Yardi® Kube

March 2019

Converting Vacant Space To Shared Space

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Featured Industry Experts

Melissa Schilo

Melissa Schilo is the founding partner of Workspace Concierge LLC, a boutique consulting firm offering consultation and advisory services specifically for the flexible workspace, serviced office and coworking industries. Melissa has over 12 years of global operations and sales experience, having previously held a senior executive position in an ASX-listed global serviced office and coworking company.

Her clients include individuals looking to start a coworking business, providers who have been in the industry for decades, and property managers and landlords looking to transform underutilized space.

Releasing in early 2019, Workspace Academy will be an online industry platform with on-demand access to ebooks and online courses for clients looking to start, develop, and grow their shared space business.

Waad Nadhir

Waad Nadhir has worked at BOSC Realty Advisors LLC as the co-founder and president since 1989. BOSC's business includes the development and redevelopment of grocery anchored shopping centers, Class A office buildings, single tenant medical buildings, single tenant retail properties, and consulting services aimed at obtaining entitlements and leasing of retail projects. The company is in the process of expanding in Southern California and planning a national expansion.

In 2018, Waad acquired Irvine CoWorks in Irvine, California.

Waad is a graduate of Michigan State University and obtained an MBA from the University of San Diego.

Bart Leslie

Bart Leslie is a business and management consultant who works with investment funds, property owners, real estate professionals and Coworking operators.

His Coworking experience includes due diligence on property developments, setting up multi-space coworking brands, leading project teams through all development phases and product launches, restructuring coworking businesses and managing several coworking property redevelopments.

His market experience includes projects in New York City; Washington, D.C.; Alexandria, Va.; Chicago; Houston; Milwaukee; Hartford, Conn.; and Cincinnati. He has an MBA and master's degree in Marketing from Melbourne Business School in Australia.

INTRODUCTION

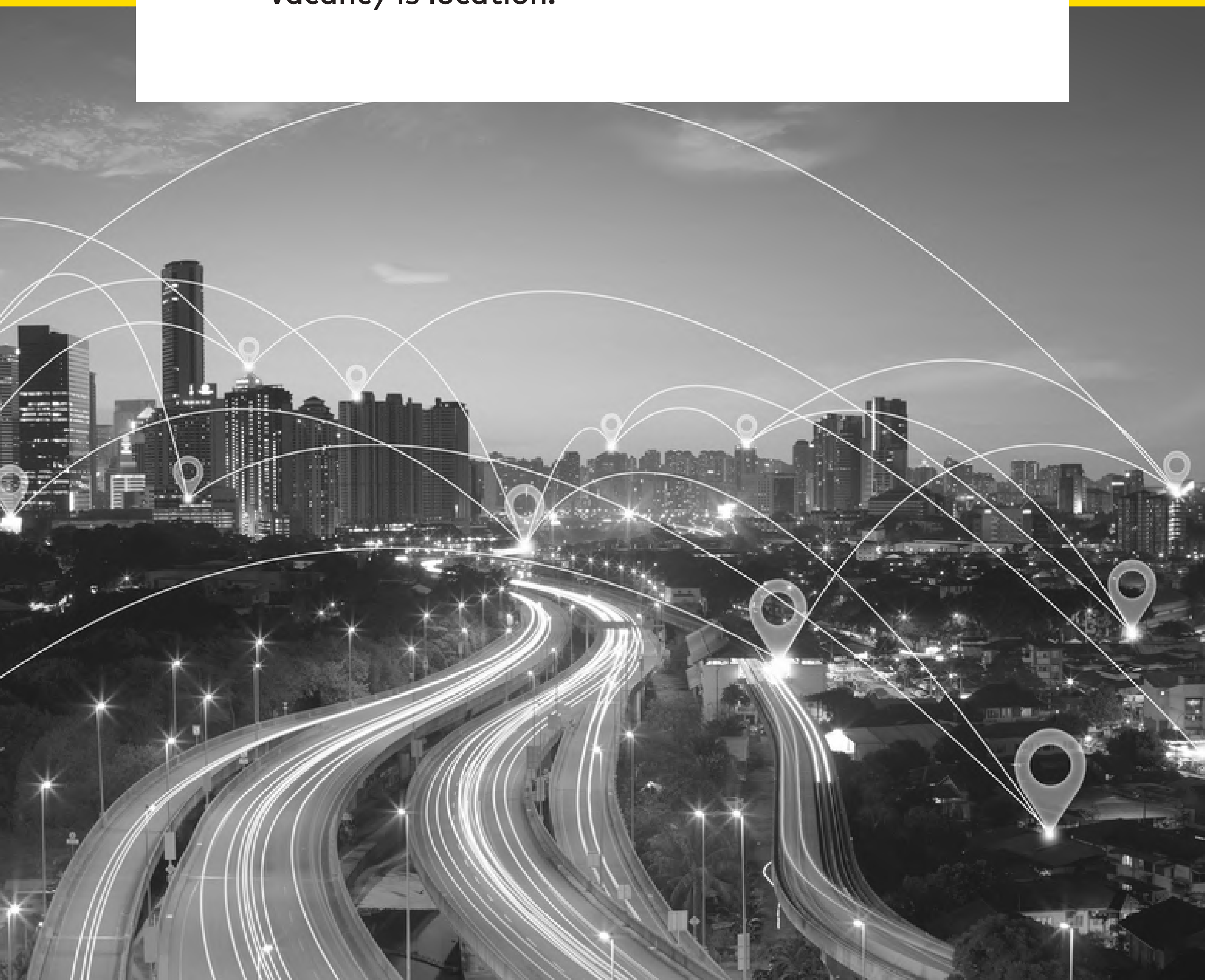
As Coworking becomes more mainstream, many building owners and property managers are looking to incorporate Coworking spaces into their portfolios by converting a percentage of their traditional space to Coworking space.

In this ebook, we'll dive into the pros and cons of Coworking versus traditional tenants, which amenities to value inside the Coworking space and in the surrounding areas of the building, and the ideal options for building out a Coworking space.

Most importantly, we aim to clarify whether a conversion to shared space would be worthwhile and, if so, other factors that should be considered.

PART 1:
PROPERTY LOCATION

The most important factor in determining whether Coworking is a viable option for your vacancy is location.



Determining location demographics, demand and forecasts

It's vital to understand the demographics of the city/region, the demand for Coworking in that location, and the forecast for the industry in the coming years. Locating your Coworking space in a city that you've determined has the right demographics, population trends, household income, work-from-home density and entrepreneurial base is one of the keys to getting off on the right foot or expanding in the right direction.

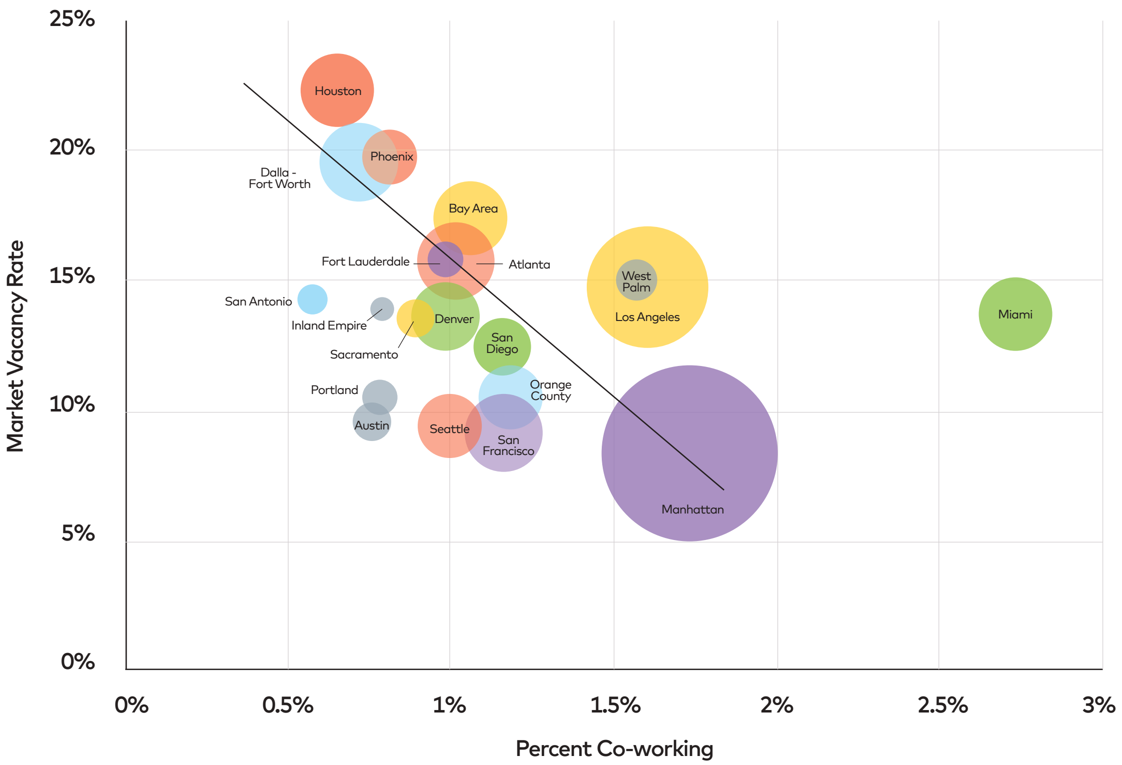
All you have to do is take a look at the WeWork model, which has basically taken New York City by storm. WeWork is now the single largest tenant in the city, with 58 Coworking locations in the city, several of which are within 1-2 city blocks of each other. For the most part, they operate at capacity. It's truly a remarkable accomplishment in a relatively short period of time. WeWork is up to 472 locations in 91 cities, but clearly has expanded rapidly based off the thriving demand for Coworking in New York. Workbar provides another great example. They're going to open their ninth location within the greater Boston metro area.

In 2018, Yardi Matrix compiled a report detailing statistics on a city-by-city basis for Coworking. One of the most valuable findings was that while New York had a commanding lead in terms of square footage allotted to Coworking, 10 other markets housed over 1 million square feet of shared spaces. In other words, you don't have to be in New York, Los Angeles or the San Francisco Bay Area to occupy a major Coworking hub.

Also according to that study, Miami is by far the national leader in terms of Coworking space as a percentage of total real estate. In terms of vacancies, however, it ranks in the middle of the pack.

There does seem to be a strong direct correlation between fewer vacancies and more Coworking space. As you can see in the chart, Houston, Dallas and Phoenix have some of the highest vacancy rates in the nation, and also three of the smaller percentages in terms of space allotted to Coworking. It's important to do research like this to see whether your market is ready for more Coworking.

Market Vacancy vs. Percent Co-working

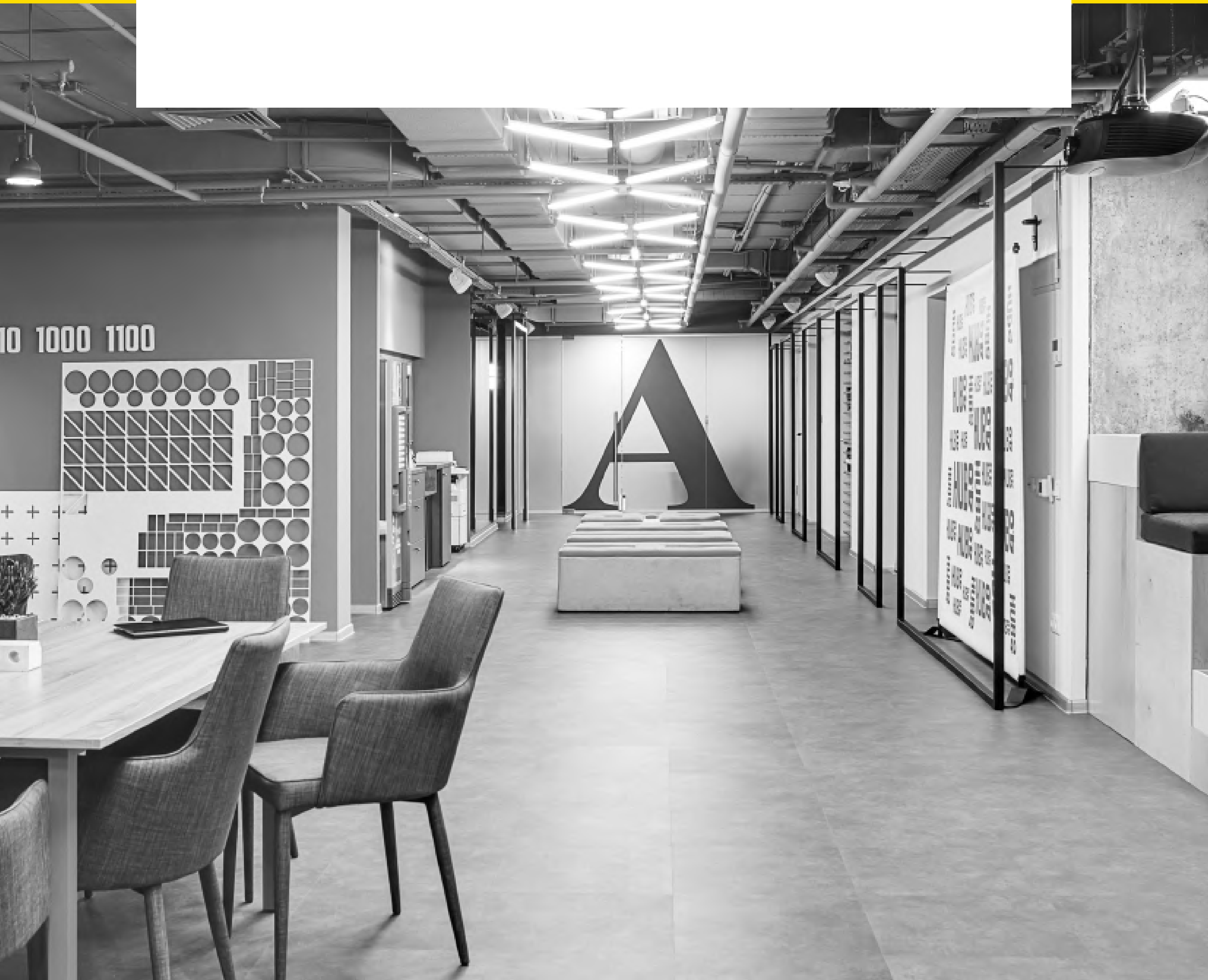


Deskmag, a tremendous asset for Coworking surveys and research, found that "location of the space" was the most important reason someone would choose a given space. Coworkers want to have easy (or relatively easy) access to the space, and in an ideal location. **Which takes us into the second part, what makes an ideal space?**

Coworkers want to have easy access to the space, and in an ideal location.

PART 2:
THE IDEAL SPACE

You need to maximize all the reasons why members would want to join your space.



Dealbreakers

In terms of amenities in and around the vacancy, be aware of what's a dealbreaker and what's something that's just nice to have. If you're in a building with the most beautiful rooftop terrace in Miami or in Chicago but it's unusable for half the year due to extreme weather, how much value is it providing your space?

When considering the ideal location, factors such as proximity to mass transportation, parking and dining and entertainment options are all vital to a decision.

"I've got landlords with an interest in Coworking and they say 'yeah I've got a cool building for that, we should do it right here,' and that's great but your building is nowhere near mass transport and to me that's a deal breaker," said Bart Leslie, a partner at Canmore LLC.

Take into account not only the immediate expenses of a Coworking space buildout, but also the factors that come with it.

"If you're going to fit out a 10,000-square-foot space, you're going to throw $150,000 of your own money, and that's before you start factoring in operating expenses, marketing costs, etc., so you want to de-risk it as much as possible," Bart explained.

That's why the amenities are so important. You need to maximize all the reasons why members would want to join your space. Think about how important parking is in your location. If it's New York and you don't expect the majority to drive to work, that's very different than Miami where public transportation is unreliable, and the vast majority of people need to drive and will pay for monthly parking.

Typically, you'll find your premium Class A space in your central business district. It has higher rent and more congested parking options but ideal access to transport.

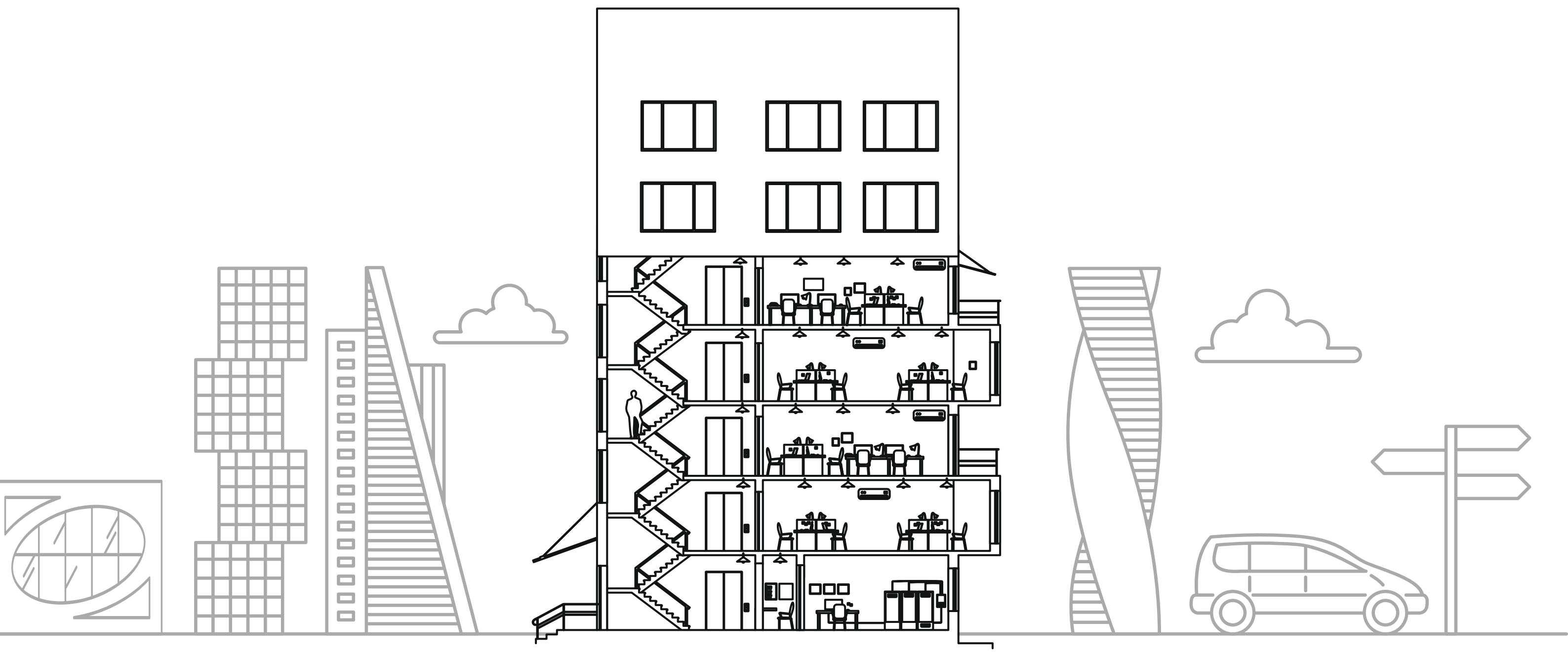
Of course, in places like Chicago, San Francisco, and New York, people are more likely to choose public transportation. Having a Coworking location in a Class A building makes sense primarily for that reason. However, factor in costs in these areas.

"If someone wants to drive into a high-density central business district, and they're a coworker renting a desk for maybe $400 a month, do they also have $200, $300 for parking a month? Sometimes the same amount as they're paying for a dedicated desk? Probably not," said Melissa Schilo, founding partner of Workspace Concierge.

Also, as the public generally becomes more environmentally conscious, a growing trend is "green" buildings. WELL buildings and LEED Certified buildings are becoming favored because they meet certain criteria for health, wellness, energy efficiency and environmental standards, among other factors. While the look of these buildings is usually extremely modern and very attractive, the costs are much higher for the building owner. The demand for these criteria isn't at a peak yet; it's growing, but not at the level where it's a must-have amenity.

Some of the features of these buildings, such as natural light and outdoor spaces, are valuable, and can be found in buildings where the cost doesn't skyrocket due to LEED certification.

"Property managers might say 'we've got a lot of vacancy in this building; how can I make my building more attractive?' As long as it has the amenities and transport around it, it could be a good position for Coworking," Melissa said.



Urban Core vs. Suburban Market

One question that has to weigh on the decision is whether to take a vacancy in a secondary or suburban market or piggyback off the success that many spaces have had in an urban core. Obviously if everyone else is thriving downtown, why can't you? But what if you're the breakthrough in an area with minimal competition?

Melissa believes not only that suburban locations are a great place to start, but also that there are many options that work well.

"If possible, I would absolutely start in the underserved market," she said. "Suburban markets are on the rise in this business. Ignoring the Class B buildings would be a shame and a loss to the industry. There are higher profits in the underserved buildings because everyone's pursuing the Class A."

It can be difficult for operators to turn a profit in a market where a dedicated desk is going for $400. Millennials are trending away from the downtown core in many cities if they're being priced out. Don't be surprised if they're the ones who can afford the space if you're in a suburban or secondary market. Landlords in secondary markets commonly have higher vacancy rates to deal with as well. Consider these demographics and trends when deciding whether your space would be in a thriving Coworking area.

"It's nice when you have a market that already has a lot of Coworking because people are already familiar with the concept. We believe we're going to be one third of the office industry within the next 10 years, with flexible workspace operations and tens of millions of square feet,' explained Waad.

> **"If possible, I would absolutely start in the underserved market. Suburban markets are on the rise in this business".**
> **- Melissa Schilo**

What if the majority of Class A buildings in your area are not near where your target demographic lives? According to Deskmag's annual survey, results show that 60% of the Coworking community commutes between 5-30 min to work, and the average commute is just 21 min. Make sure you're aware if your vacancy poses these challenges.

"You can have a Class A building in a more suburban area but if that building has access to complimentary parking, even for a short period of time (3-4 hours a day), nearby amenities like a local gym, and closer to residential areas, then that building may actually be more profitable for the property manager, even if its 15-20 min away from the CBD.' Melissa stated.

Consider how important up to date technology is to a Coworking space as well.

"You need to have fiber coming into the building. You'd really like to have multiple fiber providers to give you some choices," Waad explained.

It is imperative that you have the right tools to support coworkers. That starts with the right technology. It takes more than just mundane internet service. Will there be virtual offices available? Can you build out private quiet phone areas? These details will have a huge influence in determining whether you can turn your vacancy into a profitable Coworking space.

Keep in mind, there's already been a significant shift in the models of these shared spaces.

"Chop the space up and put as many desks as you can in there. That was the old model. Now people are getting more toward amenity, collaboration, open spaces where people can work together. Space for a desk has increased a bit," Bart added.

PART 3:
COMPARING VACANCIES

Not all vacancies are well suited for Coworking, and there are critical factors when comparing spaces that may have similar qualities. Is it on a high or low floor?

Retail Locations

Is it in a Class A building? Does it have sufficient space, or can it be configured for all sorts of desks, offices, conference rooms and common areas? Some Coworking spaces recently have begun to pop up in retail locations. What are the differences when comparing these to traditional vacancies in office buildings?

"The retail environment is a fantastic opportunity for property managers with empty spaces. Rents may be a little bit skewed because that's just the retail environment, but there are spaces becoming available such as those previously occupied by Barnes and Noble, Toys R Us, HH Gregg, big box retailers. This space is all going to get cut up and re-leased," Melissa says.

These spaces do offer fantastic opportunities for free parking, ground level access, and typically in untapped suburban areas. Waad owns retail real estate and has handled leasing for multiple malls. He provided a different opinion on those spaces Melissa described.

"We like to be within office clusters, or an office submarket. If that retail happens to be in an office submarket, great. Otherwise you are on an island away from other offices, which poses some different challenges."

Some companies are jumping on Macy's, Sears, and other department store spaces that have closed, but the overall sustainability of this trend remains difficult to judge.

Let's say you only have an average buildout, average amenities and a standard design, but the space is in the perfect location. How does that compare to having an incredible space, all the right amenities, the best creative look and feel and a beautiful interior, but in a less-than-ideal location? All three contributors agree: location wins every single time.

Research shows that as long as the space is an open concept and has quality, private areas/offices, that's good enough. Aesthetics of that space will be secondary. Of course, if you have a lot of virtual clients, that may play a role in the value of physical space. But location should win out in most comparisons.

"There are Coworking locations where property managers have had some additional space and they've slapped the word 'Coworking' on the front of the door, and then had a lot of designers or entrepreneurs who just needed somewhere to sit because the Starbucks was packed with people on their laptops," Melissa said.

This is why location is top factor in building out a Coworking space. And this is why you need to do demographic research, as mentioned in Part 1. Your member base is going to be nearly as important as the location. It can potentially be a pitfall in attracting the volume or quality of member you need to be profitable.

Melissa was the most emphatic about location as a top criterion:

"If you're a property manager who spent three million dollars on a buildout and it's absolutely gorgeous but no one can afford to go there, or you're 20 minutes outside the central business district and the industries around aren't entrepreneurs or don't support work from home, then you're out of business. You don't have a business."

High Floor vs. Low Floor

There's also the comparison of how high or low you are in a building. Does the floor matter? According to Melissa, it does.

> **"The lower the better. Because it also serves as an advertising medium for the property manager. You have a buzz of people constantly in and out. Think about who the coworker is. 70% of them go in three to five times a week."**

This is a valid point. The traffic coming through a lobby or mezzanine area will create a sense of excitement and exposure to the building.

Of course, there's value in having a 40th story bay view if you're on the water. It's not like you can go wrong filling that vacancy with Coworking. But keep in mind the inherent benefits that come with having a successful Coworking space in areas prone to heavy foot traffic.

If someone is seeking, for example, 5,000 square feet, or an entire floor, and they walk in on ground or mezzanine level and see a thriving Coworking space, it can also serve as a vision for how the property manager can work with them or what kind of space they can have within that building.

Considering that there is more appeal to the top floors of a high rise, the odds are favorable that those floors will be the first to sell. Likewise, the bottom few floors of a high rise can be the hardest to sell. A Coworking space could be ideal.

PART 4:
COWORKING VS TRADITIONAL TENANTS

What will be a better option for your vacancy?
A Coworking space or a traditional tenant?

Benefits of Coworking

"The real benefit Coworking provides to a landlord is the opportunity for a partnership. 'Your business is going well, I want to help you expand your business. There's a vacancy or an open floor, why don't we look into a partnership?" Bart explained.

Bart summed up some of the major factors in the decision landlords face when they decide to turn to Coworking.

"If I devote 5% of my building to Coworking, that's a big space. I now have a higher density flow of people coming and going. I have people that don't work traditional business hours, so do I need to put on extra security staff? I have potentially higher wear and tear on my property. And I have the wrong image (in their mind) of people going in and out of the lobby, which takes away from the 'exclusive feel.'"

> "The real benefit Coworking provides to a landlord is the opportunity for a partnership." - Bart Leslie

Consider in a major Class A building as well, there will be guests of other tenants, or major conferences/events. You can create day passes for these attendees or visitors. You can create signage and marketing pieces directed at those who need extra meeting room space. Always keep the promotion of your space in mind when you're in such a high traffic, popular area. It's easier there than in suburban locations. This is a major plus for continuing the success of a Coworking space.

"You're also supplying the other tenants in the building with additional amenities that they can be utilizing, in or out of hours," Melissa added. "You can provide them with options for meeting spaces, a different view, or just somewhere to move around. This is proven to be a huge benefit to cure stagnation."

Consider as well, if one of the members one day needs to outgrow your space, it isn't necessarily a bad thing. If they need 1,000-2,000 square feet, they're already in the building. Continuity is huge. Knowing the address, the staff, and the amenities of the building is important in that member's decision to stay within it when he/she decides to expand.

"The cons for Class A space comes down to cost per square foot. You've got expensive real estate, you can make money off it, you have premium tenants, and the asset owners feel their buildings have a certain type of tenant that works best there," Bart reiterated.

That statement hits hard on a stereotype the Coworking industry has long worked to move away from. The issue is in the fact that coworkers often do fit this made-up image of what a high-class tenant is. In the past there was a negative connotation associated with Coworking. This industry has evolved from a frat house feel with liquor, ping pong tables, and bean bag chairs. It's a professional, entrepreneurial, small business, and now enterprise business world. What's more, there should be no distinction between a lawyer, accountant, writer or designer who works out of a Coworking space as opposed to a traditional office.

"Seriously, if you sit outside these buildings and look at the people that come in, they're dressed no differently than 95% of coworkers are. Landlords may look at WeWork, and not see Industrious, where it's more enterprise clients. They've got the image in their mind of the early adopters of Coworking, and assume everyone's like WeWork," said Bart.

Minimizing Risk

"As a landlord, owner of a building, offering Coworking space means you're offering month-to-month memberships, which makes it very challenging for the owner of a building. Lease terms and stability are an important factor in getting financing," Waad said.

Keep in mind that Coworking, by nature, is not extremely stable. There's high turnover because you're offering high flexibility.

The risk for the landlord is basically operating a business that is not traditional real estate. Although the market is growing exponentially, many landlords—a majority, actually—do not feel comfortable with the concept of flexible workspace, whether it's due to lack of knowledge, or the higher perceived risk.

"What happens with Coworking is that you have a business that turns over 1-3% per month. It's an operating business, operating software, you have an HR element, you have high technology, and you have to be marketing constantly," Waad stated.

This is an important distinction because in traditional commercial real estate, you may not have any marketing components at all once the five- or 10-year lease is signed. In Coworking, the constant turnover means you need to get new foot traffic every month, and fresh sets of eyes on your space whether it's digitally or physically. The landlord basically passes the risk to the Coworking operator, so the operator does what they do best, and the landlord continues to manage the building as they do best.

As we've mentioned, flexible workspace is an expensive build out. It poses different challenges in the relationship between landlord and operator. But the return in some cases, can be greater as well, as Bart explained.

"For a developer or an asset owner, if they've got safe, traditional leases locked in, making $70 per square foot in a Class A building in Manhattan, they could make $300 per square foot if they go into Coworking."

The difference is that industries they consider infallible are worth a risk. Many landlords see a boom or bust situation with Coworking.

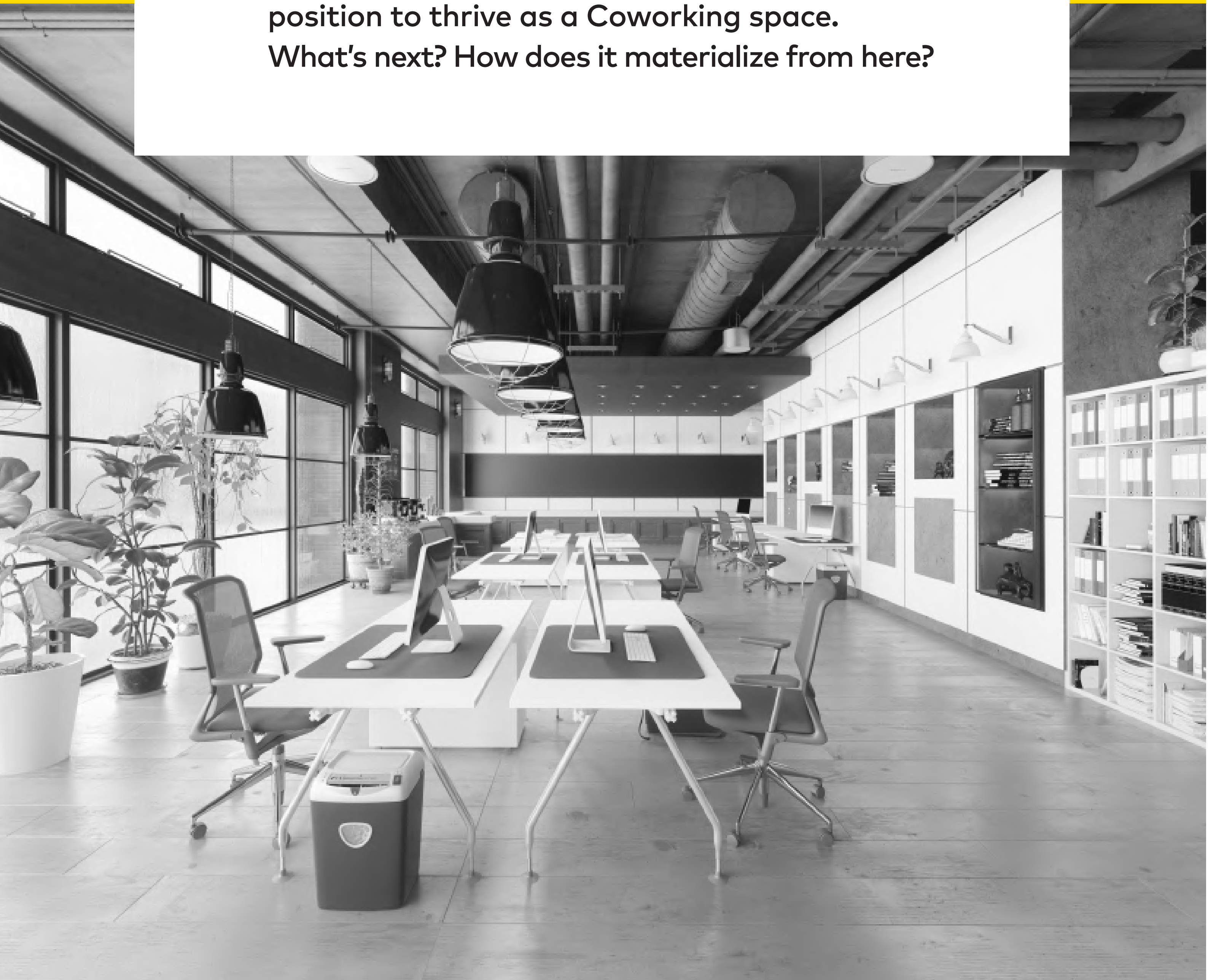
"If the bottom falls out of Coworking, I've got a bank that's going to be on me that's going to repossess my building," Bart continued.

According to Waad, the investment ranges anywhere from $100 to $150 per square foot. As a result, the deal structure of how much a landlord takes on and how much the tenant takes on is vital.

"The landlord wants to see stability from their tenant, and we want to see a significant contribution from the landlord because of the benefit we're bringing to their building," he said.

PART 5:
WHAT'S NEXT?

Based on everything we've covered, let's assume it looks like your vacancy is in a great position to thrive as a Coworking space. What's next? How does it materialize from here?



Comparing DIY, Partnership, Outsourcing Models

Let's take a look at three options available to property managers.

The thought of the DIY model creates hesitation. Property managers will want to partner with someone knowledgeable in the industry. Many of them will say they're in the business of renting floors, not going out and acquiring members, marketing a Coworking space, hiring a community manager and other tasks innate to the Coworking industry.

"In the DIY process, where it's 100% owned by the landlord, what the landlord is taking on is all the complexities of an operating business in order to fill space," Waad said.

Waad gave a great example relating to the retail vacancies we spoke about in section 3.

"The correlation is like a mall owner, where there are now significant vacancies because of the department store failures, deciding to open a retail store to fill a hole in the mall. This is the same concept. Since most landlords do not have the operating background, they'll try to bring in the skills to do it."

If you have the capital, the possibility isn't as daunting as it seems. But maybe a partnership option is a better solution.

"You have access to do something like a profit share, maybe with a coffee company. Where your kitchen or cafe area may actually be a real coffee company, coming in and paying you rent inside your Coworking space," Melissa said.

As mentioned in section 4, this could become a big benefit to the rest of the tenants of the building as well. They can access the Coworking space or floor and purchase a cup of coffee or a snack, which again, brings free exposure and positive marketing to your space.

Bart agrees this method is popular, if not the most ideal method yet.

> **"I have more conversations today about partnerships than ever, and there's certainly a lot of appetite for it. There's follow up discussions, but in terms of people pulling the trigger, there's more now, but it's not the greatest route yet," Bart said.**

The third option is outsourcing. This gives certainty to how much rent the landlord will collect every month, so this might be their first choice. But of course, the operator might feel like their best bet is a partnership. Negotiations can be tricky, but the growing success of shared spaces is going to lend to more overall knowledge of this industry and more lenders and landlords willing to invest in Coworking.

Outsourcing is a common option for some companies coming into the U.S. The property manager can turn to the operator to manage it, with people the operator hires, and pay them a management fee every month to do so. The fee is insignificant in the long term, because the space also provides amenities and accessibility to those already in the building.

'The landlord's first choice is to outsource and do a long-term lease with a Coworking operator who knows what they're doing and will enhance their building," Waad said. "Partnering with a third-party operator is perfect for the Coworking company, because you're not taking on the full risk of the lease."

There is a lot of acquisitions, partnering, or management-style contract profit sharing in the news recently. In September 2018, Convene, a giant in the Class A flexible workspace industry, expanded on its partnership with RXR Realty in New York. Convene will occupy four floors in RXR's Fifth Avenue Manhattan location, the largest of the four locations in the strategic partnership.

In 2017, The Office Group, one of London's premier Coworking brands, announced that Blackstone, a global real estate investing firm, had acquired a majority interest in the company, for over $600 million.

These deals are going to continue to happen. The growth in the flexible workspace market and the ideal partnering with CRE lends itself to massive deals like these.

> "It's a true partnership. It's not 'Here's your 10-year lease, well see you in 10 years to renew.' The property manager becomes part of the equation and part of the success," Melissa said.

CONCLUSION

One thing that often stops property managers from getting into the Coworking world is that they simply don't understand the industry, which is okay.

"How are we going to manage it?" "All these people coming in and out." "We've got all these invoices," etc. These are common thoughts and concerns. It's important to realize that while turning your vacancy into a Coworking space revolves around different factors than leasing to a traditional tenant, there is capacity for income.

There is a continuously growing and evolving industry, which is following the path of the modern working adult: technology driven, business savvy, and social.

A savvy landlord or property manager will review all the factors: quality property, located in a good market, demographics are ideal, disposable income is relatively high (because some people do use additional income as their means to afford Coworking), rising demand for Coworking. **And if they can check all or most of the boxes, they should certainly consider adding a Coworking space to their building portfolio.**

> To not tap into this market while most believe it's still nowhere near its peak, would be a potentially missed opportunity, especially given the difference in price per square foot between Coworking and traditional tenants.

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