Flexible working: sub-brand, sub-let or JV?

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With office tenants increasingly prizing flexibility and no longer wishing to be bound by 25-year office leases, commercial landlords are having to quickly explore new options. The UK market has seen a surge in demand for serviced offices – but how do commercial landlords go about engaging with this latest market development?

Commercial landlords can enter into the market directly but, more commonly, are being offered opportunities to team up with serviced office providers, which includes serviced or flexible offices, co-working spaces and even virtual offices. With so many new options available for landlords looking to branch out into the serviced office market, it is worth remembering that the devil is in the detail and striking the right contractual agreement is key to success, especially against the backdrop of We Work's cancelled initial public offering (IPO).

Sub-brand

A landlord might choose to enter the serviced office market directly and handle all dealings with tenants. While initially costly, this option can provide the best returns.

The landlord will need to invest in: creating and developing its branding; capital expenditure in modernising the property; and providing additional services and amenities to create a more collaborative work experience. One option could be operating the business as a subscription-based members' club and stipulating the terms of the flexible occupation through the membership agreement. Another avenue could be entering into standard form tenancy agreements – and requesting deposits to mitigate the risk.

Ultimately, the landlord will have to deal with a significant number of occupiers directly so it will be laborious to manage, but after the initial start-up costs, profits can be enjoyed directly. Additionally, the landlord can directly enhance or re-position their brand to market needs, such as changing a property's profile by ensuring occupier mix is complementary or by focusing on revitalising their properties in more fringe locations.

Before embarking on this option, landlords who only hold a leasehold interest in their property should check the headlease to ascertain whether subletting of part is possible and whether consent is needed. If subletting is prohibited, this option won't be available. If consent is needed, this will be costly and time-consuming – and is likely to make this option unattractive.

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Subletting

A landlord can let a whole building to a serviced office provider (as tenant) by incurring limited costs only, especially as the operator is likely to want to control common areas so they are consistent with their brand. This option is most akin to the grant of a traditional lease and is definitely the most straightforward.

Security can usually be obtained with a guarantee and/or rent deposit from the serviced office provider, which helps mitigate its potential risk, and can enforce lease covenants – such as dilapidations at the end of the term – directly against them.

On the downside, the landlord has limited control on branding and direction of the office space, and most underlettings are at fixed rent, with no top-up rental profit payable. In some cases, landlords are able to request a profit rent from service providers to benefit more from the income split.

Again, before embarking on this option, landlords with leasehold interests will need to consider headlease restrictions against subletting. Even if the lease contains restrictions, in practice some head landlords may waive the restrictions if the letting is to a well-established shared office provider. Landlords will usually seek to approve the form of tenancy agreement to be used and will want to ensure that no security of tenure is granted to occupiers.

Joint venture

This is probably the most complicated option, but is perhaps the best of both worlds. A joint venture (JV) with a serviced office provider could allow a landlord to benefit from the expertise of an established serviced office provider and obtain an income fee split with them.

To limit the landlord's potential risks under a JV agreement, the landlord should look to propose change of control and assignment limitations. Any agreement should require performance ratchet clauses so the percentage of equity in the JV increases or decreases based on the performance of the business.

Under the JV arrangement a landlord may have to put in capital expenditure, but it is possible to recover such initial costs via the profit share once the business is operating. To ensure adequate protection for reversionary interest, the landlord could require that a certain percentage of the turnover each year is set aside for the maintenance, repair and upkeep of the property under a reserve fund.

Ultimately, the biggest challenge with this option will be finding a JV partner whose vision and branding is aligned with the landlord's. The next biggest challenge will be negotiating a JV agreement that works for the landlord and which provides sufficient safeguards if things don't work out.

Be prepared – and flexible

Flexible working and serviced office space is here to stay, with businesses of all sizes looking to explore how they can benefit from more flexible office arrangements. While there will always be demand for longer leases among larger, more mature businesses, landlords need to be alive to the changing market.

For landlords used to being relatively hands-off, it is important not to underestimate the effort, skill and investment needed to develop a new service office offering and make it work in an increasingly competitive market. For those considering JVs, it is worth investing proper time into identifying the right partner and not simply going for the latest hot operator who may turn out to be a flash in the pan.

At present, many serviced office operators are seeking to quickly build their portfolios and are on the hunt for good buildings, but this might not always be the case. In a fast-moving market, clever landlords will be those that have properly reviewed their options, developed a robust strategy and taken clear action.

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