marketbeat
Barcelona Offices

FLEXIBLE SPACES

MARKET SUMMARY

The take-up of office floorspace reached 146,000 m² in the first quarter of 2019, an increase of 50% if we take into account the same period the previous year. Notable among the main deals for the year is the 18,000 m² turn-key transaction on the part of Agrolimen in Sant Joan Despí. With a significant presence in the city centre and 22@ district, WeWork has added some 8,300 m² to their facilities in Barcelona into the recently opened 22@ Platinum project.

The number of contracts relating to larger floorspaces has been particularly noteworthy during the first quarter. Of the 98 deals struck, 17 exceeded 2,000 m². Some 23% of the total corresponded to deals of between 1,000 and 2,500 m², followed by those of between 2,500 and 5,000 m², at 22%. Contracts on floor areas of less than 500 m² represented some 50% of deals. The average floorspace transacted hovered around the 1,400 m² mark, whereas the average floor area for deals exceeding 2,000 m² stood at around 5,300 m². This is some 13% above the average size for transactions of this type recorded in 2018.

In terms of submarkets, demand was focused on the New Business Areas, with these cornering 57%. Take-up in the city centre and CBD represented 22% of the total, whereas the Out of Town zone cornered 21% of the total. For the first time ever, coworking spaces swallowed up the largest share of take-up with a figure of 23%. Services (17%), industrial businesses (16%) and ITT firms (13%) continue to represent a significant share of the total.

The available supply of offices in Barcelona at the close of the quarter continues to trend downwards, the vacancy rate shrinking to 4.8%. The vacant space amounts to 319,000, some 20% lower in comparison with the figure one year ago.

In the area of the CBD and the City Centre, the vacancy rate is no higher than 2%. In the New Business Areas this indicator hovers around 5%, whereas on the Periphery it stands at below 13%. Some 50,000 m² of office stock will be added in Barcelona prior to the close of year, of which 70% is already committed.

The recovery in rents has consolidated across the various zones. Prime rents of around €27/m²/month correspond to growth of some 13% on the figure for one year ago, whereas average closing rents have risen by some 15% in comparison with the previous year (€17.50/m²/month). The market continues to display very strong fundamentals which are evolving positively, leading to a figure of 198 billion euros in new investment deals at the close of the first quarter.

MARKET INDICATORS Q1 - 2019

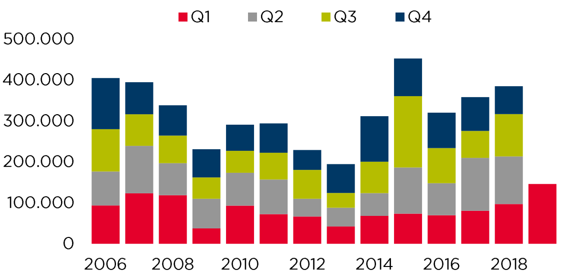
Occupancy

- OFFICE STOCK: 6,600,000m²
- NEW BUILD: 69,000 m²
- TAKE-UP: 146,000 m²
- PRIME RENTS: €27.00/m²/month

Investment

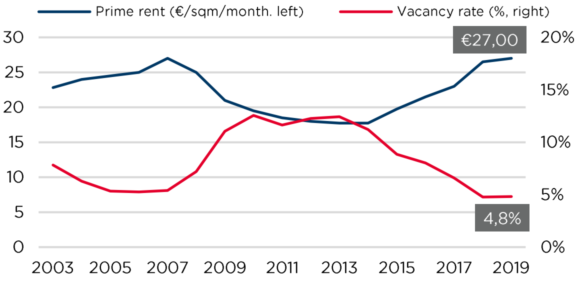
- OFFICE VOLUME: €198 billion
- PRIME OFFICE YIELD: 3.5%

Trend in take-up in Barcelona by quarter (m²)



Source: Cushman & Wakefield

Prime rent and vacancy rate - Barcelona



Source: Cushman & Wakefield

FLEXIBLE SPACES

BARCELONA AND MADRID IN THE MID-RANGE

At the close of 2018, Cushman & Wakefield estimated a figure of 11 million square metres of office space assigned to coworking and flexible offices worldwide. Although it remains concentrated in the world's more connected cities, the concept of coworking, fully fitted offices, flexible spaces, etc. has been spreading to new markets. Even so, the total for flexible space represents just 1% of the worldwide office stock.

These spaces have generated significant interest in the real estate sector, not only as a result of the volumes involved, but also due to the growth potential and major changes regarding the manner in which businesses can use their office space.

Around 40% of the entire coworking space worldwide is located in North America, the remainder being split evenly between Europe and Asia. The latter region boasts the greatest share of office stock (2.1%), whereas this figure in Europe and North America amounts to around 1.0%.

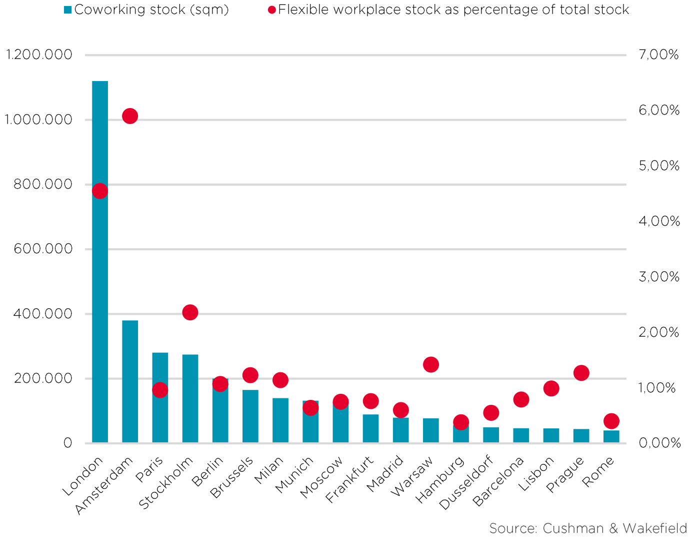
Worldwide, there are around 31,000 flexible spaces housing 5 million users. The leading European capitals have strong markets in terms of this type of workplace and the flexible spaces offered here are located 60% in the city centre and in other business areas.

Rising demand is guaranteed over the coming years. According to the most recent Cushman & Wakefield studies, smaller capital cities are seeing the greatest demand for this type of space and cases such as those of Dublín, Stockholm and Copenhagen demonstrate this fact by heading up the ranking of the best coworking offices at a European level.

Companies appreciate the ease with which they can adjust their staffing levels and reduce costs, enabling them to remain competitive and adapt quickly to internal changes and the continuous transformation of markets worldwide.

At the European average with around 1% of total stock assigned to flexible spaces, Madrid and Barcelona are among the key cities undergoing significant growth in terms of these types of spaces.

The sector is within the growth phase and the trend is very clear. It is anticipated that flexible spaces will represent 10% to 15% of total stock in 2023 and up to some 30% in 2030.



Source: Cushman & Wakefield

The explosion in coworking facilities has been exponential. Many of us saw coworking as a variation of the serviced office model (the short-term rental of small spaces and workstations). The operator Regus (nowadays IWG) became the global leader of the sector and faced relatively little competition until the appearance of the coworking phenomenon.

Coworking differentiates from serviced offices in that costumers are treated as members of a community rather than tenants. Whilst enabling both collaboration and networking, coworking is strengthened through the careful design of work spaces, the technology platform, support services and events.

Coworking is also leading owners of traditional offices to refine their 'client' retention strategies within an ever more competitive market. These initiatives on the part of landlords positively impact workers and stretch from the modernisation of the common areas of their assets and improved sustainability, up to embracing collaboration with local service providers (restaurants, gyms, etc.).

How does all of this affect valuations?

In my view any office property that is capable of attracting a leading coworking operator is achieving a significant quality seal in that these clients/tenants are very demanding. The fact that part of an office building is occupied by high standard coworking reflects favourably on the valuation. Nevertheless, where a building is mainly or entirely occupied by an operator of this type, we would get into a debate over whether the landlord is over-exposing to a relatively new market which may prove vulnerable to economic and occupancy cycles.

With hindsight, the situation faced by IWG following the bursting of the dot-com bubble (2002/2003) is still fresh in our minds. The firm saw an excess of office space let over the long term which required subletting in a weak occupier market. The impact on today's market is that certain investors do not see the solvency of a leading coworking operator as being equivalent to that of corporate occupier. The underlying assumption is that the latter is less exposed to the ups and downs of the property market.

There are, however, many investors attracted by the opportunity of acquiring offices that are either fully or mostly occupied by a coworking or flexspace operator with a strong reputation that buttresses the quality of the building and its location and who has invested in the creation of first-class office space in which users wish to work.

That is why a negative impact on the value has yet to be demonstrated. Nevertheless, it is true that each case requires careful study (as in any investment analysis), particularly with regard to the relationship between the headline rent and effective rent paid by the operator. The latter point is key to any valuation. Flexspace is growing so fast and there is such a demand for space that rent levels could surpass potential sustainability.

Tony Loughran, RICS Registered Valuer
Partner, Head of Valuation & Advisory, Spain

RESPONDING TO DEMAND

The positive trend in terms of the take-up of flexible spaces is clear. In the case of Barcelona, more than 10% of take-up corresponded to spaces of this type in 2018, the figure for Madrid being 7.5%.

The floorspace transacted depends on operator type, varying from 800 m^2 up to 10,000 m^2. This first quarter of 2018 has seen the letting of 8,300 m^2 by the US firm WeWork in one of the buildings belonging to the 22@ Platinum complex in Barcelona.

Asset location plays an increasingly important role in the decisions of pure coworking operators and the CBDs of Madrid and Barcelona represent their first choice. IWG has signed a lease on 5.156 m^2 at no.200 on Paseo de la Castellana in Madrid, in addition to the one at no.102 Avinguda Sarrià, in Barcelona. These represent two clear examples of deals being closed on class-A buildings within the final quarter of 2018. The leading players in Madrid during the first quarter were Networkia and WeWork, both firms once again choosing the CBD at no.23 Poeta Joan Maragall and no.106 Francisco Silvela respectively. Confidence in this business model is on the rise, favouring growth in the take-up of floorspace with an average area transacted exceeding 2,500 m^2.

There is also a strong market for flexible spaces . This is tilted towards assets located in areas with a good residential and service mix enabling them to create a 'near at hand' environment. One of the main requirements for their buildings is that they are located within a setting that invites collaboration and innovation. This fact enables them to take advantage of synergies created through meetings and events organised by the providers of these services.

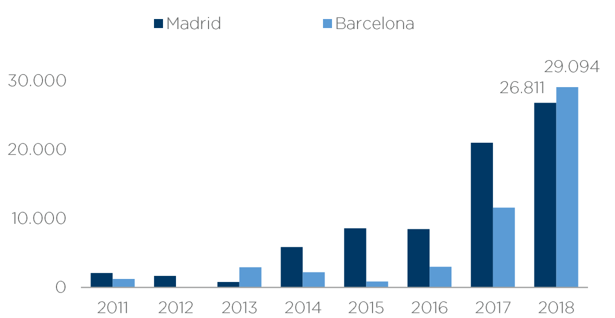
The main areas offering coworking spaces in Madrid are located in zones adjacent to the city and the city centre itself, more specifically the historic centre of Madrid where they make up more than 40% of the supply of these types of offices. Within Barcelona, District 22@, Poblenou, Gràcia and the city centre stand out, reaching a share exceeding 60% of the spaces of this type.

The preferred location for these types of flexible spaces is in emblematic buildings, however the scarcity of available options since 2017 has entailed an increase in the number of pre-letting deals in newly constructed or fully refurbished buildings. Examples of these are the aforementioned recently delivered WeWork building on Calle Pallars in 22@ Platinum and no. 27 Calle Eloy Gonzalo in Madrid. The latter consists of a 3,700 m^2 pre-let, thus ensuring an expansion of 12,000 m^2 of their stock in the two cities.

The average rental price of one of these spaces stands at €280 per workstation per month, with rents hovering between €250 and €380/person/month. The cost varies according to the number of persons working in the location and the complementary services added to the contract.

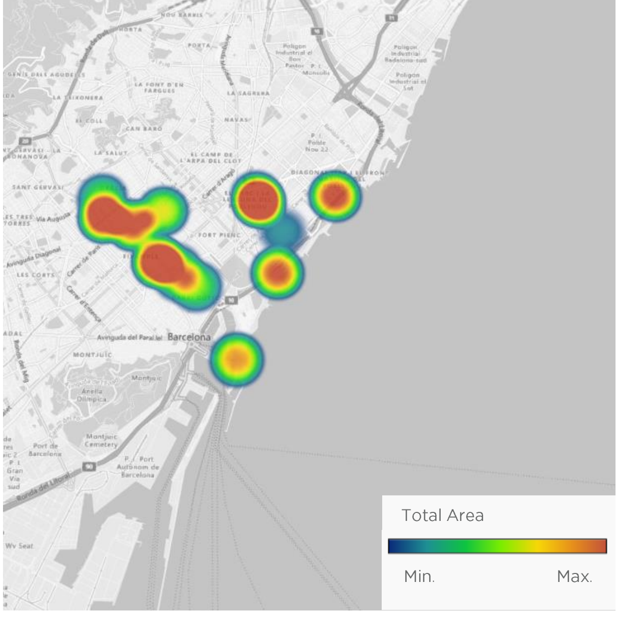
The growth of this type of spaces is exponential and it is anticipated that this trend will hold firm, the demand for large spaces rising while offering added value to business people and the self-employed as well as corporates. The latter, faced with the lack of spaces which fit their needs, are finding this to be a temporary option that was not even considered a few years ago.

Trend in take-up of flexible spaces (m^2)

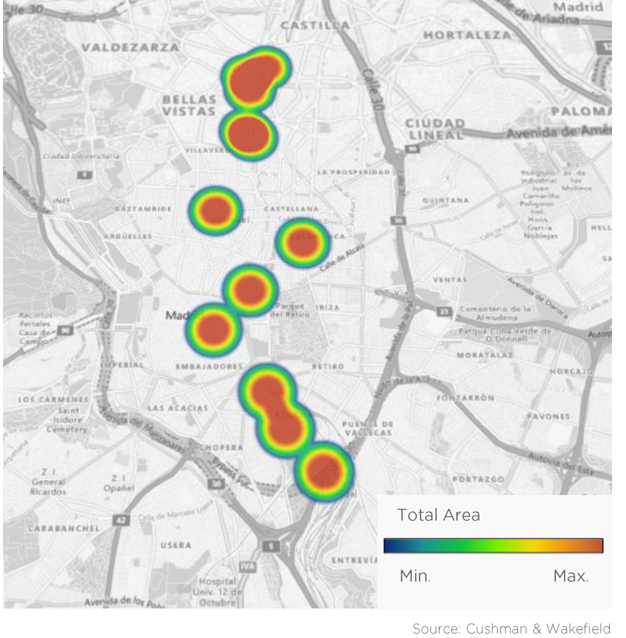


Source: Cushman & Wakefield

Concentration of flexible spaces in Barcelona 2018



Concentration of flexible spaces in Madrid 2018



Source: Cushman & Wakefield

CAPITAL MARKETS

The Spanish real estate sector is still lacking sufficient comparable investment deals for tenant-occupied buildings with flexible spaces.

Nevertheless, it is possible to draw an outline of the behaviour of the capital markets with regard to coworking due to buyer intentions in Spain and the evidence from other markets such as the United States and the UK, where a greater number of acquisitions of this type have been recorded.

Tenant solvency is one of the essential elements in investment. In the case of office buildings with flexible spaces, the investor analysis consists of understanding and predicting the behaviour of this type of business over the medium and long term.

The following points are analysed in detail in any deal:

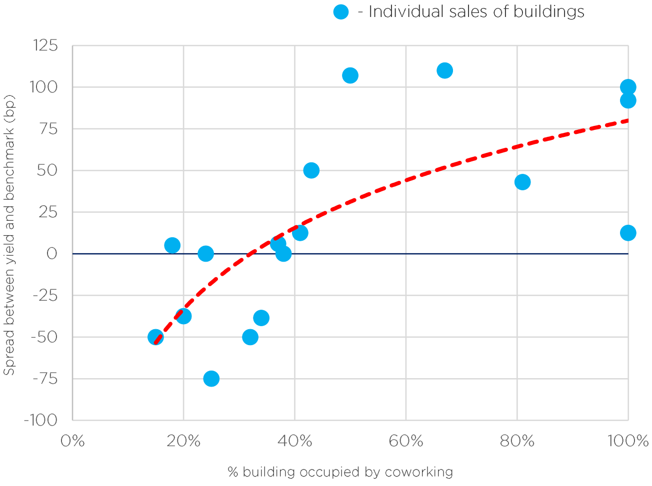
- **Lease contract guarantees.** Due to the type of businesses that take on spaces to let, the risk of the loss of the end tenant means that the landlord requires additional collateral, such as bank guarantees or other surety.
- **The solvency and reputation of the flexspace firm.** Landlords also take into account the solvency of the firm managing the flexible space in order to analyse how, and for how long, a loss of the end user may be handled.
- **The effective rent accepted by the flexspace firm.** A headline rent above market level is sometimes explained by initial free-rent periods or fit-out costs (Capex). The gap between the headline and effective rent will have an impact on the internal rate of return (IRR) of the investment.
- **The length of the free-rent period.** Those buildings in which the free-rent period expires will have better cash flow than comparable buildings in their area, improving their profile within the capital markets.
- **Percentage floorspace occupied by buildings assigned to coworking.** For now and by way of an example, the perception of risk with regard to a building which is 100% occupied is greater than that of a coworking building occupied at 50% or 15%.
- **The rate of depreciation of furnishings.** The greater crowding and turnover of people in flexible spaces reduces the lifespan of furnishings, likely requiring earlier refurbishment expenditure in comparison with a traditional tenant.

The structure of the coworking operator is also relevant: whether it consists of a single firm or various companies in a single building. The risk would be lower in the latter case.

EVIDENCE FROM ABROAD

Taking US investment activity regarding coworking or similar assets as a reference, it is possible to draw valuable conclusions that may serve as a benchmark for markets with lower liquidity in these types of deals.

In Cushman & Wakefield's report *Coworking and flexible office space. Additive or disruptive to the office market?* , 17 acquisition deals involving buildings that house operators of flexible workspaces during the first quarter of 2016 and final quarter of 2018 were analysed. The results are shown in the following graph:



Source: Cushman & Wakefield

The graph shows the relationship between the percentage occupied by flexible space and the initial yield of the deal. The latter is the spread between the deal under study and a benchmark in a similar building with a traditional tenant. Three cases appear:

If the spread is positive, the risk of the deal with coworking is perceived as greater than that relating to the traditional market.

Where there is no differential, the risk is equivalent.

In cases where the spread is negative, the perceived risk regarding the building with coworking is lower.

Given that the differential is zero or even negative, it can be stated that investors feel *comfortable* with a coworking occupancy in the asset of between 15% and 35%.

Nevertheless, risk perceptions will change as investors gain experience of the management of these types of operators, whilst the model, though still young, is demonstrating its solvency and value in the real estate market.

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