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THE RISE OF COWORKING AND THEIR IMPLICATIONS ON TRADITIONAL LEASING MODELS

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ABSTRACT

Coworking, or provision of communal, flexible office spaces on a short-term basis, is a rapidly growing phenomenon in the modern office markets. Coworking was initially driven by the preferences of freelancers, knowledge workers and start-up communities; however more recently the industry has targeted large corporate organisations as their new path of growth. Many landlords are being challenged by this growing demand for flexible, collaborative spaces, and are increasingly looking at how to leverage the benefits of including such spaces within their portfolio. For coworking spaces, landlords are required to revisit traditional lease structures and introduce more creative, alternative means of leasing in order to facilitate new leasing options that provide greater ability to manage volatile headcounts.

This conceptual paper analyses the existing literature to identify alternative lease models that can facilitate the growing demand for flexible, scalable and collaborative spaces. The findings identify flex and core leasing model, revenue and profit share model, city campus model, joint venture model and management model as appropriate alternative lease and operating structures for coworking spaces. The findings also identify the advantages and challenges associated with each lease model from the landlord's point of view. The findings emphasise the importance of having more dynamic and creative lease structures that are better aligned with the interests of landlords, space operators and diverse groups of office space users in flexible office arrangements.

Keywords: Office property, Coworking spaces, New ways of working, Commercial leasing, Flex and core leasing models

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INTRODUCTION: THE COWORKING PUZZLE

Coworking, which provides independent work spaces in shared office environments to members from diverse organisations and individuals, is a rapidly emerging workplace phenomenon in today's knowledge-based economy (Spinuzzi, 2013; Parrino, 2013). It provides flexible spaces where members can work alone or interact with like-minded people on short-term basis, mainly on a pay-as-you-go basis (Bouncken and Reuschl, 2016). While workplace evolution has historically being gradual, the coworking industry has been expanding at an exponential rate over the last decade in many global property markets (Knight Frank, 2017). For example, the total flexible office spaces available in the Asia Pacific region in 2018 is approximately 3.5 million square metres and this is an increase of 27% from 2017, and an increase of 56% in the 12 months prior (Boucher, 2018). Coworking was initially driven by the preferences of freelancers, knowledge workers and start-up communities; however more recently the industry has targeted large corporate organisations who seek innovation and direction to expand their footprint. Therefore, rapid growth for coworking spaces coupled with advancements in information, collaboration technologies and globalisation of the business portfolio sees an emerging need for flexible office environments. People now require more options on how, when and where to undertake their business activities (Kojo and Nenonen, 2016).

Due to the high cost of establishing and maintaining traditional office spaces, traditional lease structures are usually long-term with limited flexibility in lease covenants (Miller, 2014).

Therefore, traditional lease structures have remained elusive for most coworking space users. This is mainly because they lack the required capital, are not credit-quality rated, and need the flexibility to expand and contract their space requirements as needed (Green, 2014). However, with the preference to lease spaces to established tenants on long leases, many landlords have been cautious in welcoming coworking operators into their buildings or incorporating coworking spaces into their office developments.

With the growing share of the coworking sector in the office markets, landlords are required to revisit traditional lease structures and introduce more creative, alternative means of leasing in order to facilitate new leasing options that provide greater ability to manage volatile headcounts. Despite the growing demand for coworking spaces, there is currently limited empirical research on strategies for alternative leasing models impacting on the performance and utilisation of office property assets.

By conducting an extensive literature review, this conceptual paper examines possible alternative lease structures that are appropriate for coworking space users who demand more flexible and scalable spaces. The main objectives of this paper are:

1. To examine alternative lease structures that are appropriate for coworking spaces
2. To understand the advantages and disadvantages of each lease method form the landlord's point of view

The literature review focuses on academic and industry research which examines various commercial leasing models. We commence the literature review with an overview of traditional leases and their limitations in the application of flexible spaces such as coworking spaces followed by a discussion on the changing patterns and suggested leasing models to accommodate the coworking platform.

DO TRADITIONAL LEASES WORK FOR COWORKING SPACES?

A traditional standard commercial lease for office space is usually for a set term plus an option to extend the term. Depending on the length of the lease and provision for outgoings, and rental increases, it is also possible to negotiate a free rental period upfront. The supply and demand factors governed by the economic environment influence the negotiations for the lease terms and conditions. With the financial stability of the tenant verified, it is generally accepted the landlord has a secure tenant during the lease tenure. Such fixed long-term lease structures are more appropriate for well-established tenants who would like to secure stable spaces for their core workforce. Firms that are growing or shrinking or experiencing significant turnover would struggle with matching such leases with their changing needs (Miller, 2014). As a result, if firms decide to break their lease contracts, they will be required to pay the concomitant charges if they have to reposition their space needs.

Furthermore, conventional office spaces on traditional leases may not be suitable for small scale organisations that require small office spaces. For example in Australia, more than 90% of businesses employ less than 20 people and therefore they do not require large office spaces (Philipp, 2018). The existing literature also suggests that in the traditional leasing environment, many landlords attempt to enforce strongly pro-landlord lease forms by being largely inflexible towards tenant lease requirements (Crosby et al., 2003; Crosby et al., 2006; Dunn, 2003; Edward and Krendel, 2007; French and Jones, 2010; Lizieri et al., 1997). For instance, in the UK, studies (Crosby et al., 2006; Sanderson and Edwards, 2016) identify a high level of frustration among tenants who are committed to leases that lack the flexibility in lease covenants, which ultimately affects their overall satisfaction with the lease.

Advancements in information and communication technologies and globalisation of business have created a need for flexible office environments in which people have more options for how, when and where to work (Kojo and Nenonen, 2016). One consequence of this paradigm shift has been the increasing demand for flexible spaces such as coworking spaces that allow occupiers to be more adroit in reacting to sudden changes in business conditions (CBRE, 2018). In contrast to rigid traditional leasing model, coworking spaces provide their occupiers the freedom to expand and contract their space requirements as needed and allow them pay for the space they actually use (Green 2014). This continued expansion of flexible spaces will drive a structural shift in the office markets, at least in the short-term (CBRE, 2018).

Recent research by Brown (2017) suggests the use of caution when setting up coworking hubs, as not all locations will meet the supply and demand expectations. This is further reiterated with the consideration of the financial viability for landlords and if the coworking business model can be sustained (Brodel et al., 2015; Chuah 2016). This recent research has identified the difficulties in attracting new clients to a coworking hub, and the viability to sustain the membership fee, with some landlords indirectly offering a subsidised fee structure. Whilst this approach can be argued as similar to offering an upfront rent free period on a traditional lease, there is a higher risk factor due to the instability of the user pay method.

Historically, leasing models most commonly used by freelancers and similar individuals included serviced offices and shared office facilities on a more permanent basis rather that a user pays approach or membership facilities as is common now with coworking spaces. The serviced office approach was introduced many decades ago, and the package of benefits included reception and secretarial services, phone lines, faxes and postal services. Additionally the norm was to include a dedicated office space to the same users, in other words, the right to occupy the same space during the term of the tenancy. The tenancy length was flexible including the option of short term leases of 12 months. However in the last decade, the way people work has changed considerably. For instance, technological improvements with benefits such as the advancement of mobile phones, internet and cloud based access have contributed to flexible working environments (Waters-Lynch and Potts 2017). In the next section we discuss this changing pattern and the accompanying leasing models.

The Changing Pattern

Where once upon a time, the traditional long term lease rental was the expectation for corporate businesses and freelance individuals chose to work from home, the last decade has witnessed a shift in the office environment (Dixon and Ross 2011; Bryant 2003; Brunelle 2013; Ross and Blumenstein 2013). There appears to be an increasingly popular demand to position coworking centres in key regional areas (Cameron 2012; Forbes 2014). For example, the number of coworking spaces in Australia has grown rapidly, by 297% between 2013 and 2017, to 309 coworking centres (Knight Frank, 2017). By the end of 2017, more than 193,000 m2 of coworking spaces had been available across the six main capital cities – Melbourne, Sydney, Brisbane, Adelaide, Perth and Canberra – which was equivalent to 0.6% of the nation's total office stock (Knight Frank, 2017). Commercial landlords may consider this as an exciting opportunity to transform difficult to lease commercial premises into coworking vibrant hubs. While leases by other industries are driven by relocation, expansion and renewals, leases for coworking spaces are mainly a new demand and involve large space requirements (CBRE, 2018). An area of significance is the regional scene as opposed to the CBD location. However, this changing work pattern is considered a guide for commercial landlords to rethink their tenant mix and the design of spaces and how the spaces are used within industry.

Therefore, with the increasing growth of flexible spaces, it is critical for landlords to achieve an optimal balance of traditional and flexible spaces with in their portfolios (CBRE, 2018). Furthermore, flexible spaces should be accompanied by flexible lease options that provide less rigid form of tenure with more flexible lease covenants. Woollam (2003) suggests that organisations' property requirements should be classified as core, tactical and surplus/semi-surplus when determining the best type of lease arrangement. Accordingly, long term leases for core properties, flexible leases for tactical properties which are more prone to change, and more flexible leases with provisions for assignment and subletting for surplus/semi-surplus properties, are appropriate.

Emerging businesses generally prefer coworking spaces because of their collaborative layout, scalability, short-term leases with cancellation rights, low overhead and minimal capital investment (Green, 2014). Flexible leases for flexible spaces are typically designed to be user-friendly (Reed and Stewart 2003) with considerable flexibility (Byrne at al., 2002; Lizieri 2003), such as the ability to use the space on a short-term basis or to vacate rapidly (Gibson 2001; Byrne et al, 2002). Coworking spaces are reported to be a less expensive solution compared to spaces on long-term leases or serviced offices (Jones Lang Lasalle, 2016; Olma, 2012; Spinuzzi, 2012). This change in tenants' requirements for core and peripheral space is a structural change in leases rather than a cyclical change in the market (French, 2001).

ALTERNATIVE LEASE STRUCTURES FOR COWORKING SPACES

The coworking phenomena has steered the need for adaptive approaches to the current leasing models for commercial office space. This section of the paper examines alternate leasing and operating models that are appropriate for coworking spaces.

The core and flex lease model

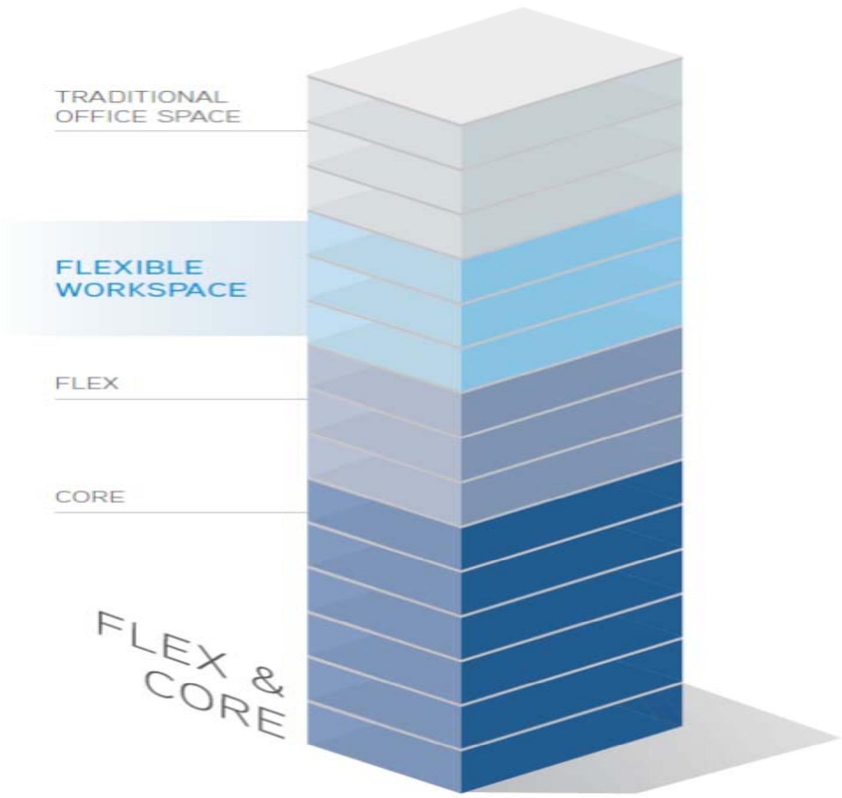
To achieve an optimal balance of traditional and flexible spaces, it is feasible for landlords to set up their own coworking platforms within their portfolios by providing the services themselves and leasing spaces directly to coworking space users. In fact, CBRE's 2018 Asia Pacific Investor Intentions Survey found that about half of investors believe that allocating under 20% of the total lettable area of the building to flexible spaces can enhance the value of the property (CBRE, 2018). An appropriate lease structure for properties that offer both conventional and flexible spaces is identified as core and flex leasing model (Colliers International, 2018). This concept involves leasing spaces to more established tenants who have stable office requirements on long-term basis while leasing spaces for coworking users on short-term, less rigid form of tenure with more flexible lease covenants to accommodate volatility in their headcount and space required. This approach will also encourage corporate occupiers who seek buildings with traditional leases, the option to house their core workforce, and simultaneously provide a large coworking space within the same building for the peripheral workforce.

By entering the market directly and cutting out operators this is an opportunity for landlords to meet the growing demand of flexible leases and capture a market segment of start-ups and freelancers that otherwise would not fit under their traditional leases. The next step of coworking could see corporate occupiers seeking buildings where they can lease small corporate offices on traditional leases for their core workforce, but only where there is a large coworking space provided within the same building for the peripheral workforce. In terms of the financial viability of flexible spaces, a survey conducted by CBRE in the CBDs across various Asia Pacific markets identified that around 75% of hot desks in flexible space centres are priced at a 100% premium over rents in their corresponding office buildings (CBRE, 2018). In fact, China, Korea and Australia were identified as the most profitable markets for flexible spaces in the Asia Pacific region, with the price for hot desks more than 200% higher than corresponding office rents in certain cases (CBRE, 2018).

It is expected that the demand for coworking spaces and flexible leases will further increase with the recently introduced changes to International Financial Reporting Standards (IFRS). Effective from 2019, IFRS will change the accounting practices for occupiers of real estate, eliminating off-balance sheet reporting and requiring them to recognise most leases on balance sheets as liabilities (CBRE, 2018). Since any lease obligation which is less than 12 months is exempted from the new rules and will be accounted as an expense, it is expected that many organisations would be increasingly considering the use of flexible spaces with short-term leases. It is anticipated this will force multinational corporations to take less core space on traditional long-term leases and rely on flexible space operators to provide flexible spaces to deal with their temporary headcount swings (Colliers International, 2018).

Additionally, 'core and flex' lease model can be used as an appropriate lease model for coworking spaces themselves, as shown in Figure 1 (Colliers International, 2018). It involves leasing spaces to coworking providers or directly to coworking space users on a long-term deal for their core operations together with an agreement to provide flexible spaces on flexible leases to accommodate volatility in headcount. The flexibility to adapt for variances in the headcount and future use are the key components to the model.

Figure 1: Core and flex leasing model for coworking spaces



Source: Colliers International (2018, p.16)

While direct leasing to coworking users enables landlords to retain full control over their building and the end user profile, it also exposes them to business risks and variable income (CBRE, 2018). Particularly, the operation of coworking spaces is labour intensive and many landlords typically lack the economies of scale to operate coworking spaces effectively (Colliers International, 2018). This will require an active asset management, not only to achieve operational efficiency, but to create an attractive working atmosphere for coworking space users, enhanced by technology and facilitated by mobile devices (CBRE, 2018). These types of space and lease arrangements are therefore more appropriate for landlords with large portfolios and sufficient vacancy to accommodate the new platform into their buildings (CBRE, 2018).

Furthermore, Lizieri et al. (1997) identify that the institutional structure of the property market imposes certain constraints on achieving flexibility in leasing structures. These include valuers and valuation models penalising non-standard lease structures in the market, legal advisors resisting different contractual forms, institutional investors looking unfavourably on leases with flexible provisions, and tenants being unwilling to pay a realistic price to achieve flexibility. Changes in tenant requirements will influence the level and the stability of rental income. Therefore, any move towards more flexible patterns of occupation will tend to increase the risk of investing in real estate for developers, for banks financing and funding property and for long-term investors holding property as landlords (Lizieri, 2003).

The revenue and profit share model

With the increasing popularity of coworking spaces, many landlords are interested in partaking in the coworking platform and share from the prospect. This can be undertaken by leasing office space to coworking providers on 'revenue and profit share models'. Under this arrangement, landlords lease space to coworking providers at a base rent (fixed component) plus a turnover rent (variable component) depending on the EBITDAR (earnings before interest, tax, depreciation and amortisation) of the coworking business (CBRE, 2018). The leases are typically long-term leases where the fixed base rent and the turnover rent, which could be a percentage of the business revenue/profit, are negotiated within the lease conditions. Under this arrangement, both landlord and the coworking operator share the benefits as well as the operational risk of the business.

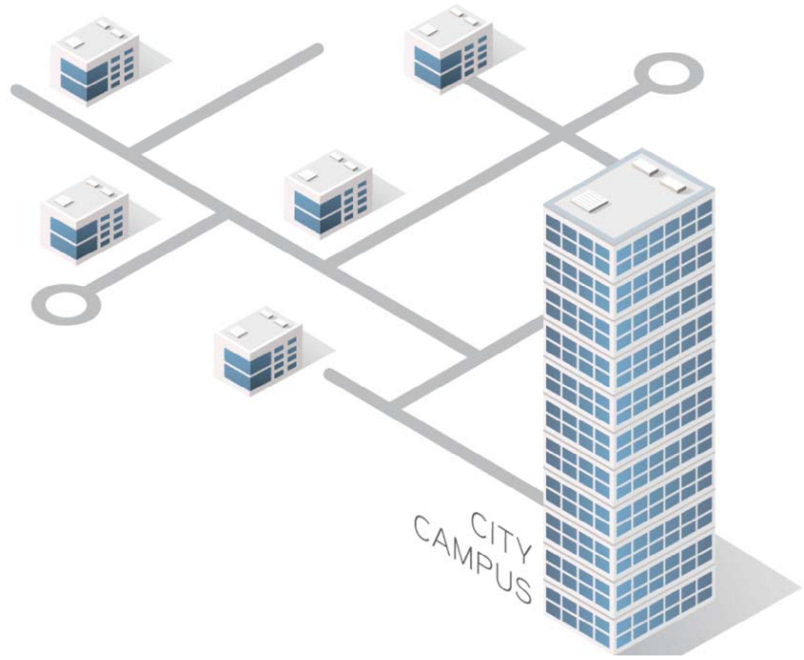
This lease arrangement would be more appropriate with more established, large coworking providers, such as WeWork, as they tend to be more cash positive. In fact, it is suggested that 70% of large coworking operators are profitable and expect a significant up scaling of their operations (Moriset, 2013). By surveying coworking providers in Japan, Uda and Tomokazu (2016) found that most (56%) spaces with fewer than 10 seats are incurring a loss and profitable spaces are the minority (25%) while the majority (70%) of spaces with 50 seats or more are making a profit, and only some (20%) of such spaces are operating at a loss. Therefore, landlords should closely evaluate the profitability of individual coworking operators and ascertain whether those groups are best suited for such lease arrangements. At the space level, occupancy and average monthly per member revenue are the most meaningful indicators to identify the operational profitability of coworking businesses (Zhai, 2010). Additionally, this lease model is more appropriate for coworking spaces in new buildings located in competitive markets which have the potential for further growth of demand (CBRE, 2018).

The city campus model

The 'city campus' leasing model, in which businesses with mobile workforce utilise satellite flexible spaces owned by the same landlord spread across a city in addition to a primary headquarters, is also becoming increasingly popular as an coworking space delivery model

(Colliers International, 2018). The model involves organisations minimising the space requirements for their headquarters while enabling them to place staff in digitally connected satellite offices across a number of locations within the landlord's portfolio. The proposed lease model is illustrated in Figure 2.

Figure 2: City Campus lease model



Source: Colliers International (2018, p17)

It is suggested that this lease model is suited for sales and client-facing businesses that are mobile or dealing with clients at different locations. The success of this model will be largely geared around the strength of the landlord's / flexible workspace operator's digital platform and its ability to link with existing businesses on planned technology (Colliers International, 2018). This arrangement provides a wider geographical spread for coworking spaces as it encourages landlords / operators to set up several smaller sized spaces rather than fewer large scale spaces. In addition to the savings on leasing costs, existing literature identifies satellite offices as a way of being more productive for space users. It would increase their effectiveness through fewer interruptions and disturbances, and favour better concentration (Bergum, 2007). Also the avoidance of commuting is often considered as a method of utilising working hours more effectively (Tremblay, 2002; Bailey and Kurland, 2002). The disadvantages of such arrangements are less interference with other coworking workers and less opportunities for personal and professional development (Tremblay and Thomsin, 2012).

The joint venture model

The joint venture model between the landlord and coworking provider, where the landlord and coworking provider enter a joint venture agreement, is another space delivery arrangement for coworking spaces. Under this arrangement, the landlord contributes to the majority of the initial investment and has the priority in receiving profits while the coworking provider has the operational control of the coworking space and receives profits after the landlord's agreed returns (Zhai, 2010). Such agreements provide the opportunity for landlords to capture a market segment of start-ups and freelancers that otherwise would not fit under their traditional leases. Profit shares for the landlord and coworking operator are decided in their joint venture agreement.

The joint venture model provides benefits for both parties. From the landlord' point of view, such arrangements not only provide their preferred returns, but also provide them an in-depth understanding about coworking business practice (Zhai, 2010). The knowledge and expertise acquired from the joint venture experience can help landlords to capture future optimal investment opportunities to operate their own independent coworking spaces. From the coworking provider's perspective, this arrangement alleviates their initial capital stress and allows their business to grow rapidly without raising large sums of capital (Zhai, 2010). On the other hand, due to the nature of interest alignment in the joint venture model, both parties will suffer if the coworking business experiences adversity.

The management model

The management model, where the landlord and the coworking provider enter a management agreement, is another space delivery model for coworking spaces. Under the management agreement, landlords are typically responsible for all the capital expenses and recurrent operating expenses while the coworking provider is responsible for the design and operation of the space, marketing and sales of membership, event organising, and community building (Zhai, 2010). For operating and managing the coworking space, the coworking provider earns a management fee. The fee could be a previously agreed fixed amount, or a percentage of the total revenue, or a mixture of both as agreed in the management agreement.

The main advantage of this model is that both parties can focus on their specialities, i.e. coworking providers on running coworking spaces and the landlord on managing his investment properties. By entering management agreements with coworking space providers, landlords would be able to utilise the expertise of established coworking operators to improve their building stock. Similarly, the coworking space providers would be able to find spaces to run their coworking business without paying any rent. However, the landlord's and coworking provider's different business objectives might cause tension between the two parties. For example, the coworking provider may want to increase capital expenditures to upgrade the space to enhance its competitiveness and marking strategies, while the landlord is reluctant to do so (Zhai, 2010). Such disagreements may be more likely when their business profits are weaker and may result in litigation if the two parties fail to reconcile their disagreements (Zhai, 2010).

CONCLUSIONS

This conceptual paper investigates the implications of the coworking phenomenon on traditional office leasing models. By conducting an extensive literature review, the paper identifies alternative leasing and operating models that can facilitate the growing demand for flexible and scalable coworking spaces.

The findings identify five main lease and operating models for coworking spaces. Table 1 below summarises different models, suggested landlord profiles best suited for the various models, and the main advantages and disadvantages associated with each model.

Table 1: Coworking leasing and operating models

Lease model	Lease concept	Who should use this model?	Advantages	Disadvantages
The core and flex lease model	• Coworking users on short-term, less rigid form of tenure • Established tenants on a long-term basis and tenure.	• Landlords with large portfolios and sufficient vacancy to accommodate flexible spaces.	• Enables landlords to retain full control over their building and the end user profile.	• Exposes landlords to business risks and variable income. • Issues with the valuation of properties on flexible leases.
The revenue and profit share model	• Lease with a base rent and a percentage on business' turnover or profit.	• More established, coworking providers. • Buildings which have the potential for further growth.	• Enables landlords to share the business success.	• Landlord's total rental income suffers when the business experiences a downturn.
The city campus model	• Leasing headquarter space and satellite offices in different properties owned by the landlord.	• Portfolios with properties that are strongly digitally linked.	• A wider geographical spread for coworking spaces.	• Less connection with coworking users in their portfolios.
The joint venture model	• The landlord and coworking provider entering a joint venture agreement.	• Landlords desiring a high involvement in their coworking portfolio.	• Are able to learn from coworking providers while receiving preferred returns.	• Both parties will suffer if the coworking business experiences adversity.
The management model	• The landlord and coworking provider entering a management agreement.	• Landlords desiring a high involvement in their coworking portfolio.	• Both parties are able to focus on their specialities.	• Different business objectives might cause tension between the two parties.

In summary, this paper provides a foundation for further exploration of the implications within the coworking asset portfolio which relate to the traditional leasing practice and lease structures. As the coworking industry sector evolves and becomes more commonplace, the demand for additional flexible, short-term leases will become more prevalent. Even large, long-established companies will understand the benefit of such a competitive cost alternative compared to the traditional lease model. Particularly with the changes in accounting standards for commercial leases, flexible spaces within flexible lease models will become more attractive not only for coworking space users but also for multinational corporations who are increasingly seeking flexibility. These changing patterns desired by occupiers leasing coworking spaces add a new dimension to the office leasing market and the associated practices. In summary, the findings emphasise the importance of applying more dynamic and creative lease structures that are better aligned with the interests of landlords, space operators and the diverse groups of office space users in the flexible office arrangements. Entering into this emerging market sector would generate several tangible and intangible benefits for traditional office landlords. In this regard, various strategic considerations, if adopted and implemented by landlords, will ensure an optimum growth for their property asset investment.

Further Research

The coworking business model is an emerging area of research which will require testing under varying property market conditions. Therefore, as part of a wider study the research will expand to explore the implications of the coworking phenomenon on the performance and utilisation of corporate commercial real estate assets and the behaviours of market participants such as landlords, coworking operators, and coworking space users.

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