Serviced offices now comprise a separate asset class – but they are valued in the same way as ordinary offices. New approaches that take into account revenue streams, costs and other factors are coming to the fore. Piers Wehner reports

Revising the
onny Rosenblatt is the founder of Headspace Group, a design-led flexible working space provider for tech and creative start-ups and boutiques. Also known as a serviced office. And Rosenblatt is on a personal mission. “As the serviced office sector grows and diversifies, it is time that it was viewed as an asset class in its own right,” he says.

Why does he say this? Because Rosenblatt is one of many in this sector feeling a little, well, undervalued. Literally. Traditional valuations, as anyone with a passing understanding of commercial real estate will tell you, are based on a simple formula – rent payable multiplied by the covenant strength of a tenant and the length of lease. As far as Rosenblatt is concerned, it is not so much simple as downright stupid.

“It’s antiquated and doesn’t provide a real valuation on the additional revenue that any serviced operator worth its salt can add,” he states.

Of course, it isn’t the first time we have heard this. In fact, this has been the chief gripe of the serviced office sector since before it was a sector. The same injustice was probably being noted and debated and ignored when Regus founder Mark Dixon was starting out.

The difference is that this time things might be changing. The sector has grown up from a fringe concern to being a key element of the commercial property world. As of the end of last year, according to the Business Centre Association’s figures, there were some 70m sq ft of serviced offices in the UK, housing more than 80,000 businesses.

Serviced offices now account for 12% of the central London office market, according to a report by Instant Group. And with WeWork taking 170,000 sq ft at Moor Place, EC2, in March, it seems we are at a golden age of the rent-a-desk.

For years serviced office players appealed to banks and the like to look upon their market as a service industry, as well as a property business. And now some believe that what was once treated with suspicion is now being taken as gospel. Serviced offices need to be valued differently.

“The valuation of properties as serviced offices is becoming more sophisticated to reflect both the merit of the operating business as well as the real estate itself,” says Chris Strathorn, director of valuation advisory at JLL.

One element of the process is to assess the added value of having a serviced office provider as the long-term occupant and caretaker. “A serviced space is willing to spend a large capital expenditure from day one on fit-out,”

formula
EG OFFICES VALUATION

says Rosenblatt, adding that, because of what their customers demand, serviced office providers are often the first to install cutting-edge technologies.

In addition, serviced buildings have a huge variety of revenue streams, which often don’t get taken into account at valuation. “Meeting room usage, conference space, F&B offerings, courier and postage services are just a few additional revenue streams that generate income for an operator heavily invested in improving the fabric of a real estate asset,” adds Rosenblatt.

Indeed, the profit method, which allowed Regus to float at £1.5bn back in 2000, is now often being used to provide a more accurate valuation.

To do that, analysis of the trading business is vital. Within that analysis, all the income streams have to be assessed and included. That means revenue from rents and licences, but also from meeting rooms, telecommunications, virtual office services, even the coffee machine, café and the pop-up back massage place.

Giles Fuchs, co-founder and chief executive of Office Space in Town, argues that serviced offices should be valued in the same manner as hotels, and with the same multipliers [see above].

For many, that is not such a bad idea. “Serviced offices could be valued on a profits approach,” says Tim Stoyle, who works in Savills’ hotel valuation team. “That method is already being used in the self-storage market, so there is a precedent outside the hotel space.”

But there are also other costs. “Running costs including onsite managers, heating, lighting, cleaning, insurances and business rates must be deducted,” Strathon points out.

What you end up with is a net operating figure that is more or less an EBITDA. That would still give you a healthier valuation than one based on bricks and mortar alone. “It is always interesting to compare the EBITDA figure against a standard estimated rental value of the office building,” says Strathon, “because it demonstrates the premium that is being created by the operating business. “This can then be multiplied by an appropriate figure to get a capital value.” “Simple,” as that pesky meerkat advertisement would say.

Maybe not. We may have come a long way from the days when anything other than a straight up-and-down property valuation for a serviced office was viewed with suspicion, but that doesn’t mean the square has been circled just yet.

FUCHS’S FORMULA

(EBITDA equal to market rent (at 5% yield) + (remaining EBITDA x 80% (at 8% yield)) = value of serviced office building

“In my experience, many valuers recognise the EBITDA approach, but there is inconsistency in the analysis of the income,” says Strathon.

Some valuers use only one year’s figures, for instance. But the main stumbling block is the choice of multiplier in relation to that EBITDA.

If the same multipliers are applied to the services and additional revenues of serviced offices as are applied to those of hotels, as Fuchs suggests, then you are looking at a multiple of 12 to 14 times – or, for the sake of ease, an 8% yield.

But there is no industry standard. “There is not much transparency in multipliers because, when serviced offices are traded as going concerns, details remain opaque,” says Strathon.

Aside from that area of complexity, there is also the question of how bankable that revenue is, as the very nature of the serviced office model is short-term.

Fuchs says that only 80% of this income should be included in the valuation, as the remaining 20% can merits based on EBITDA and multiple revenue streams. They will also want a vacant possession value, based on the estimated rental value of a standard lease on a market rental basis, and a yield reflecting the lack of a tenant.

After all, banks are only partly interested in what happens when the business is doing well. It is what happens when that business begins to wobble, and whether they will get their money back, that really matters.

“If an operator fails then, particularly during the recession, the relevant office becomes vacant and so reverts to a significantly lower value,” says Strathon.

In order to add some robustness to the proposition, he says, valuers should review at least three years’ accounts and a forecast budget in order to analyse performance, particularly in terms of occupancy and pricing structures, as well as the costs over time.

Although it is easier to compare the EBITDA or premium income value against the standard rental value, it is important to note that the yield or

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then act as a safeguard in the event of a recession.

It sounds quite compelling. The problem comes when that nasty little recession comes. As Regus found when almost all of its hip and happening dotcom tenants suddenly evaporated in 2002, it isn’t just 20% that you can lose. With the serviced office industry now bigger than ever before – or on the back of what some have described as a new tech bubble – there are mutterings that this could happen again.

Which makes a profits-based valuation look less appealing to some.

Valuations are not, after all, simply an academic endeavour to establish what a business is worth. They are a tool used by remarkably risk-averse entities, namely banks, to make lending decisions. And when undertaking valuations for secured lending, a valuer, in most cases, will not just be asked to assess a serviced office’s multiplier does reflect lease length and covenant strength. “The guaranteed income is, by nature, short-term,” says Strathon, “compared with a standard property investment let to a single tenant on a good covenant for 10 to 15 years.”

Although the valuation of serviced offices has developed in the past few years, it is by no means sophisticated. “There remains a lack of consistency in approach and the market still lacks transparency compared with other real estate assets,” says Strathon. “To a certain extent, that hinders accuracy.”

And until that wrinkle is ironed out, there will be those who say a simpler, bricks-and-mortar valuation is safest. Or, as Cibase chief executive Steve Jude wrote (24 January, p54), with traditional long leases becoming an endangered species, and the inexorable rise of the serviced office, maybe we just need to rethink valuation altogether?