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CBRE Research – Valuation Series

Building Value: Coworking and Property Valuation

CBRE

 

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Introduction

Just a few years ago coworking was regarded as a fad catering to tech start-ups and solopreneurs in search of affordable space and a collaborative environment. Fast forward to today and coworking is a cornerstone of a new business ecosystem transforming corporate real estate and the way people work.

While considerable time has been spent explaining the evolution of coworking, tracking its footprint and analysing its adoption by enterprise users, there has been relatively little discussion of its impact on property valuation, largely due to a lack of hard data on a trend that is still at a nascent stage.

However, as more investors and landlords recognise the strategic value of coworking and introduce operators into their portfolios, there is growing demand for appraisals of the impact that flexible space, specifically coworking, can have on building value.

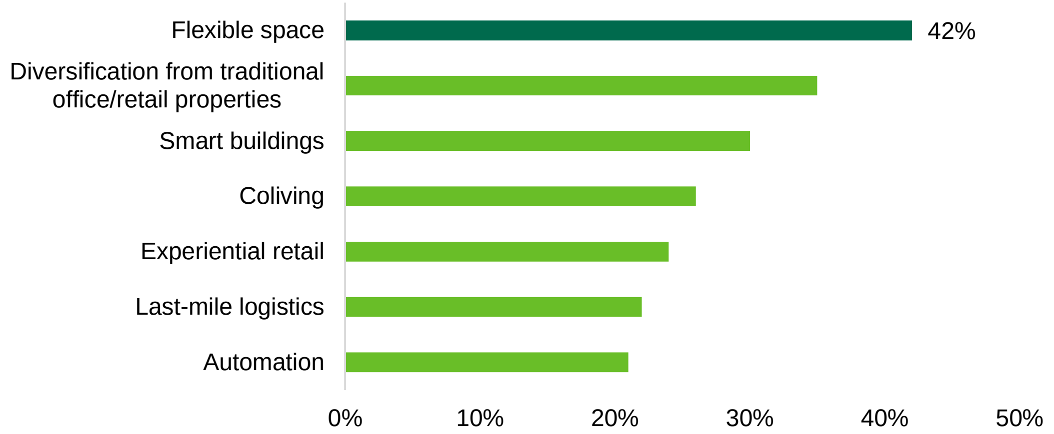
This ViewPoint draws upon recent CBRE Research studies and CBRE Valuation & Advisory Services expertise to provide an assessment of the impact of coworking on property valuation in Asia Pacific.

Investor and landlord perceptions

Many investors and landlords already believe that the presence of coworking space can enhance building value. When asked to identify occupier trends exerting the greatest impact on real estate value, most respondents to CBRE's 2018 Asia Pacific Investor Intentions Survey selected "flexible space", or space that can be procured quickly, with little capital investment and at very flexible terms[1].

[1] 2018 CBRE Investor Intentions Survey, CBRE Research, March 2018

Figure 1: Occupier trends that investors believe have the most impact on real estate value



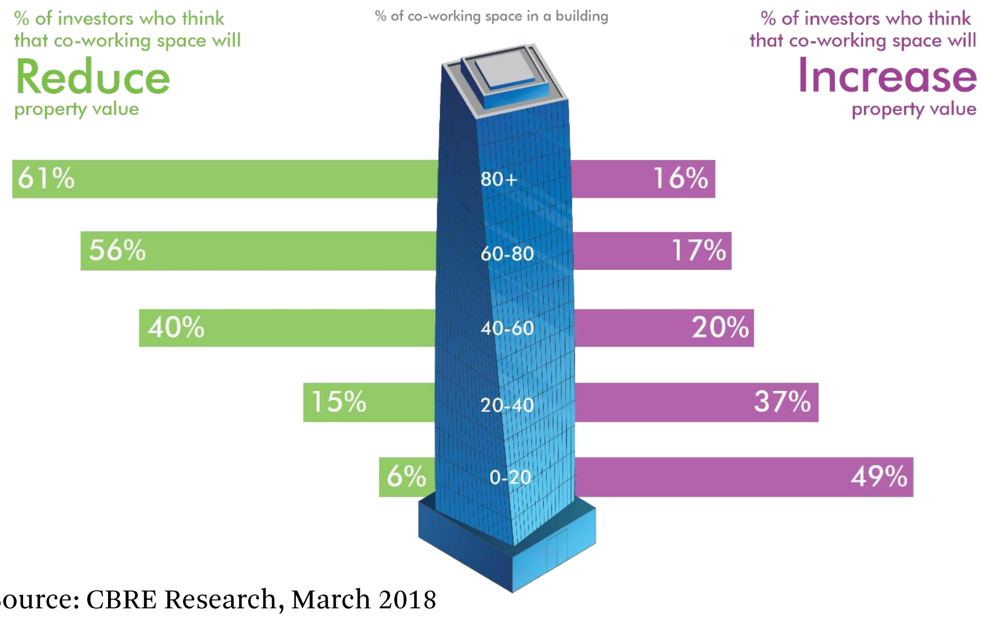
Source: CBRE Research, March 2018

The same survey found that many investors have already ascertained the optimal proportion of coworking space that can enhance the value of an individual building.

Most investors believe that up to 20% is the ideal proportion of coworking space in a single office building to enhance its value. If more than 40% of space in a single building is allocated to coworking, investors believe its value will be negatively affected.

Although some lower grade office buildings have recorded value appreciation after adding more than the ideal portion of space to coworking, investors are generally unwilling to allocate too much space to coworking.

Figure 2: Proportion of coworking space and its impact on building value



Source: CBRE Research, March 2018

Quantitative findings

While many investors hold the view that coworking can enhance property value, and some have determined the exact proportion of coworking space in buildings they believe is most beneficial to enhancing property value, there has been a lack of hard data supporting these views.

However, the initial results of a survey currently being undertaken by CBRE Americas Research on the impact that flexible space, specifically coworking, has on building value in the U.S., found that as the share of coworking within a property rises, it is initially correlated with lower cap rates. Conversely, as the share rises above roughly 30%, it is correlated with slightly higher cap rates.

The findings echoed that of CBRE's 2018 Americas Investor Intentions Survey, in which most respondents indicated that they believe coworking will have a neutral to positive impact on building value when present in less than 40% of the building.

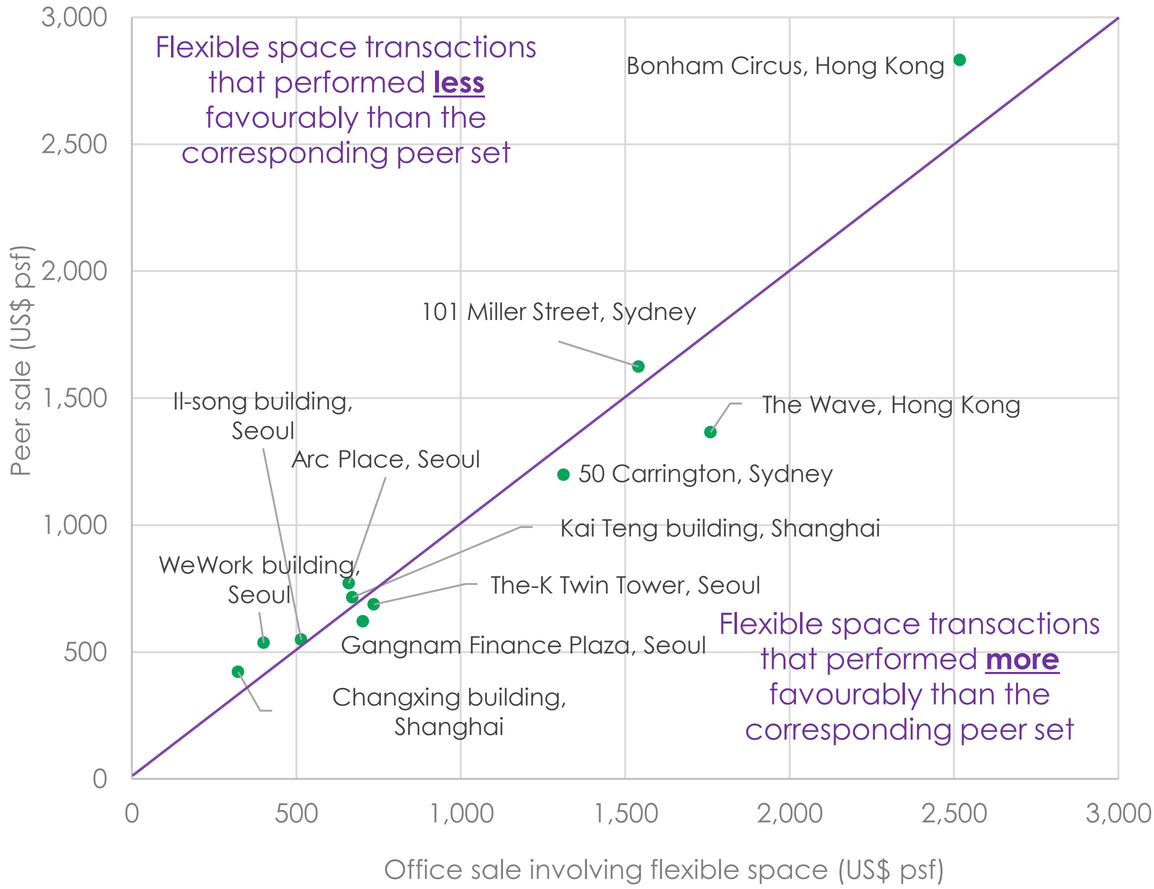
In Asia Pacific, CBRE Research set out to ascertain the effect of coworking space on building value in this region by reviewing office transactions completed between 2015 and Q3 2018[2].

A total of 11 deals involving office properties with a dedicated coworking operator were compared on a price per sq. ft. basis with transactions for office buildings without a coworking operator in similar locations. The findings show that there is not a significant price differential between the two sets of transactions.

Although the sample was small, the study found that buildings with coworking space located in major business districts rarely commanded a capital value premium. However, in some cases, non-prime buildings with coworking space commanded a 5-10% capital value premium, indicating that hosting coworking operators can improve the appeal of non-prime buildings and enhance their values.

[2] Exploiting the Agile Revolution: Prospects for Landlords and Investors, CBRE Research, October 2018

Figure 3: Capital value of flexible space transactions in Asia Pacific



Source: Real Capital Analytics, CBRE Research, October 2018

Other determinants of value

While these surveys and studies provide an indication of the ideal proportion of coworking space to enhance property value, and signal a growing awareness among landlords and investors of the existence of this association, several other factors must also be considered.

Some investors in the Americas, Europe and the Pacific are concerned about the growth of coworking due to perceptions that it could erode capital values and increase cash-flow concerns because of its weaker covenant strength. However, this is less of a concern in Asia, where lease terms are shorter than those in the West.

Nevertheless, while many local investors typically do not undertake rigorous assessments of covenant strength, in recent years, the market has seen an increase in core and open-ended funds seeking to purchase core properties. These buyers are often more conscious about covenant strength compared to other investors, meaning that they may apply a yield penalty to properties with higher proportions of coworking tenants.

The strength of specific coworking operators must be considered when measuring the impact of their presence on building value. While 48% of coworking centres in Asia turn a profit, many smaller independent domestic operators with one or two centres may not survive the next downward cycle. Consolidation in the industry, which remains extremely fragmented with the top three players accounting for just 22% of the market by footprint, may therefore impact the value of non-prime or secondary assets occupied by potential takeover targets.

Any assessment of value creation provided by a coworking tenant should therefore include an appraisal of the specific operator's business track record and ability to service and complement the asset's or neighbourhood's tenant mix. The operator's engagement model with the landlord, whether it be revenue sharing, platform or traditional lease, should also be carefully assessed.

Many landlords require coworking operators to pay a rental premium due to the higher risks associated with this business model. In some cases, landlords provide tenant improvements as incentive in return. While the capex for space conversion to coworking or a more innovative and collaborative environment can enhance the attractiveness of the building, and may provide the landlord with greater flexibility towards setting rental levels for other tenants within the same building, CBRE does not believe that this can directly translate to a higher valuation of the property.

The rent rolls and lease terms of coworking operators should be closely examined when determining asset value. Some operators expect higher or front ended rent free periods; above market tenant incentives or fit-out contributions; lower security deposits; fixed escalations in rent; and longer than market leases.

Conclusion

Despite limited hard data, the notion of a link between flexible space and higher returns is gaining traction among many owners, landlords and investors, especially in the case of non-prime buildings. This trend has been evident in Australia and Greater China, where there have been several cases of coworking operators leasing space in properties in non-core areas and adding value to buildings that were having difficulty securing tenants. In these instances, high profile commitments by coworking operators helped generate demand from other tenants and made these developments more viable, indicating that coworking operators can help redefine a building or precinct when occupying a suitable property.

Nevertheless, CBRE believes that the impact of coworking on asset value will only become fully apparent once the industry matures and models are cycle tested. Landlords, investors and other stakeholders are advised to familiarise themselves with the risk-return dynamics in this relatively new business ecosystem.

CBRE GLOBAL RESEARCH

This report was prepared by the Asia Pacific Research team which forms part of CBRE Global Research –a network of preeminent researchers who collaborate to provide real estate market research and econometric forecasting to real estate.

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