Brief | Adaptive Spaces

What's Next for Flex: Rising Demand Supports Viability of Flexible Office Industry

CBRE RESEARCH | AUGUST 2023

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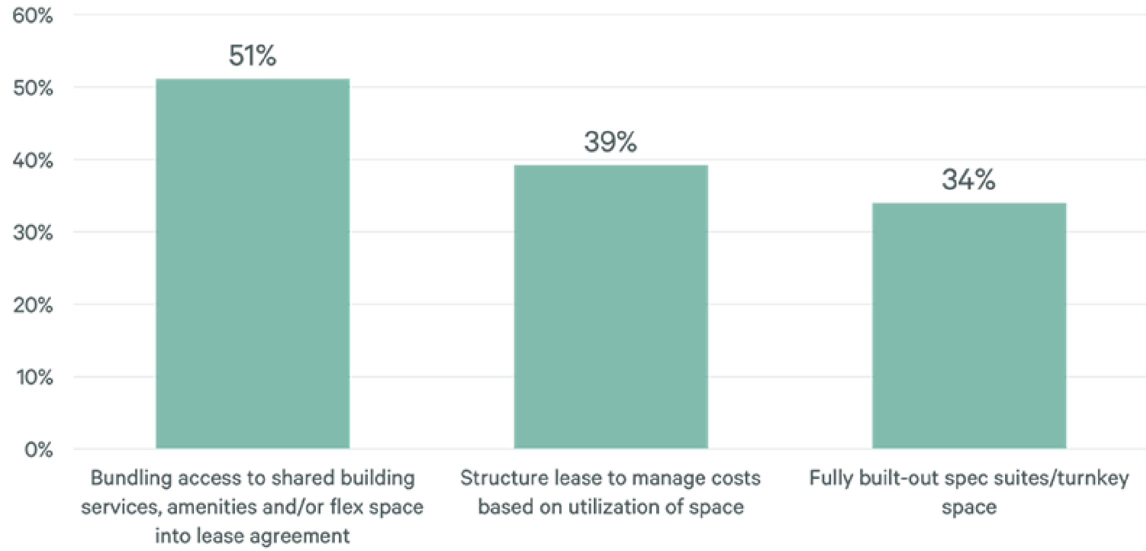
Pioneering flexible office provider WeWork's recent warning about its long-term viability has raised questions about the future of the broader flexible office market. However, a recent CBRE survey of office-using companies indicates that there is growing demand for flexible leasing arrangements to accommodate a number of increasingly relevant space planning scenarios. As such, we believe WeWork's challenges are largely specific to its business model that locked it into long-term lease commitments made prior to the pandemic, while facing significant debt-service costs amid steeply rising interest rates.

Today's office tenants are focused on optimizing their portfolios amid an unprecedented shift to hybrid work and an uncertain economic outlook. To that end, many are looking to negotiate flexibility into traditional leases through sizeable expansion and contraction options. Sixty-two percent of respondents to CBRE's Spring 2023 U.S. Occupier Sentiment Survey said that they are either executing or exploring these strategies with their office landlords. And with the overall U.S. office vacancy rate at a 30-year high of 18.2% as of Q2 2023, landlords are becoming increasingly motivated to meet these demands.

In addition to flexibility in traditional leases, more than half of CBRE's occupier survey respondents also want flexible access to shared building services and amenities, such as meeting space, overflow space, day care and fitness facilities. Nearly two-fifths want the ability to structure their lease and manage costs based on actual utilization of space. This is especially true of tech companies, which are generally the most receptive to long-term hybrid working arrangements for their employees. In short, tenants are looking for landlords to provide flexible options that allow them to quickly expand or contract their office space as business conditions dictate and office attendance rates shift.

Figure 1: Most Attractive Agile Strategies for Office Tenants



Source: CBRE Research, Spring 2023 U.S. Occupier Sentiment Survey, April 2023.

Tenant use of flexible office space is increasing. Thirty-six percent of respondents reported that flexible space made up more than 10% of their office portfolios, compared with 19% of respondents to the 2022 survey. Over the next two years, 50% of respondents anticipate that flexible space will make up more than 10% of their office portfolios.

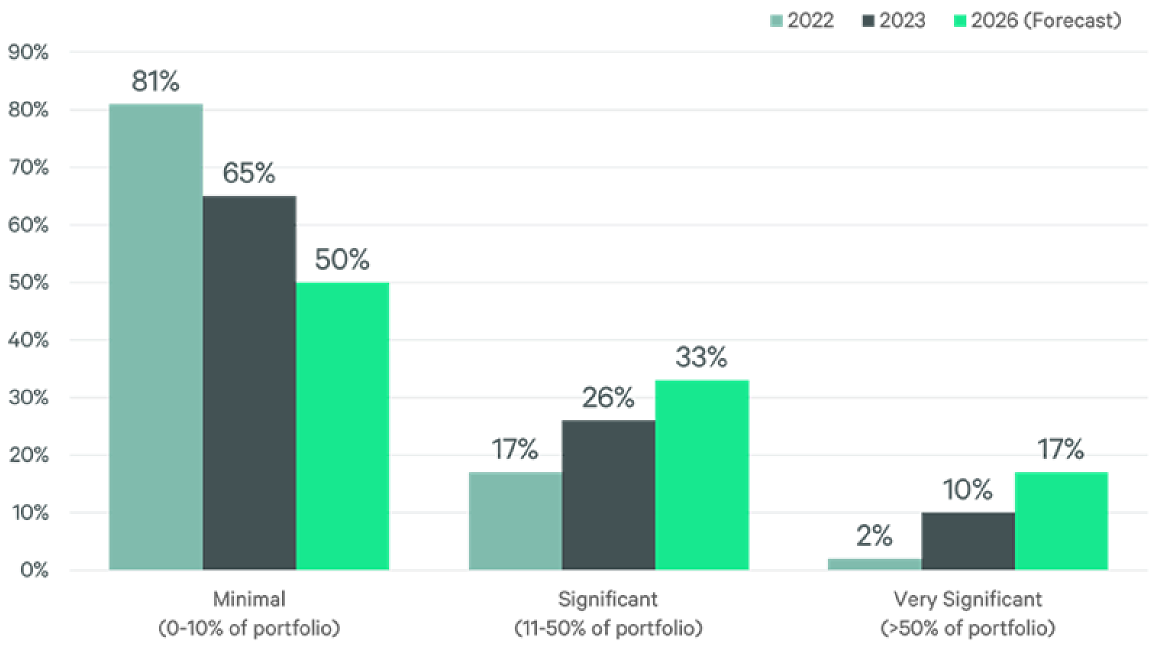
CBRE's Agile Practice Group reports that while the largest share of flexible office space requirements is for 10 seats or less, the highest demand growth is for requirements of up to 50 seats. While an increase in interest from more than just tech companies is one factor, growth in flex space demand has also been driven by higher seat-sharing ratios from an average of 1.5 people to 1 seat before the pandemic to as many as 3 to 1 today.

For requirements of less than 50 seats, flexible leases are almost always cheaper than traditional ones because of shared amenities. Requirements for more than 50 seats are usually better suited to traditional lease agreements, especially in today's tenant-favorable market. Although requirements larger than 50 seats are only about 6% of all flex deals, they account for 40% of the total flex square footage leased.

Certain circumstances make flex financials compelling even for these larger requirements, including using flex space as a stopgap to a permanent solution, rapid changes in headcount, entering new markets and reducing initial capital outlays. Although even the largest multinational companies appear interested in using flex space, it is smaller companies that are fueling demand for flex space the most.

The largest flexible office providers have seen increased sales this year. IWG reported a 48% year-over-year increase in earnings for the first half of 2023, while WeWork reported a 21% year-over-year increase in all-access membership.

Figure 2: Office Portfolio Share of Flexible Space



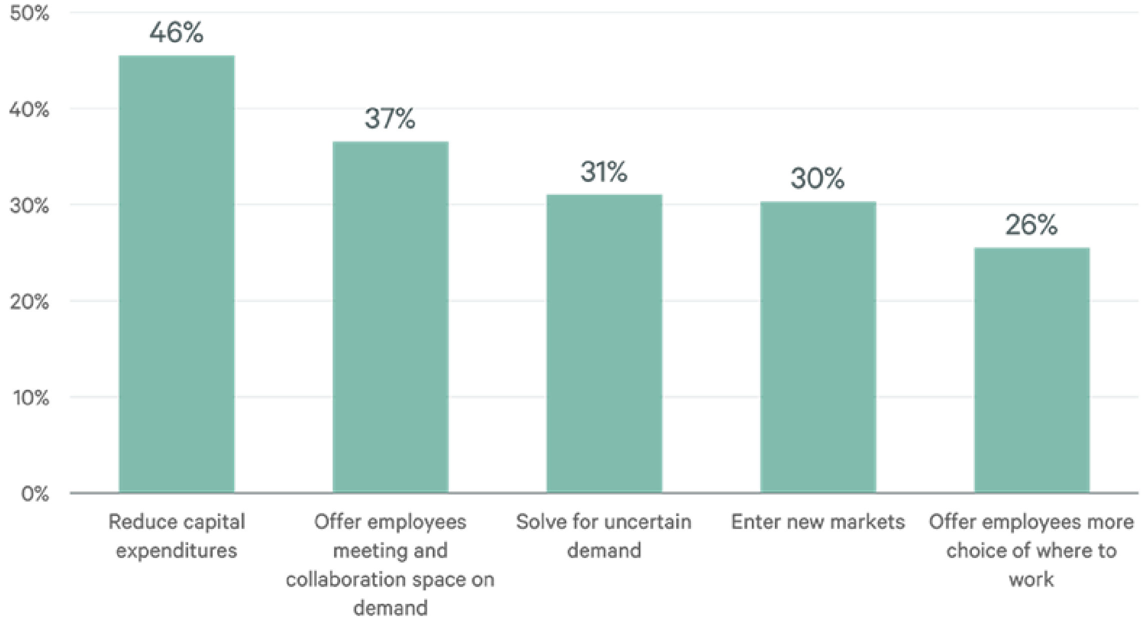
Source: CBRE Research, Spring 2023 U.S. Occupier Sentiment Survey, April 2023.

Reducing capital expenditures is the biggest driver of demand for flexible office space, since the cost to build out quality space that attracts employees back to the office is becoming more and more expensive. At as much as $400 per square foot in some markets, the cost of upgrading office space can be much more expensive than the rent itself. This is why more than 30% of survey respondents want landlords to provide speculative suites that significantly reduce or eliminate these costs.

Another big demand driver for flex space is the rise in hybrid working arrangements. In the short-term, companies are looking for more efficient ways to support space planning amid lower and more volatile space utilization than before the pandemic. In the long-term, supporting employees with a network of offices and meeting space that can adapt to their needs is an emerging trend.

Entering new markets is another common reason companies are adopting flexible space strategies, especially among large companies. Amid a tight labor market, more companies are looking farther afield to attract and retain skilled talent. Using flexible office space to give these employees a place to congregate is becoming more common.

Figure 3: Top Occupier Motivations for Using Flexible Office Space



Source: CBRE Research, Spring 2023 U.S. Occupier Sentiment Survey, April 2023.

The flexible office industry will continue to evolve as underperforming locations close, providers shift to an asset-light model that involves partnership and management agreements with property owners, and landlords explore ways to provide flexible-space options directly to their tenants. Given that flexible office space currently accounts for only 1.7% of total U.S. office inventory, this market has plenty of room to grow.

The biggest challenge will be creating flexible structures that produce winning outcomes for the tenant, landlord and flexible office provider. This evolution in how the office market adapts to support the needs of tenants has only just begun.

This is the first in a series of CBRE Briefs on the state of the flexible office market. The next installment will explain how landlords are coming up with creative ways to offer flex solutions directly to their tenants.

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