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Recent Developments in Flexible Business Space

A Research Note by

Business Centre Capital Company Limited (B3C)

Investors in Business Centres

Recent Developments in Flexible Business Space

This is one of a series of occasional research notes produced by Business Centre Capital Co Ltd. (B3C) the specialist fund management advisory company for the business centre industry.

Contents

This note reviews DTZ's series of Flexible Office Market (FMO) research reports that were published between November 2004 and September 2006. It then goes on to consider the implications of recent investments in flexible office space.

DTZ's FMO Research

The FMO series of reports, culminated in the fourth Flexible Managed Office (FMO) report, published in September 2006[1]. That report claims that the serviced office sector has almost doubled in size between 2000 and 2006 and that the larger companies are in the process of swallowing up smaller fry and this has been supported by a number of major organisations including the British Property Federation, the British Council for Offices and the Business Centre Association.

Collectively these reports are the most important independent research on this sector since the papers published more than five years ago by Reading University[2]. In saying this, we are excluding our own research[3], not out of false modesty, but as advisers to investors in business centre buildings, we might be thought not to be truly independent.

Stage 1

The Stage 1 report, published in November 2004, set out the definitions used in the reports. This is important as there had been much discussion and little agreement about the precise meaning of the phrases, 'business centres', 'serviced offices' and 'managed offices'.

DTZ's definition has three limbs:

- The provision of short term flexible office space
- Supported by a range of business services, and
- Actively managed by on-site staff.

The importance of this definition is that it defined the industry by reference to the services provided and the flexibility of its arrangements, not by the location, length of the term or by the nature of the rental contract. It also makes the point that the

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[1] Available to download free of charge from www.dtz.com/research

[2] see e.g. V Gibson. "How Corporate Real Estate managers Evaluate Business Space Options" published in 2000.

[3] The Performance of Business Centre Over a Complete Business Cycle, J Price; T Spicer

success of the industry depends upon continuous innovation and improvements in service delivery.

Any research has ultimately to be judged by its accuracy and usefulness so it is interesting to look at the predictions DTZ made when writing the Stage 1 report in November 2004. It forecast a rise in demand caused by a resumption of investment in IT; a trend towards flexible overheads and shorter business cycles.

DTZ estimated that this demand would push up the total amount of FMO space from 900,000 sq m to 1,030,000 sq m, representing approximately 0.8% of total UK office space. In terms of workstations, DTZ estimated that the number in central London had risen from 26,000 to 45,000 between 2000 and 2004.

The report also quoted with approval the Chartered Institute of Purchasing and Supply studies which concluded that for many smaller space requirements, flexible space was materially cheaper on a life-cycle, or total occupancy cost basis than conventional space.

Stages 2 and 3

Stage 2 of the report, published in May 2005 reported that the predicted growth in demand had occurred and that this had led to an increase in average workstation price in 2004 of 3.3% to £410 per month. The growth was not however evenly distributed with Edinburgh seeing a localised decline in prices and Newcastle and Leeds experiencing double digit increases.

Interestingly, DTZ noted the first signs of structural change occurring in the FMO market with certain operators specialising in different levels of service, and with a differentiation between serviced offices and managed offices and an increasing use of profit sharing leases.

Stage 3, published in October 2005, confirmed the pattern of growth of the industry, which seemed to have accelerated in H1 2005 to the point where FMOs represented 1.7% of total office stock in the markets surveyed, compared to 0.8% initially estimated. Average occupancy had risen to 86% and enquiries were running 50% ahead of the level of a year earlier and the number of central London workstations had grown to 52,000 compared to only 26,000 in 2000.

It went on to examine the nature of the users and concluded that the three most important sectors were finance, computing and professional services. We agree that these sectors are important and represent typical users of business centre space in that companies in these fields tend to have lots of fee earners and fee administrative staff available to manage office space. Small professional firms are very appreciative of the one stop shop aspect of a serviced office.

What the Stage 3 report neglected to highlight was the counter-intuitive and perhaps surprising incidence of public sector bodies as users of business centres. In most developed countries, if one takes all public sector bodies including quangos together, it represents the largest single user of serviced space. The reason for this unexpected use of taxpayers' money is the difference between revenue and capital accounting. The capital expenditure of public sector bodies is tightly controlled, whereas revenue expenditure is a lot looser, leading to some creative behaviour. For example, the Asset Recovery Agency, which was set up quite quickly and without an adequate capital budget, was for that reason located in a managed office.

The report then started to consider business centres as an investment, a theme which was picked up and developed in thestage 3 report. It took as its starting point the IPD index for flexible managed offices and compared that with the index for conventional offices. It concluded that the total return for 1997-2004 for flexible offices was 9.8% compared to 9.5% for the conventional office sector.

We are extremely sceptical about the value of the IPD business centre index because of our concerns about definition and measurement. Flexible space produces a profit which, if positive, is higher than rent paid (or the opportunity cost of rent that could be attributed in an owner-operated enterprise). A positive net income by definition says that the return will be higher than the same type of property conventionally let. The problem is that many owner operators are unwilling to disclose their true income returns and landlords don't capture the full value generated by the operator, only the rent paid. The problem is highlighted when looking atthe income return quoted by IPD of 7.5% which is lower than the conventional office return of 7.6%.

Stage 4

The main topic covered in the FMO Stage 4 report is the investment value of business centres in relation to the investment value of the property from which they operate.

The report noted that owing to the increase in buying pressure on conventional property driving down rental yields, investors had been paying more attention to other types of asset outside the usual categories of office, retail and industrial. Hotels, student accommodation, nursing homes and public houses were identified as examples of alternative asset classes that had attracted investor interest. One might suppose that this would mean that investors would consider investment in business centres too, but with a limited number of exceptions, most notably Morgan Stanley's MSREF's investment in Executive Offices and Deutsche Bank's RREEF's investment in Longford, it hasn't yet materialised on any scale.

Another issue with investment in business centres has been valuation. FMOs are hybrid by nature, deriving their income partly from renting space and partly from services. There is a significant difference in approach for company valuation and for property valuation. A conventional property valuation approach when applied to a business centre will tend to produce a low value owing to the relatively poor covenant of most business centre operating companies. The RICS Red Book does of course allow a different valuation approach for operational entities, but, as the report pointed out, all other uses required specialist property with "strictly limited use" within the RICS Red Book definition. Business centres typically operate from conventional office buildings.

In our view the Red Book is outdated and needs revising. It should accommodate the increasing number of property uses that lie outside the traditional sectors of commercial, industrial and retail and it will have to take account of shortening conventional lease lengths in any event.

The stage 4 report considers this issue in some depth and gets a bit confused in its analysis of the problem, but ends up proposing a sensible combination of the two approaches.

The general investment pricing that has emerged in the market is around 2.5 to 4 times EBITDA for operations in leased premises and around 10-12.5 times for operations with the underlying freehold or long leasehold. This is broadly in line with the approach that we adopt given that there is a positive trade-off between owning the real estate and renting it. We also note that these multiples are moving upwards but don't reflect the multiples that are applied to listed companies in the sector where a company's price reflects prevailing equity yields.

The report went on to record the rise in market capacity from 125,000 workstations in 2000 to an estimated 200,000 workstations in 2006 and noted that over the last three years the occupancy rate in the main market in SE England improved from 76% to 84%.

It also looked at the structure of the industry and correctly identified a process of consolidation that is underway through a series of mergers and acquisitions. Some of the latter occurred as a result of the down-turn of 2002-2003 which caused a small number of operators to go bust. The report lists some of the unlucky ones but omits Enterprise Business Centres, a five centre operator, that went into administration early in the period. These centres were divided up among other operators or the buildings were taken back by landlords.

Comment

The DTZ report is without doubt a major contribution to the general knowledge and understanding of the flexible managed office industry and the people who contributed the time and effort to get it off the ground deserve thanks from everyone interested in the industry. It also addressed one of the main issues affecting the industry, namely the valuation of business centres. But it made no attempt to address the biggest question of all: namely the future of flexible space in the context of the office market as a whole.

Our view is quite clear. Business centres, serviced offices and managed offices are in a long term structural growth trend. This growth is accelerating as more and more individuals and businesses become aware of the advantages of flexible offices. As the operating companies expand they are able to advertise more widely, stimulating further demand so the demand side is self –reinforcing.

The same virtuous circle can be seen in the investment field as well. As more institutional investments are made, more investors will become interested in the sector, which will have the effect of increasing capital values and of bringing more capital into the industry for further growth.

This process is bound to result in the sector becoming large enough to be considered at the very least a recognised sub-sector of the office market. We see flexible offices in their various forms becoming as much as 25% of total office space within the decade, totally at the expense of leased offices.

For the sake of completeness, we should add that this growth trend can be seen in every market in the world. Business centres are available to occupy or to invest in anywhere in the world.

Recent Investment News

The most recent announced investment is by Kenmore Properties private equity fund in Avanta Offices, run by one of the most well-known figures in the industry, David Alberto formerly managing director of MWB Business Exchange. Unlike Regus and MWBex which have generally operated out of leased space, Avanta is pursuing a ‘mixed’ model where some of its space is leased (the minority) some is managed under contract and some is owned by the group. This diversification of business model has the advantage of flexibility – if a good building comes along, Avanta can secure it, whether it is for rent, for sale or available to be managed – and of avoiding excessive operational gearing.

Kenmore has committed £30 million of equity to Avanta, which effectively gives it approximately £100 million to spend.

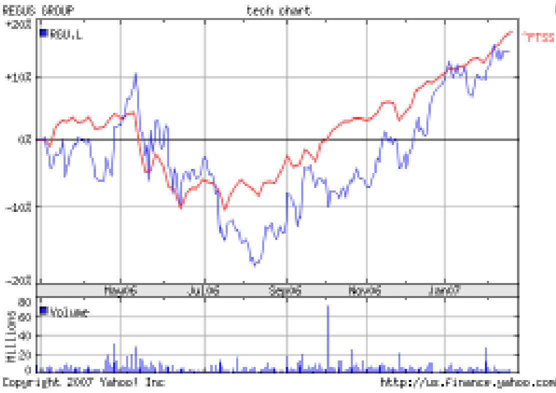
In another surprising development, Larry Lipman, the former managing director of BizSpace, having sold that company to Highcross, has reassembled his old team of key staff and has acquired Watford Business Centre for a reported £15.75 million through his Safeland property company. What is surprising is that he was allowed to do this under the terms of the sell-out to Highcross, unless of course the idea is that he will build up another similar operation to sell them as well.

Stock Market NewsThere are now six quoted companies that can be considered to focus on flexible managed space. Two companies are main market listed (Regus,Workspace) and the remainder are AIM listed (Stonemartin, Serviced Office Group, MWBEX, Yourspace).

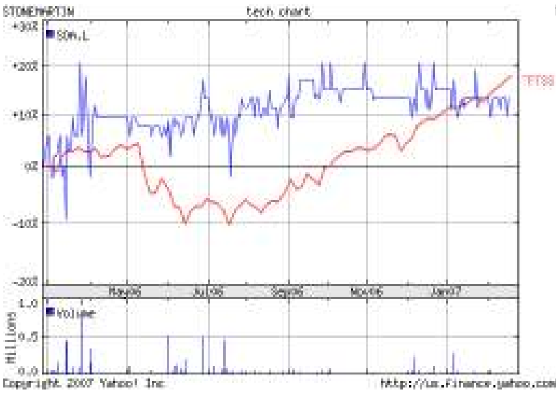
All six have outperformed the FTSE Support Services sector of the year. Indeed, Regus announced its intention to pay its first dividend at the end of 2006. Yourspace has shown considerable improvement in share price although a significant amount of this has come from playing the property market which included a sale and leaseback of a property in Manchester and successful planning applications for student accommodation nearby.

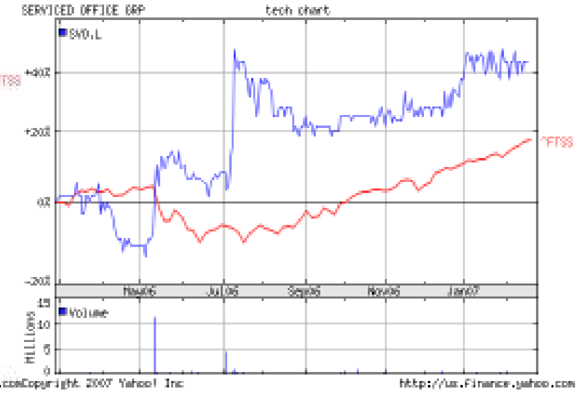
MWBEX has continued to be active in acquiring leaseholds in London, creating hubs of serviced space. Workspace is moving further into the more traditional serviced office market with recent acquisitions including a property formerly managed by Spacia in Southwark, London and properties in Clerkenwell and Haverlock Terrace. Meanwhile, Serviced Office Group has acquired its 12th centre in Chiswick.

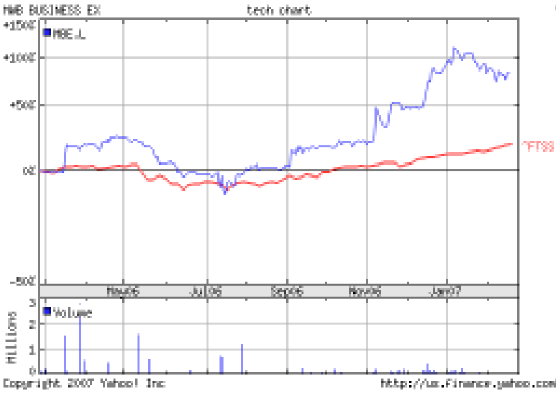
Company	Mkt Cap (mill)	Price (p)	YOY change	Yield
Regus	£1,280	130	+6p	0
Workspace	£864	496	+186p	0.79
Serviced Office Grp	£10	11.5	+3.1p	0
MWBEX	£116	169	+71p	0
Yourspace	£29	147	+99p	6.7
Stonemartin	£9	7.5	+0.5p	0

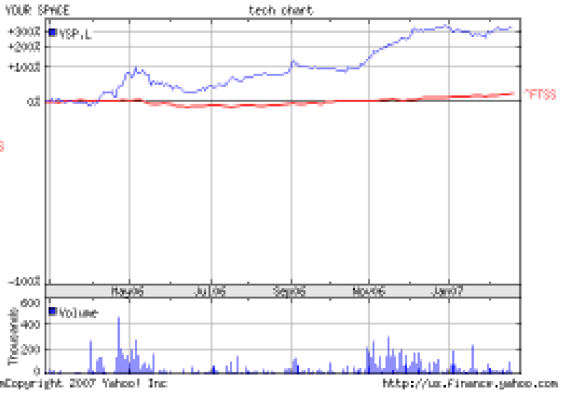


FTSS = Service Sector









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