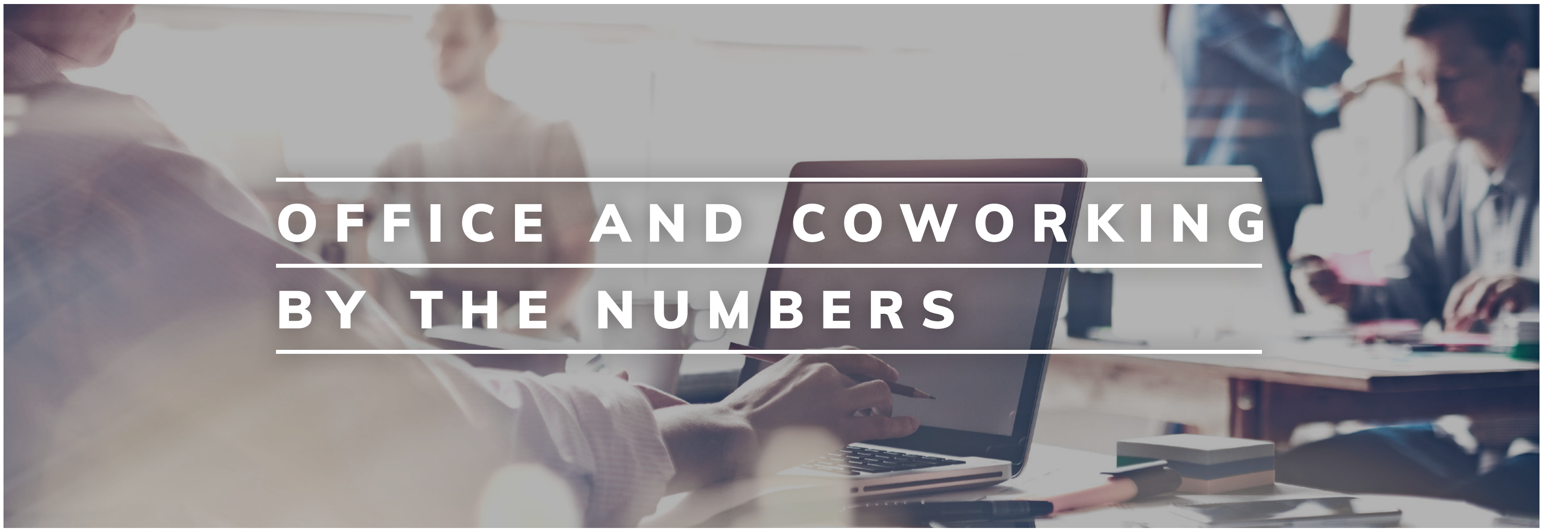
After decades of evolution, flexible workspaces are taking a heightened role in addressing the changing tenant priorities forged by the pandemic.

MAJOR THEMES ADDRESSED IN THIS YARDI SPECIAL REPORT

- The office and coworking markets by the numbers
- COVID-19's impact on corporate occupiers
- How landlords are getting more strategic
- Cultural considerations in joint ventures
- The blurring lines between coworking and traditional lease options
- How automation eases space marketing and take-up

A historic inversion is unfolding in the world of corporate space occupiers. Traditionally, decisions came from the top down on such issues as corporate strategy and culture, space needs and worker expectations. That structure has been turned on its head by post-COVID rules of engagement, and employees are exerting upward pressure on employers regarding a new set of expectations. In turn, lease terms are being increasingly dictated not by the landlord to the tenant but by the tenant to the landlord.

Broadly speaking, this role reversal has driven the surging demand for flexible spaces and coworking options for corporate occupiers. The role of office space is changing and the numbers tell much of the story.



OFFICE AND COWORKING BY THE NUMBERS

To fully understand coworking's impact on the office, it is essential to consider the state of the office leasing and shared-space markets as COVID-19 starts to recede in the nation's rearview mirror.

"Durability" and "resilience" are two words JLL uses to describe the office market in an **April report**. After what the firm calls a late-2020 trough, the market has at last shown signs of touching bottom. Absorption in the first quarter of 2022 was essentially flat and translated to a modest 0.1 percent decline in occupancy.

As hybrid work models solidify, clarity is coming to the office sector, especially "regarding [users'] longer-term space needs, boosting term lengths in the process," the JLL report states. Geopolitical crises and the inflationary threat have not significantly impacted leasing volume, which rose 5.4 percent during the first quarter.

Using a broader timeline, Cushman & Wakefield's numbers suggest an even rosier picture. The four-quarter rolling leasing activity increased 41 percent during the first quarter, according to the newly published "**Office of the Future Revisited**." Gateway markets reported a 63 percent surge over the same stretch. No matter the yardsticks, the message remains the same: The worst is apparently over for the U.S. office market.

Despite the rise of hybrid work, coworking and shared space models did not meet with unrestrained enthusiasm during the pandemic. The sector has settled into a much broader path of acceptance, but acceptance was hard-won. The vast majority (79 percent) of coworking providers responding to a **recent Deskmag survey** described their current situation as "good" or "satisfactory," suggesting moderate but not overwhelming progress.

Additionally, in 2021 profits dropped significantly from pre-pandemic levels, as more coworking spaces recorded losses than profits, the Deskmag survey found. But optimism among providers runs high, with three-quarters of respondents saying they expect increased membership during the next three months. Sixty percent also expect higher revenues, and 20 percent are planning expansions.

None of this should come as a surprise. The COVID-19 pandemic rocked virtually all boats equally. The current promise of revitalization will determine growth for all sectors, but that growth will be driven by those new rules of engagement.

COVID-19 AND CORPORATE OCCUPIERS

It is hard to overstate the effect that COVID has had on office-use strategies in a short time. “The pandemic completely upended longstanding, previously unquestioned decision points on space management,” says Scott Morey, president of technology and innovation at WeWork. “Companies occupied vast amounts of space because they thought that's what they needed to do. Cut to today, and businesses must now solve for how to bring flexible work models to life without sacrificing the culture, collaboration and productivity that happens in person.” Moreover, many office tenants are concluding that it is good policy to give employees more say about where they work. A telling statistic from CBRE’s April 2022 Occupier Sentiment Survey reveals that, while 31 percent of companies are opting for prescriptive return-to-office timelines, 53 percent are “leaving the decision up to their employees.”

At the same time, the call for more face-to-face collaboration has grown during two years of forced isolation. “We already knew that in-person interactions lead to innovation and the creation of social ties that help employees advance in their careers,” says Andrew Kupiec, the Manhattan-based president of agile real estate and experience services for CBRE. “COVID made this more apparent than ever.”

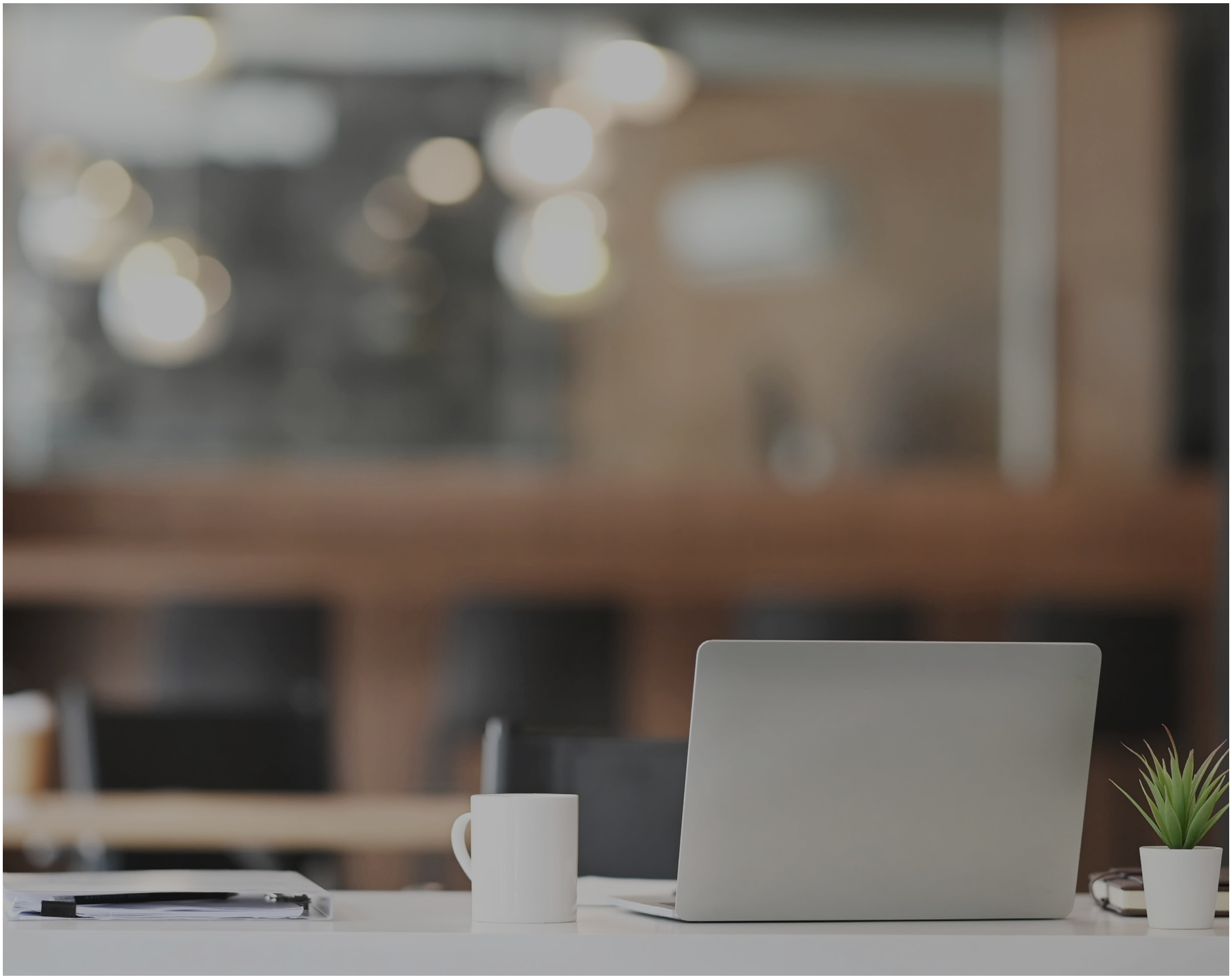
Hybrid work models caught on in the past two years as decisionmakers were forced to accept remote work to salvage productivity. But a December 2021 report from BOMA International makes the distinction between the kinds of productivity being achieved: on one hand, the lower-case ”p” productivity that consists of heads-down daily tasks, and on the other, the upper-case “P” Productivity—the big-picture strategic initiatives that need in-person collaboration to get off the ground.

“Workplace strategies no longer are centralized solely around physical office space,” Morey says, “and as a result, the stakeholder pool has expanded to account for a more diverse set of needs across the business.”

But it is not just the Fortune 1000 that is reaching this realization. “Every corporate occupier, large and small, is thinking about implementing remote work and flexibility in the workplace and finally putting their employees first,” observes Frank Cottle, CEO of Alliance Virtual Offices and Allwork.Space in Newport Beach, Calif.

Hybrid work models were not born in the pandemic, but use of shared space became more tactical, and coworking spaces were called into service for small teams on an ad hoc basis, Cottle says. “The big change over the past two years hasn’t been in the product. The big change is that the use is more strategic.” Or as BOMA might put it, coworking has graduated from lower-case productivity to Productivity with a capital “P.”

It must be added that the competition for talent has played a major role in the advancement of greater work flexibility. Even corporate executives with stalwart faith in traditional office concepts are reading the tea leaves and responding to the wants and needs of potential employees.



Several key indicators help paint a picture of the hiring issue. Cushman & Wakefield notes that U.S. employers are struggling to fill 11 million jobs in an economy with a baseline unemployment rate of only 3.6 percent. Meanwhile, as CBRE reported in its survey, executive attitudes toward a full return to the office are evolving in the face of "a tight labor market that demands more flexibility in work arrangements." That, in turn, is putting job candidates in the driver's seat.

Warren Hersowitz, Miami-based manager of Yardi Kube, relates that in the firm's search for new hires, "I ask them if they're comfortable with remote training and onboarding. Typically they respond by asking, 'What else would I expect?'" The 12-person office was replaced recently when the lease came up for renewal. All 12 team members now work remotely, with the option of turning to coworking space as projects dictate.

In light of all these factors, more owners and managers than ever are recognizing coworking's benefits. That represents an evolution from a relationship long marked by tension. In 2019, S&P Global characterized the issue this way: "For some traditional landlords, coworking remains stubbornly linked to its early public identity: A millennial-focused real estate offering for freelancers and startups that either cannot afford or do not want to pay for permanent space, with free beer and ping-pong thrown in for good cheer."

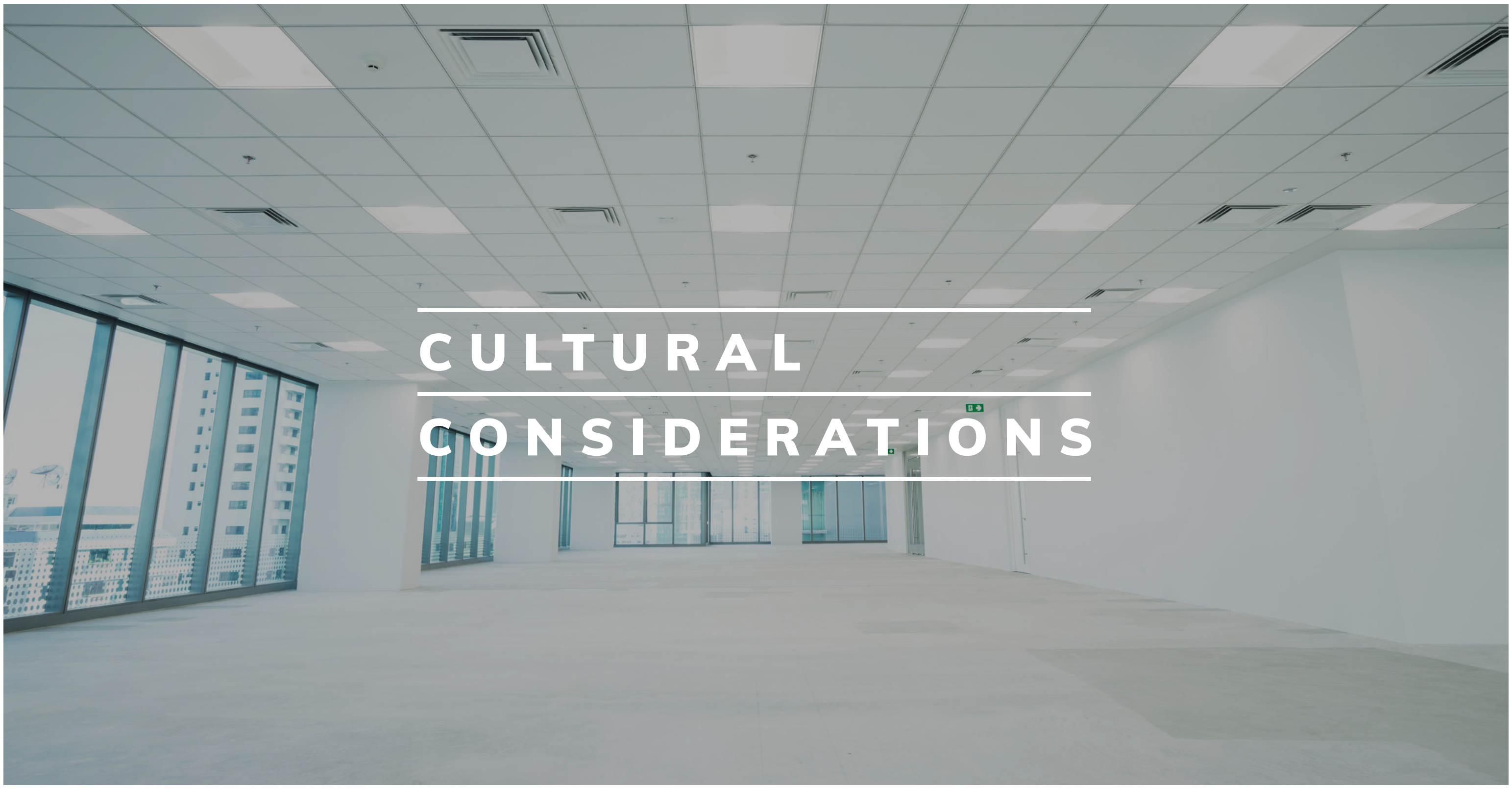
Ping-pong aside, landlords see the potential in those startups, and they recognize that coworking spaces are terrific incubators. "Landlords see that small startups will move into a coworking facility for a year or so and then relocate to a full floor, hopefully in that same building," says Cottle. He puts the average member lifecycle at about three years.

A flex offering improves a property's occupancy outlook, Kupiec observes. Coworking options provide tenants with the flexibility their employees expect and a safety net that helps manage market uncertainties as well as future growth. "If flex is part of an asset," he says, "the best partners will also enable landlords to ensure that they have optimized the rest of the asset."

In this context, the reference to "partners" is telling. The onetime love/hate relationship between building owners and coworking providers has blossomed into "serious dating," says Cottle, in the form of joint ventures and a focus on mutual benefits rather than differences. "In a JV, the operator minimizes their risk and can share the startup cost," says Hersowitz. For their part, landlords are pressured to "give their own tenants some sort of shared space." Most obviously, joint venturing with a coworking provider creates a ready taker for that otherwise vacant space.

The benefit to the coworking tenant—the member—comes not only in flexibility but also in the budget. Yardi's Miami operation took flex space that accommodates four people, since, says Hersowitz, "It's rare when we bring everyone together." When the need arises, it can simply take additional space on demand while enjoying a 50 percent cost savings realized by closing out its traditional lease.

Industrious is a big fan of joint ventures, and its landlord relationships kicked into high gear last year when CBRE acquired a 40 percent stake in the provider. Kupiec, who calls JVs a "seamless delivery of exceptional service," was previously CEO of CBRE's Hana offering, which was sold to Industrious last year as part of the deal. Today his focus is to work with Industrious leadership to ensure a successful merger with Hana while forging a strategic global partnership between CBRE and Industrious.



CULTURAL CONSIDERATIONS

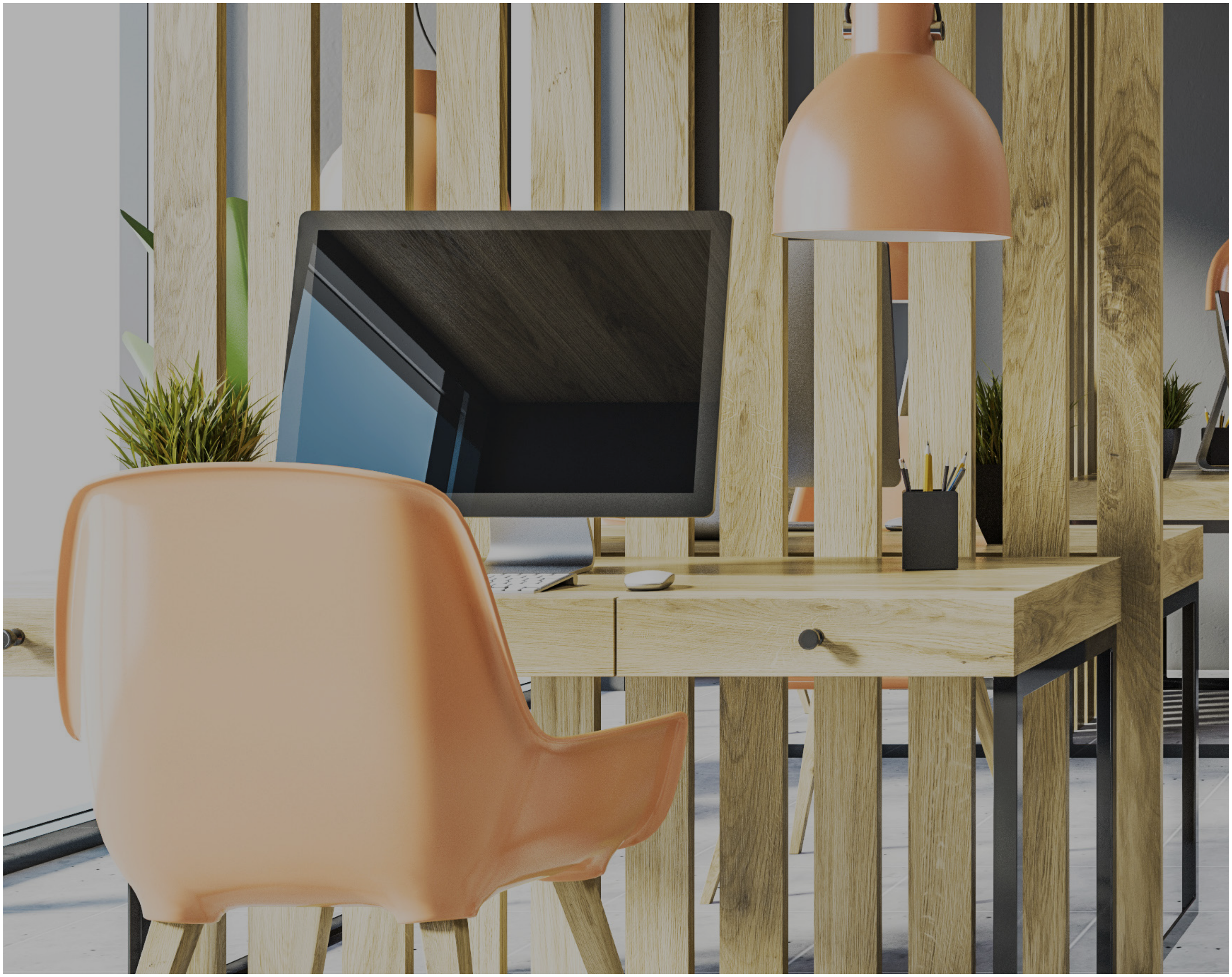
JVs are typically handled on a building-by-building basis, Hersowitz notes, although a broader scope of local and regional alliances has emerged. Joint branding with the property owner is an option, as well, but familiar names like Industrious, WeWork and Regus might be the bigger draw, he adds.

But branding also speaks to culture, a major concern today for occupiers and their need to create an employee experience that boosts retention. Culture is mostly a top-down statement of policy and an alignment with the goals and interests of employees, but it is also reflected in the office's physical layout. How can shared spaces compete with dedicated leases and the customized fit-outs that come with them?

There does not need to be a perfect match between a shared space and, for example, a corporate headquarters, says Kupiec. "But there should be compatibility for employees whether they travel to an Industrious (location) in San Francisco or the corporate office in New York." He says that CBRE clients have indicated their interest in a professional, hospitality-focused environment that aligns with and promotes corporate culture. That means amenities, onsite staff support and productivity-enhancing technology. Those spaces may also include some corporate branding.

However, asked "How important is it for a 12-person office in Miami to have a consistent, detailed look with headquarters," Turner Levison, Yardi's industry principal for commercial, estimates that there are 20 different coworking operators within 15 minutes of his Atlanta home, all with a different look, feel and energy. "The focus shouldn't be on copying a corporate aesthetic as much as on curating productivity and employee happiness, and members can buy into this," he says.

By all indications, members are doing exactly that. At an average rate of $961 per month for a private office desk, New York City topped a recent list of the most expensive flexible office locations compiled by Workthere, Savills' flex-space brokerage. San Francisco came in a close second at $950, followed by Singapore ($834), London ($803) and Berlin ($800).



Those are bold numbers, especially for city centers, many of which are still trying to bring people back to the office. In April 2022, for example, **Manhattan's office vacancy** hit 14.2 percent—a 290-basis-point uptick, according to CommercialEdge.

"COVID has actually turned the coworking issue upside down," says Hersowitz. "Some urban centers have seen recovery, but many are still waiting." With large numbers of workers still leery of boarding a train or riding a crowded elevator, suburban areas and smaller markets now have a much more significant role to play.

The *New York Times* **pinpointed the trend** in October 2021: "A growing number of startups are betting that the pandemic has spawned a new kind of worker—one who will not be commuting into a central business district five days a week but would still desire occasional office space closer to home for a distraction-free environment."

BLURRED LEASE LINES

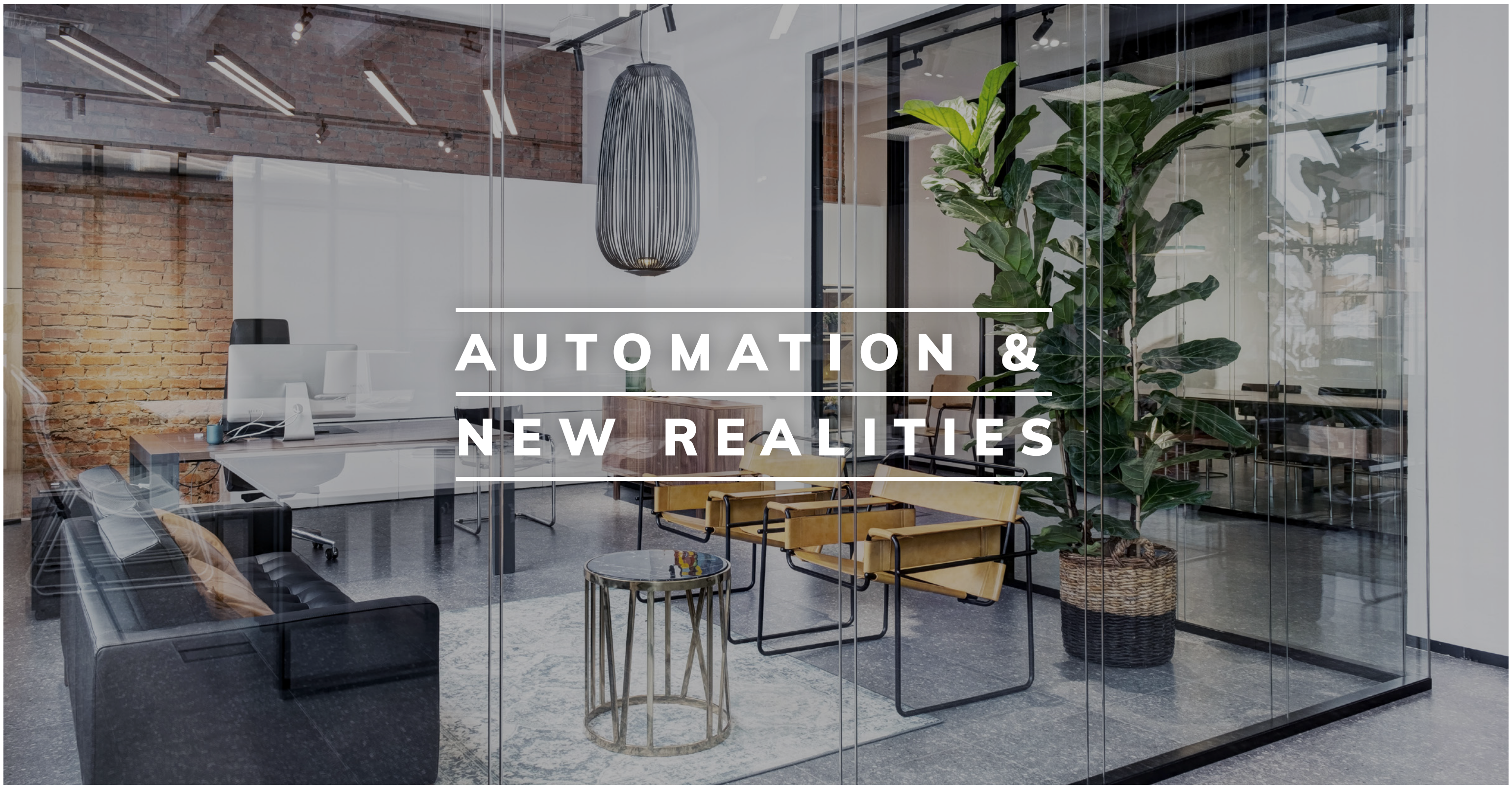
The growing call for more flexibility by corporate space users does not by itself lead to more coworking JVs. By necessity, landlords are also easing the reins of traditional lease terms to provide yet another option for their constituents. Working more closely in this way with potential and renewing tenants is a mark of the transition of leasing from a product to a service.

Capturing those companies for their entire lifecycle, whatever their changing wants and needs, has become the goal. As Cottle puts it, the landlord will be there "when they need incubation, when they need growth and flexibility, and when they need larger, permanent space."

Every major property company, he adds, is now faced with the reality of space cutbacks when or if occupants renew. If their people are working from home two or three days a week, "they'll need maybe 40 percent less space when the lease comes up." Happily, landlords are responding.

Experts say that corporate occupants are focusing on the ability to meet expectations, not whether the space comes with a coworking agreement or a traditional lease. "That line is fading away," says Hersowitz. "If they don't want coworking, they still want more flexible leases and shorter-term contracts—and they want amenities. That's why we're seeing those lines blur."

How much are space needs being trimmed? According to Moody's Analytics/CRE, average office lease terms inched down from 65 months to 63 months from 2020 to 2021. While it was accelerated by COVID, the contraction reflected a **decade-long trend**. This does not include shorter-term leases, which Moody's makes the province of smaller tenants. "Their leases became even shorter during COVID-19. While the average lease term dropped from five to four years, the median term decreased even more, from about five years to three years."



AUTOMATION & NEW REALITIES

As the coworking industry puts traditional landlord-provider tensions behind it, it also sheds any remaining reputation that may be left over from the 1980s for plain-vanilla boxes. There are digital platforms that make the search more efficient, but the creation of coworking spaces often needs curation, as well. Frank Cottle calls it "the human touch," and here the lines between coworking and traditional space offerings blur still more.

"Larger corporate occupiers generally have an assigned person or team that manages their flexible office contracts," he explains, and that person typically has a counterpart at the space provider's shop. Much like a traditional lease, the client expresses the need and the provider comes up with design solutions. Both teams are using automated search systems, but that addition of a human touch to the science is necessary to make the process come together.

For smaller takers, which constitute 50 to 60 percent of the occupied space in a coworking center, he says, automated searches usually fit the bill. And while that's good enough for some, "We have many smaller clients with specific needs for individualized service," Cottle says. "So there's still a lot of consultation and care in the delivery of the workspace overall." For a provider to fall short of that delivery is to increase the churn rate and materially reduce the effective average revenue per available desk.

Less concern over the nature of the agreement—and more concern over needs being met—in a way eases the space search, not only for corporate occupiers coming back to the office but for the providers of those spaces. In short, the tools are also keeping up with the new rules of engagement.

Options are available to search by agreement type, traditional lease or coworking membership. More advanced platforms, such as the five sites in Yardi's CommercialEdge ILS network, also offer an option to search by need, with the type of arrangement recorded as a color-coded footnote.

"We saw what was happening in the market and decided to blend our coworking and commercial listings," Hersowitz explains. If you search for a Manhattan lease, for instance, traditional and flex offerings live side by side. In the accompanying map, all spaces that fit the filtered criteria are color-coded: green for coworking, blue for traditional.

Additional ease of use comes in the syndication of search and offering data. For instance, Yardi curates five internet listing sites, and partners inputting data will see that information syndicated to all participating sites. This syndication also includes Kube, Yardi's platform for coworking operators.

And when special needs are not an issue, says Levison, coworking members using Kube can "set it up without talking to another human," from the beginning of the search until a user badges in with a supplied QR code.

In the depths of the pandemic-induced recession, the media made much ado about the supposed death of the office. Professionals who understand market dynamics have always known better. But when trends toward new rules of engagement emerged, the wisest among them began adjusting. New cloud-based tools available today can only ease this engagement.

As Andrew Kupiec aptly puts it: "While these new ways of working might seem like a new, post-COVID normal to some, we view it as a continual evolution of real estate and the workplace—and we believe it's here to stay."

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