A survey of Landlords and the impact of co-working on their Australian business and the industry.
The co-working juggernaut continues to roll through Australia’s major office markets. In many ways co-working groups have chosen an opportune time to expand rapidly in Australia, as consistent low office vacancy in Sydney and Melbourne coupled with strong white collar employment growth has created a ready market of office-based workers needing a desk. Add to this is the growing requirement from corporates to have flexible expansion and contraction options, as well as an ongoing trend for office space that more reflects the needs of a younger cohort of workers. Consequently co-working groups have found themselves a wide gap in the market waiting to be filled.

While the occupier side of the office market is evolving rapidly, a concurrent change in the way most purchasers invest in office buildings has yet to be felt to anywhere near the same extent. It is true that while new market entrants from all points of the globe continue to enter Australian office markets, the underlying attraction of the assets they purchase remains unchanged from years’ past – long term, fixed growth income streams from strong covenants in large, secure markets. When compared to major office markets such as Manhattan and London, co-working groups occupy a small percentage of office space in Sydney, Melbourne and Brisbane. However, they continue to grow faster than most other occupier groups and will be a growing force in the pre-commitment market, which is a traditional source of investment stock for major office investors.

Colliers has sought out the opinions of some of Australia’s leading office owners and investors to gather their overarching views of the market, and to try and ascertain just how co-working groups will impact occupier and investment markets going forward. We hope you enjoy our report.
CO-WORKING - CURRENT STATE OF THE CBD MARKETS

*Data and information correct as at November 2018. Colliers makes every effort to ensure the accuracy of our data, but gives no warranty as to accuracy.

<table>
<thead>
<tr>
<th>City</th>
<th>Locations</th>
<th>Occupied</th>
<th>% of CBD Stock</th>
<th>Average Size</th>
<th>Current Briefs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brisbane</td>
<td>30</td>
<td>57,500m²</td>
<td>2.6%</td>
<td>1,900m²</td>
<td>30,000m²+</td>
</tr>
<tr>
<td>Sydney</td>
<td>47</td>
<td>112,000m²</td>
<td>2.3%</td>
<td>2,400m²</td>
<td>22,000m²+</td>
</tr>
<tr>
<td>Melbourne</td>
<td>48</td>
<td>85,000m²</td>
<td>1.9%</td>
<td>1,800m²</td>
<td>49,000m²+</td>
</tr>
<tr>
<td>Canberra</td>
<td>4</td>
<td>8,807m²</td>
<td>0.2%</td>
<td>1,202m²</td>
<td>0m²+</td>
</tr>
<tr>
<td>Perth</td>
<td>8</td>
<td>22,728m²</td>
<td>1.3%</td>
<td>1,420m²</td>
<td>11,000m²+</td>
</tr>
<tr>
<td>Adelaide</td>
<td>8</td>
<td>8,483m²</td>
<td>0.6%</td>
<td>1,060m²</td>
<td>8,200m²+</td>
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</tbody>
</table>
Separate surveys were sent to landlord clients who lease and operate office buildings/portfolios and to landlord clients who manage the funds these office buildings/portfolios sit in. For the purposes of this report, we will refer to these groups as ‘leasing’ and ‘investor’ clients respectively.

In many cases, we surveyed ‘leasing’ and ‘investor’ clients from the same organisation. This was a deliberate strategy that we took, as we were interested in the varying perspectives from the two groups. Both client types can have different motivators, although their operational strategies at the end of the day are closely linked, and this is important for co-working groups and the wider industry to understand.

Question: Do you believe the co-working market has a positive impact on your business/Australian Investment Portfolio?

The majority of both leasing and investor clients believe co-working has a positive impact on their business/ portfolio.
The results suggest a slight mismatch between the outlook in investor and leasing clients. This perhaps is due to the global reach that investor clients have, and the fact they may feel more comfortable with co-working groups as occupiers of their assets given a positive experience overseas.

In a similar vein, investor respondents were also more ‘bullish’ on their preference for co-working occupancy across their portfolio, than their leasing counterparts.

A majority of 60% of leasing respondents chose ‘0% to 10%’ when asked how much space in their portfolio will consist of co-working. 35% chose ‘10% to 20%’ and only 5% chose ‘20% to 30%’.

On the flip side, when asked ‘In your view, what is the maximum percentage of co-working occupancy (sqm) you would consider across your portfolio as ideal?’, investor clients were more weighted to the higher proportions. 46% believe ‘0% to 10%’ is ideal,
These answers are relatively unsurprising given the infancy of the co-working industry. However, there is work to be done by co-working groups to ensure landlords have positive experiences in the future. This is most important in Sydney and Melbourne, where space opportunities are few and far between, and co-working groups are competing with traditional tenants for limited space.

Question: Do you believe the co-working market has a positive impact on your business/the property industry?

- Leasing Landlord clients were more positive on the impact of co-working groups on the market, than on their own business.
- Most agreed that co-working is positive for the market (90%), although a smaller proportion (65%) believe co-working is positive for their business.
Co-working groups should seize this information to communicate their business plans more closely with building owners, which may help more owners change their view to that of ‘a partner’.

When asked which of the following best describes a co-working operator, 30% of operator respondents chose ‘A Partner’, 10% ‘A Competitor’, 10% ‘An Ordinary Tenant’ and 5% chose ‘No View’.

What is interesting is that 45% of respondents chose the response ‘All of the Above’, meaning there seems to be much uncertainty in the industry as to what the long term business objectives of co-working groups actually are.

Question: In your view, which of the following best describes a co-working provider?

Source: Colliers International
In order to aid their expansion, co-working groups should work to change this perception within the landlord community. Central to this; explain how or if their business strategy will change in an environment of rising unemployment and vacancy. Landlords are likely to change their perception of co-working groups as a covenant if they are more comfortable that the operators can withstand a market downturn.
This is a positive growth outlook for the industry, as co-working occupancy is still less than 3% in all CBDs. The challenge will be stock availability to accommodate this growth.

Importantly, all respondents had a less than 10% exposure to co-working groups, and only 35% expected that this exposure would increase by 3 years’ time to between 10% and 20%, and 5% (or 1 respondent) to between 20% and 30%.

Source: Colliers International
When asked about impacts co-working groups have had on their asset(s), 45% chose ‘tenancy profile has changed (i.e. corporate to casual). This was the most selected response, and was followed by 35% of respondents each choosing ‘change of asset perception’, and ‘building management – i.e. more cost due to wear and tear’.

25% of respondents chose ‘positive rental impact’ as an impact that co-working has had on their asset(s), while none chose a ‘negative rental impact’.

Comments included in the ‘other’ category were generally positive on the impact of co-working. Some comments on this question included ‘flexibility to existing tenants’, ‘no significant impact on the asset given calibre of operator’, ‘diversity in spatial offerings and term commitments’, ‘little to no impact’ and ‘too early to say’.

In order to try and better understand the long term viability of co-working groups in Australia, we asked our leasing clients if their organisation is considering an in-house co-working strategy.

55% of respondents responded ‘no’ or ‘not at this stage’ to this question. The remainder of respondents were at various points along the development pathway to creating their own model, although some noted that it was small-scale at this point and labour intensive. Others indicated that they were developing their own model, but in partnership with existing providers.

Landlords should think carefully about the long term implications of co-working on building management, and on their other tenants. Co-working groups won’t suit all assets, and landlords with large portfolios will benefit in the long run from identifying which assets under their management are most suitable. If existing tenants are demanding the flexibility that co-working offers, perhaps think about locating co-working in a select number of easily accessible and appropriate assets as a solution.
Finally, we asked our leasing respondents to provide any further comments on co-working and how it will impact their organisations. There were a wide variety of comments, providing some revealing insights and ‘food for thought’. While the positive comments will be encouraging for co-working operators, a number of respondents feel that consolidation is inevitable, and there is some concern about the long term viability of some operators.

“Rapid expansion is both an opportunity but also a risk as to the viability of the sub tenants in a market downturn. Seems to be a viable option for tenants and their people so I believe it is here to stay and will continue to expand however there is likely to be some consolidation and some brands or locations that fail.”

“Don’t see them however as the panacea for growth space for larger tenants, as to be economically viable, they must have high occupancy so the reality of true flexibility is questionable.”

“With so many new providers coming to the market together with landowners participating in this space, rationalisation appears inevitable.”

“It is of crucial importance that the quality of the co-working fitout and operations is consistent with that of the building, albeit some diversity of occupants/dress standard etc. is accepted and will add to the vibrancy/activation of the building. Where well managed it will assist our organisation to secure tenants that consider flex space as a positive attribute.”

“There is great uncertainty as to the long term viability of the large number of co-working operators entering the market and uncertainty as to the long term viability of at least some operators.”

“Integral part of the commercial business model of the future”

“Co-working provides a dynamic atmosphere for small companies that may not otherwise be able to achieve that level of culture and amenity on their own, something that is required to compete for talent in a competitive marketplace.”

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THE INVESTOR PERSPECTIVE

This section outlines the results of the surveys undertaken by our investor clients.

Question: ‘What is the maximum income percentage from a co-working group in a new development your investors would consider?’

- 38% chose ‘0% to 10%’
- 31% chose ‘10% to 20%’
- 8% chose ‘20% to 30%’
- 8% chose ‘30% to 40%’
- 8% chose ‘40% to 50%’
- 8% chose ‘100%’

Source: Colliers International

When asked ‘What is the maximum income percentage from a co-working group in a new development your investors would consider?’, 38% of investor clients chose ‘0% to 10%’ and 31% chose ‘10% to 20%’.

While there were singular responses for some of the higher proportional categories, these totalled a smaller 24%.

This suggests that when choosing pre-commitment tenants, developers should continue to proceed with caution when seeking commitments from co-working groups, as the eventual buyer pool of their development could reduce in reverse proportion to the size of the commitment.
When asking if their investors look more or less favourably upon new developments with a co-working anchor, almost half of respondents responded with ‘no impact’.

A further 31% of respondents chose ‘less favourably’ while a smaller 15% chose ‘more favourably’.

Taking the above question a step further, we asked our investor clients if in their view a co-working tenant has an impact on the value of an asset.

A reasonably strong majority of 62% of respondents chose ‘no impact’. Interestingly, a higher proportion (23%) chose ‘moderately positive’ than those who chose ‘moderately negative’ (15%).

While there appears to be some uncertainty as to the strength of a co-working group as a tenant covenant, there is less concern with the valuation impact. This may be due to the fact that income streams are treated by and large the same by the valuation community, and that the perceived risk of taking on a co-working tenant covenant is offset by the underlying asset value that can be achieved.

Source: Colliers International

There appears to still be some uncertainty amongst the investor community as to the strength of a co-working covenant, although encouragingly a strong proportion of investors are as comfortable with co-working groups as a tenant in addition to any other industry type.
The differences in responses to the questions regarding an asset’s valuation and yield could come down to a perception of better income metrics from co-working groups. Astute developers could be seeking higher net face rents from co-working groups, to offset any higher yield placed on an asset in order to avoid an impact on the valuation. This could otherwise be referred to as a rental ‘risk premium’ being applied.

Question: In your view, the yield of a building that is fully leased to a co-working tenant versus that of a building fully leased to a different tenant, all else being equal, should be...

- 0 to 25 bps lower, 8%
- 25 to 50 bps higher, 23%
- 0 to 25 bps higher, 31%
- Same, 38%
- 25 to 50 bps lower, 14%

When asked about the impact to the yield of an asset that is fully leased to a co-working anchor, the answers somewhat jar with the previous answers about impacts on an asset’s valuation.

While 38% answered ‘same’ when asked what the yield of a building should be that is fully leased to a co-working tenant versus a different tenant (all else being equal), 31% chose ‘25 to 50 bps higher’ and 23% chose ‘0 to 25 bps higher’. Only 1 respondent chose a lower yield (‘0 to 25bps lower’).

When asked, ‘Do your investors have a preference for a particular co-working provider and why?’, an array of varying responses were provided.

- 46% of respondents responded ‘no’. Only two respondents indicated a particular co-working group due to brand recognition and the strength of capital behind this operator.
- 24% respondents indicated that the preference is based on the strength of guarantee provided.
We asked our investor respondents to provide any further comments on co-working and how it will impact their organisations. Overwhelmingly, investor opinions on co-working groups were positive, however there was some commentary on the threat to the traditional RE model. By and large, investors seem to believe that it is a trend that the industry will need to embrace and work with if they are to attract and retain tenants in their portfolios.

“Trend to shorter term and more flexible leases acts as a threat to the traditional RE investment model”

“Will continue to have a place in the market but will shortly reach a saturation point.”

“Minimal Impact, it is industry news”

“There will be increasing emphasis on co-working over the next few years and the organisation is likely to continue to investigate and develop knowledge in the field”

“Offer future flexibility and ability to offer a choice in workspace. From an owner’s perspective we anticipate further new entrants, and consolidation with landlords choosing to provide these spaces themselves”

“Reduced requirements for a permanent office space”

“Personally very positive. They are definitely a disrupter but provide our customer base with the flexibility that we traditionally cannot. Their presence in our assets is good for our customers - happy customers - retention up!”

“We will continue to have a place in the market but will shortly reach a saturation point.”

“Will continue to have a place in the market but will shortly reach a saturation point.”

“We will continue to have a place in the market but will shortly reach a saturation point.”

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554 offices in 69 countries on 6 continents

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