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The Importance of Flexible Managed Offices as a Catalyst for Regeneration

A Research Note by

Business Centre Capital Company Limited (B3C)

Private Equity for Flexible Business Space



The Importance of Flexible Managed Offices as a Catalyst for Regeneration

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 sets out the background to the flexible managed office market, considers the factors responsible for its growth and the implications for the regeneration strategies of public bodies and the management of local authority owned centres.

Executive Summary

- The FMO market, including business centres, serviced and managed offices, is in a long term structural growth trend in the UK and worldwide.
 - The growth is driven by customer demand, as occupiers like the flexibility, convenience, cost and technology available in FMOs.
 - Tenants are also being driven to FMOs away from traditional offices by changes in accounting rules.
 - Regeneration and economic development strategies should explicitly include provision of FMOs as these assist in bringing high quality employment to the area and in filling up new developments quickly.
 - Local authorities are not natural managers of FMOs and consideration should be given to out-sourcing such management to many of the private sector companies in the field.
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Background

This short paper reviews the flexible, managed office industry and considers its implications for the regeneration and economic development policies of local authorities, regional development agencies and other public bodies responsible for regeneration and economic development.

Definition

By flexible managed offices (FMO) we mean serviced offices, business centres and managed offices, the main characteristics of which are:

- the provision of short term flexible office space;
- supported by a range of business services, and
- actively managed by on-site staff.



Business centres sometimes include studio or workshop units alongside offices and the comments in this paper apply to light industrial space in such hybrid premises.

The best known providers of FMOs are Regus and MWB Business Exchange at the more expensive end of the market and Workspace =, Evans Easyspace and Bizspace at the more economical end, but there are over 300 operators of FMO space in the UK.

The FMO market in the UK consists of approximately 1,100 offices with around 1,000,000 sq m of lettable space representing under 2% of total UK office space. This averages out at one FMO per 50,000 of the population, but this average disguises very wide variations. Outside London the average is one FMO per 75,000 population. Within the industry it is normal to measure space by numbers of workstations rather than by square metres or feet and DTZ estimates that at the end of 2006 there would be 200,000 workstations in the industry (source: DTZ Research *Flexible Managed Office Market Stage 4 Report, September 2006*).

2000-2006 saw rapid growth in the supply of FMO space with the number of available workstations in London rising from 26,000 to 52,000 over the period despite a significant downturn that occurred in 2001/02. It is useful to look at the reasons for this rapid growth rate.

Drivers for Growth

Unlike some types of real estate, the growth of FMOs has not been driven by government policy nor by the vision of large property companies; rather it has come from a growth in demand for flexible space from the end users, the occupiers. The growth has thus been customer led, not producer led.

Based upon extensive discussions over the past seven years, it is clear to us that five factors have driven the demand for FMO space, flexibility, convenience, cost technology and accounting.

Flexibility

FMOs generally offer flexible, short term leases or licences to occupy, with terms between one day and one year on units that range from 10 sq m to 500 sq m. So, if a tenant's business goes well and it needs to expand or goes badly and it wishes to reduce the space it occupies, it is not long until the expiry of its term and there are no exit costs in the form of dilapidations etc. Indeed it may well be possible to expand or contract the amount of space used even within the term of the agreement as FMO managers are inclined to be more responsive and less dogmatic than landlords.

It is perhaps stating the obvious to say that this flexibility makes it easier for the occupiers to manage the rapidly changing business conditions that can occur in the 21st century business environment.



Convenience

An FMO contract normally provides for a package of services to be included in the rent. These include on-site management and reception staff, repairs and maintenance, cleaning, security, telecoms and data connection and furniture in all but the largest units. Other services are available on a pay as you go basis from a menu including meeting rooms and conference facilities. Having these aspects dealt with by the FMO operating company leaves occupiers free to concentrate on their core business activity.

Cost

Although the headline cost of FMO space of between £150 and £1,000 per workstation per month, equivalent to £24 to £150 per sq foot per annum (depending on quality and location) may seem high when compared to the cost of conventional vacant office space, this is an exercise of comparing apples with oranges. As noted above, the FMO charge is for a package of space and services, including rates and service charges as well as rent within the base figure.

A better comparison is between the cost of FMO space and the Total Occupancy Cost of conventional space as calculated using the Total Occupancy Cost Code (TOCC). The TOCC includes all transaction costs and soft costs alongside rent, rates and service charge and incorporates an allowance for management time consumed and an estimate of dilapidations at the end of a conventional lease.

Using the TOCC to give a more realistic cost of conventional space, it is clear that FMO space compares very favourably for a range of office sizes up to 30 people and for occupancy terms up to five years. This has been confirmed in studies by the Chartered Institute of Purchasing and Supply.

Technology

Traditional landlords have never been known for their enthusiasm for technology. Even in the 21st century it is rare to see much in the way of IT infrastructure installed in buildings by a landlord. FMO operators by contrast are typically very IT literate and their offices typically provide broadband internet access as standard along with a wide variety of communications and data services. To borrow an advertising slogan for Regus plc, an FMO tenant is able to “walk in, sit down and start work” with no need to wait around for a telecoms provider to connect them.

Accounting

Changes in accounting rules have made conventional occupational leases less attractive from an accounting point of view. Under FRS 15, where a company leases premises, the net present value of all future payments due under the lease has to be shown as a liability in the company balance sheet. In the case of a 15 year fully repairing and insuring (FRI) lease the amount can be considerable and only serves to inflate the balance sheet with no corresponding increase in revenue.

As a result finance directors are not keen on FRI leases with terms beyond five years unless frequent break clauses are included.

Although the prevalence of FRI leases has probably accelerated the growth of FMOs in the UK, the industry is growing in a very similar fashion worldwide in both developed and emerging countries. We interpret this as a showing a pattern of long term structural growth in response to the demands of modern business.

Implications for Regeneration

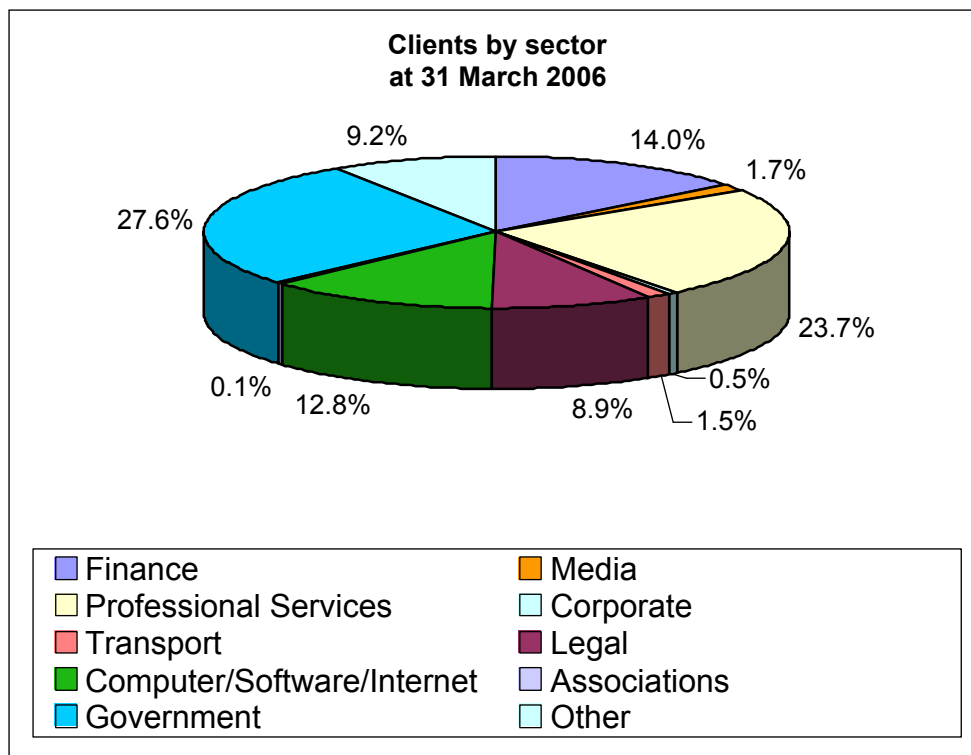
It is our view that regeneration schemes and economic development policies should explicitly include provision for FMO space for the following reasons:

- clients like the flexibility, convenience, cost and technology described above and so occupancy will build up quickly in FMO space and this will add life and atmosphere to a new development, avoiding the problem that no-one likes to be the first in;
- FMOs attract the sort of higher quality, high technology and creative employment that local and regional development agencies seek to encourage;
- FMOs bring new businesses to an area and act as de facto incubators and feeders for conventional office space;
- other buildings can piggy-back on the comms and data infrastructure provided by FMOs; and
- FMO marketing channels are different from and complementary to those media used by conventional landlords.

FMO space appeals to many different type of user. Small and medium sized enterprises and small professional firms are large users as they appreciate the convenience of the FMO model, allowing as it does the principals in these firms to concentrate on the core business and not be distracted by facilities management issues. Larger organisations, both private and public sector are also big users of FMO space, which is often suitable for teams working on project with a finite life span.

As well as appealing to organisations of different sizes, FMOs also have a wide appeal across different types of activity. This is illustrated in the table reproduced below which has kindly been provided by Stonemartin plc, the manager of the IoD Hubs, a group of high quality buildings in major cities operated in association with the Institute of Directors.

The breakdown by sector shows a good take-up by financial and legal professionals as well as IT related businesses. All these groups of user require good telecommunications and data infrastructure and provide high quality employment opportunities.



Source: Stonemartin plc.

Management of FMOs

There are many establishments around the UK that are called enterprise centres, business centres or innovation centres which are owned and run by local authorities. Some of these are undoubtedly fulfilling a useful function as incubators of business start-ups. Others may perhaps be best thought of as subsidised work space which often articulates the desire of local authorities to encourage local business generation and employment.

However, our view is that subsidised space is not appropriate for long term occupancy since occupiers are encouraged to remain in situ rather than move to commercial premises. This can encourage business profitability being driven more by cost than by revenue generation. Access to subsidised space should thus be rationed in duration with a rent escalator up to market rent applying after the agreed start-up period. encouraging businesses to move on and make room for new start-ups.

The management of premises on commercial terms is best suited to a commercial enterprise. Local authorities may not be natural managers of commercial premises finding it difficult to deal firmly with problem occupiers or to oblige them to vacate at the end of the start-up period. In addition, local authorities may not be best placed to make the capital expenditure required to maintain the high level of technology infrastructure that the best business centres can offer, or to respond quickly to changes in market conditions.



There is a wide range of private sector, operating companies of managed space in the market and local authorities should consider out-sourcing FMO facilities and their management to one or more of these companies. The South East England Development Agency, SEEDA has already done this successfully with a managed space company operating centres on its behalf.

Background Information on B3C

B3C is a specialist in the business centre and managed work space field. Since 1999 it has focussed full time on this industry and has, amongst other things, created and managed the world's first public investment fund for this industry, Business Centre Properties plc. From 2000 to 2006, B3C worked closely with Close Investments Ltd, part of the Close Brothers Group plc, the UK's largest independent merchant banking group. In 2007 B3C is using its expertise in this sector to develop an integrated international investment fund for business centres as well as assisting clients with interest in the field on a consulting basis.

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