

Flexibility is king

Jade Capper explores the rise and rise of the serviced office market



Jade Capper is an associate in the commercial real estate department at Forsters

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The rise of serviced office providers in London, and increasingly throughout the UK, has inevitably proven a challenge for conventional landlords. Vacant units and voids in their buildings cause a lack of certainty over landlords' income streams. When coupled with other financial strains, such as increased levels of business rates (for which landlords will be liable on any vacant space following any relevant relief period) and the upsurge in the use of company voluntary arrangements (CVAs) among tenants seeking to restructure their businesses and reduce their rental liabilities, many traditional landlords are under pressure. Arguably, institutional landlords have been further adversely impacted in the conventional office sector by the rise of serviced office providers, which have begun to be viewed as their own standalone asset class. Some of the more forward-thinking institutional landlords have found themselves turning to the serviced office movement, so as to diversify their portfolios and maintain a continued prominent role in the modern office market. The Crown Estate, for example, announced earlier this year that it would be launching its own serviced office brand this autumn across 25,000 sq ft of its central London portfolio.

Tenant perspective

From a prospective office user's standpoint, especially small and medium-sized enterprises (SMEs) and start-up businesses, the slick, modern concept that a tenant can turn up at a property, sign a pro-forma (and generally short-form) tenancy agreement and start operating almost immediately, with flexibility to increase

or decrease the space required, is likely to be incredibly appealing. The nature of the workspace can also provide the opportunity for professional collaborations between SMEs and start-up companies, with brands such as RocketSpace encouraging tech companies to come together in a shared office environment.

Conversely, tenants' perceptions of a traditional landlord-tenant relationship can be tainted by archaic lease wording, the drawn-out negotiation of multiple documents and unforeseen hurdles to getting started, such as delays caused by fit-out works or lengthy waits for internet providers.

Serviced offices are, however, not without their flaws, due largely to the fact that the services provided are only as good as the service providers themselves and, while flexible working arrangements can prove beneficial to some tenants, a lack of certainty has the potential to also become a logistical nightmare.

This article considers the typical characteristics of both traditional leases and serviced office agreements, as well as looking at the advantages and disadvantages of each type of letting from the perspective of SMEs and start-up companies. It will never be a case of 'one size fits all' as every business will have different needs and requirements, but there are, generally speaking, common benefits and hindrances for SMEs and start-up companies when considering which type of space to take.

Flexibility v formality

Term and demise

Serviced office leases tend to run for a period of three months to two

years, with some providers offering month-by-month rolling arrangements. The additional flexibility of being able to downsize or upscale your space and effectively pay for what you need, when you need it, can be an alluring prospect to a company in its financial infancy and where the likely headcount of the company in 12 months' time is not easily predicted. Some serviced office providers also offer a membership service, which allows even more scope for flexibility. A serviced office user may operate day to day from space in Soho, for example, but in between meetings in Moorgate may want to work out of another building in the area operated by the same provider.

However, one possible disadvantage of the built-in flexibility of a serviced office arrangement is that the provider is likely to require a provision in the agreement giving it the ability to relocate the user to another part of the building, should it be required, in order to accommodate other users. This could potentially be disruptive to users who are well-established in their original space. By contrast, traditional office leases will be drawn for a term of at least five years with a fixed demise. In terms of upsizing, some traditional landlords will agree the inclusion of a pre-emption right in favour of the tenant, giving it a right of first refusal over any additional space which may become vacant within the building before the landlord is allowed to negotiate terms with a third party. This allows the tenant to take additional space, should it want to increase its demise. Such rights of pre-emption usually provide for the tenant to take the additional space on similar terms to its existing lease, save that the landlord would generally seek to achieve an open market rent at the level obtainable at the time the right of pre-emption is exercised.

Disposal

With regards to downsizing, conventional landlords will usually allow the tenant to underlet the whole of its premises, although this is not of much help to a tenant unless it wants to give up the entirety of its space. The ability for tenants to underlet part only of the premises will not always be agreed by institutional landlords

at heads-of-terms stage, because landlords will be concerned about the marketability of the asset as a whole. The more occupiers that there are in a building, the more complex the management of that asset can become. Moreover, the premises could end up being difficult to let because it may have been sub-divided

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in a manner that is not appealing to other occupiers.

From a tenant's perspective, being able to underlet part is, of course, beneficial as it allows the tenant to remain in occupation, while reducing its space should the demise prove too large and/or too expensive for the tenant's purposes in the future. Underlettings of whole or part will usually be subject to the landlord's consent, with the proviso that such consent is not to be unreasonably withheld, and any other conditions which the lease provides that the landlord can impose on the tenant. Market norms include:

- the underlease being substantially in the same form as the lease;
- the rent being not less than market rent;
- the underlease being excluded from the security of tenure provisions contained in the Landlord and Tenant Act 1954; and
- the undertenant providing a direct covenant to the landlord that it will comply with the tenant's obligations in the underlease and/or the headlease, insofar as these relate to the premises underlet.

Landlords may also require financial information as to the covenant strength and standing of the undertenant. With a potentially long list of requirements to tick off

in order to underlet, this process can mean a considerable delay from the time a tenant is first minded to downsize to actually divesting themselves of the space.

Break clauses

Some tenants will negotiate the inclusion of a break option in order

to give them a degree of flexibility, although typically the break would only be operable on one or two specified dates, rather than on a rolling basis.

The conditions to be satisfied by the tenant on the exercise of a break option can include the delivery of vacant possession of the premises. However, due to recent case law, there has been a shift here towards a less stringent test, with many tenants pushing for this obligation to be limited to the removal of fixtures and fittings and the premises being free from any occupiers' or third parties' interests. In *Riverside Park Ltd v NHS Property Services Ltd* [2016], the tenant was found not to have delivered vacant possession of the premises as it failed to remove the partitioning it had installed during the term. The court held that the demountable partitioning was not fixed to the structure of the building and its configuration was unique and to the benefit of the tenant, rather than a lasting improvement to the premises, and the tenant had therefore not handed over the premises with vacant possession.

A further condition which a tenant will often have to satisfy is the payment of the principal rent, and sometimes all rents, up to and including the break date, which may mean the tenant has to await a refund on any overpayment of principal rent or rents beyond that date. The Supreme Court decision in *Marks & Spencer plc v BNP Paribas Securities Services Trust Company*

(Jersey) Ltd [2015] highlighted the importance for tenants to negotiate wording in the break clause to expressly state that any monies paid by the tenant to the landlord for the period beyond the break date should be refunded. M&S, as tenant, argued that despite its lease being silent on this point, there should be an implied clause in the lease entitling it to

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reclaim the overpayment of rents from the landlord. The court refused to imply such a term and found in favour of the landlord.

In addition, some landlords may insist that the tenant cannot validly exercise the break if it is in breach of any of the tenant's covenants contained in the lease. *Sirhowy Investments Ltd v Henderson* [2014] saw a tenant lose out on £70,000 after one minor breach of its repairing covenant led to the exercise of its break clause being held invalid.

Tenants therefore need to be mindful about the conditions imposed on the exercise of a break option. What constitutes vacant possession is not always clear, and an 'all rents' or a 'breach of covenant' condition can often scupper the operation of a tenant break, due to difficulties in ascertaining exactly what amounts remain outstanding and/or what breaches are subsisting.

Dilapidations liability

The biggest burden for many tenants under a traditional lease is the liability for dilapidations at the end of the term. Broadly speaking, where a tenant is obliged to repair under its lease covenants, landlords will have the ability to make a damages claim against it for any items of disrepair. This can prove a substantial financial burden on a tenant if it has been in occupation for many years and is required to reinstate the premises to good and substantial repair and

condition after a lengthy period of wear and tear. A serviced office user, however, can typically walk away when its agreement ends, having been obliged to keep the premises clean and tidy.

Security of tenure

For some businesses, their location is synonymous with their brand

identity and so they will want to remain in the premises for as long as possible. Where a tenant under a traditional lease benefits from security of tenure under the Landlord and Tenant Act 1954, being the statutory right to renew its lease and remain in occupation following the expiry of its contractual term, this provides the additional certainty of having a fixed demise for an additional period of time, or potentially a right to statutory compensation if the landlord can oppose the renewal on a no-fault ground. Serviced office users will not have the same benefit as they will usually be granted short-term tenancy agreements drawn outside the Landlord and Tenant Act 1954, or enter into a licensing arrangement with the serviced office provider.

Efficiency v dependability

Upfront costs

While a tenant-occupier will incur time and money negotiating a lease and any ancillary documents with a traditional landlord, a serviced office provider has already done the legwork on behalf of the end users and borne the cost of acquiring or leasing and fitting-out the space. A tenant can incur significant capital outlay on its set-up and fit-out costs, including rent deposits where they are of uncertain covenant strength, legal fees, agents' fees, surveyors' fees and the fees of any other professionals appointed to carry out its fit-out works. A serviced office letting, however, will usually insist on a fixed form of

tenancy agreement, which is likely to remain unamended, so it can be as simple as a tenant turning up, signing up and setting up at the premises, with the only upfront cost being a deposit. Serviced office deposits will typically be taken to cover services charges, and will be refunded on the termination of the agreement. A credit card deposit system, not dissimilar from a pre-authorisation on a hotel room, will be accepted by some providers, and the deposit will usually be equivalent to one or two months' rent. A rent deposit under a traditional lease will often be higher, ranging from the equivalent of 3 to 12 months' rent, plus an amount equivalent to VAT payable thereon if the landlord has opted to tax the property.

With a traditional letting arrangement, while locked in for a longer period, a classic lease can ultimately prove more economical for tenants, as serviced office users tend to pay more per square foot. While SMEs and start-up companies are willing to make that financial sacrifice short-term for the benefit of flexibility, long-standing, well-established companies may still opt for the traditional lease route, preferring the predictability which aligns with their ability to scope their business-space requirements over a longer period with more certainty than a start-up company.

Leasehold obligations

Where the serviced office provider itself has a leasehold interest, it has the direct relationship with the ultimate landlord, and the serviced office user will have no input on the provisions included in that lease, such as any bespoke rights or services which the user may require or desire. This may be problematic if such matters have not been catered for in the provider's lease – tech companies, for example, will often have an absolute need for a high-speed internet connection.

Depending on the terms of the agreement entered into by the serviced office provider and the user, it may be that the user takes on minimal responsibility for the upkeep of the property due to the temporary nature of the agreement, and is otherwise reliant on the serviced office provider

to observe and perform the tenant's covenants under the lease. Typically, the user will have an absolute prohibition on alienation, but will pay an all-inclusive rent and have lighter repairing obligations than a traditional lease. The serviced office provider will also deal with the cleaning, recycling and refreshment station provisions at the premises, cutting down on the supply contracts and invoices which the user has to negotiate and pay, which can be a welcome incentive for a business in its infancy.

While the lack of obligations can be beneficial to a user, non-observance and/or non-performance of key covenants in its own lease by the serviced officer provider, such as keeping the property in good and substantial repair and condition, could have a fundamental impact on the user's use and enjoyment of its space, as well as the common parts. In cases of material or persistent breach, this may lead to the landlord exercising its right to forfeit the lease. If such a scenario were to arise, the user would potentially have the ability to terminate

the agreement and walk away, but this would only be beneficial if the user views the serviced office space as a short-term option. With a traditional underletting arrangement, the ultimate user as undertenant would usually take on the full extent of the tenant's

forfeiture as an additional statutory protection. The court has jurisdiction to grant relief from forfeiture, although this is often subject to conditions whereby the tenant remedies its breach, for example the payment of arrears of rent and service charge, as well as the

In a traditional underletting arrangement, should the landlord take steps to exercise its right to forfeit the lease, the tenant would have the ability to claim relief from forfeiture as an additional statutory protection.

obligations under the lease, and would therefore have control over the observance and performance of the tenant's covenants, and, where needed, could enforce the landlord's covenants under the lease. In addition, should the landlord take steps to exercise its right to forfeit the lease, the tenant would have the ability to claim relief from

payment of legal fees and other costs incurred by the landlord in respect of the forfeiture proceedings. If, however, the tenant's claim is unsuccessful or the tenant cannot comply with the court order, the underlease arrangement would fall away and the tenant would lose its interest in the premises.

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Modernisation v saturation

The growth of technology and the need for businesses to modernise and adapt has meant that serviced office providers are a smart option for tenants who require an array of services, which a conventional landlord cannot or would not consider offering

decide the look, setup and finish of their premises, subject to the provisions of the lease which would usually provide that landlord's approval is required (not to be unreasonably withheld), whereas serviced office users are often delivered a space, or a desk, designed by the serviced office

The services provided are only as good as the service provider, and if they are not maintained and updated, then the services may not continue to meet the requirements of the end users.

to its tenants. Modern meeting rooms, cycle stores, high-speed internet and coffee-shop-style eating areas are becoming standard features of serviced office spaces. More elaborate services include meditation rooms, gyms and members' bars. Some serviced office providers are even offering 'virtual offices', whereby a user can benefit from a UK business address, mail handling and a postal service.

However, the services provided are only as good as the service provider, and if they are not maintained and updated, then the services may not continue to meet the requirements of the end users. Furthermore, the demand for the same services can lead to saturation, for example, a lack of meeting rooms if all users are requiring use of additional space. Some service office providers allow individuals or companies to make a one-off payment and hire meeting rooms only, without the need to be a user of the wider serviced office space. With a traditional office letting, facilities and services are generally comprised within the tenant's demise, and common parts tend to include more basic services, such as toilets and/or a shared outdoor area.

Copycat v individuality

Occupying serviced office space generally means that the user buys into the brand of the serviced office provider. A traditional lease allows a tenant to have its own identity, branding and signage and to create its own culture within its premises. Tenants under conventional leases will be able to control their fit-out and

provider. Providers, such as WeWork, do offer the ability for users to put their own stamp on their space by offering a custom build-out, but this is at an additional cost and would be likely to delay the user's taking of occupation while the bespoke fit-out is worked up.

Collaboration v isolation

The opportunity to meet and collaborate with other tenants and serviced office users can be appealing. Many providers pride themselves on their community environment, with some providers setting up weekly networking events. Under a traditional lease, tenants will often be permitted to share occupation with group companies to allow multiple associated entities to use the same space, but are unlikely to get the same opportunity to meet and work with other unrelated tenants within the building. It may be, however, that a tenant wants to concentrate on its own brand, work within its own team and prefers the sanctuary of its own space. This is still possible through a serviced office provider, but at a greater expense than taking fixed individual desks or hot-desking. For some tenants, however, it may not be possible, due to the very nature of their business, for them to embrace the co-operative approach due to regulatory requirements or confidentiality restrictions.

Conclusion

While not without their flaws, there are clear advantages to serviced office arrangements for SMEs and

start-up companies. The potential flexibility, smaller initial financial outlay, minimal (if any) legal negotiations, modern services, prime location and potential collaborative opportunities can all prove a real benefit to those choosing the serviced office route. Traditional leases do still have their place in the market with some new companies preferring the security of a longer term, fixed demise, the ability to negotiate directly with a reputable landlord and the opportunity to develop their own brands and cultures. Traditional landlords cannot, however, become complacent and need to ensure that they are modernising their properties and offering additional services in order to compete with serviced office providers. The minimum standard of services expected by tenants is evolving and institutional landlords need to adapt to avoid becoming obsolete in the modern office market. In the same way, serviced office providers need to ensure that they remain ahead of the curve by staying current, adopting new technology and not letting the standard of their services slip or become oversubscribed.

Some institutional landlords are also embracing serviced office providers as their primary tenants, as well as offering their own flexible working arrangements. While serviced offices are generally more expensive to run, they are in greater demand and landlords can therefore demand a higher rent. With institutions such as Great Portland Estates, British Land and even John Lewis & Partners tapping into the serviced office market, traditional landlords need not see serviced office lettings as a last resort, but instead as another product to offer to prospective tenants and a new asset class to diversify their portfolios. ■

Marks & Spencer plc v BNP Paribas Securities Services Trust Company (Jersey) Ltd & anor
[2015] UKSC 72

Riverside Park Ltd v NHS Property Services Ltd
[2016] EWHC 1313 (Ch)

Sirhowy Investments Ltd v Henderson & anor
[2014] EWHC 3562 (Ch)