Savills World Research
Japan

Asian Cities Report
Tokyo Grade B office

2H 2018

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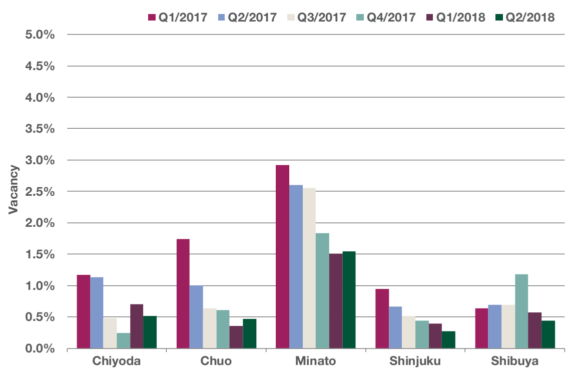
GRAPH 1

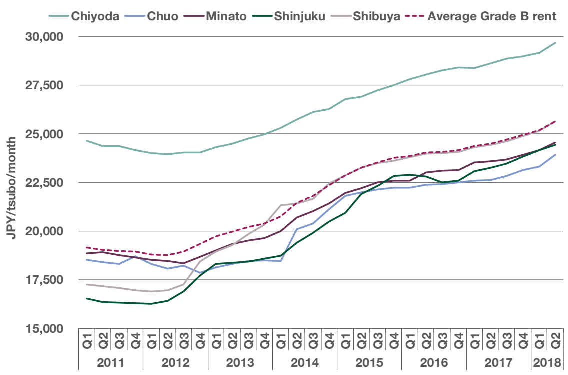
Grade B office vacancy by ward, Q1/2017 – Q2/2018



Source: Savills Research & Consultancy

GRAPH 2

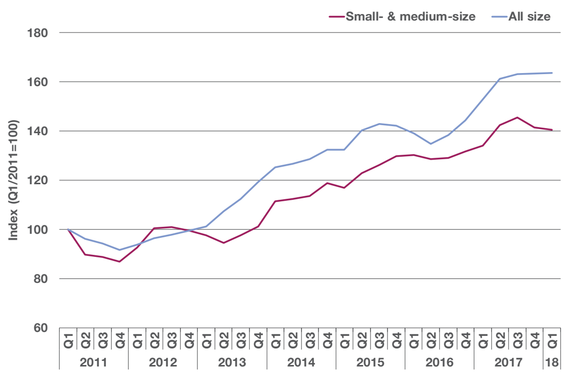
Grade B office rents by ward, Q1/2011 – Q2/2018



Source: Savills Research & Consultancy

GRAPH 3

Profits of small and medium-sized and all-sized companies*, Q1/2011 – Q1/2018



Source: Ministry of Finance, Savills Research & Consultancy
* Small- and medium-sized companies are defined as those with capital stock of less than JPY100 million.

Introduction

As the Japanese economy has grown under Abenomics, large-scale Grade B office[1] metrics in the central five wards (C5W)[2] have improved. A strong economy, with growing corporate profits and fierce competition for talent, is buffeting rents as tenants chase increasingly scarce office space. Concerns of secondary vacancy as a result of the Grade A supply boom have not yet materialised; even unaccommodated demand appears to be spilling over from Grade A to large-scale Grade B. Against this backdrop, large-scale Grade B offices in particular look well placed as they are simultaneously able to tap into the large tenant pool of small- and medium-sized companies as well as cater to displaced Grade A tenants. As opportunities to acquire Grade A offices are limited, Grade B properties should be increasingly attractive with relatively higher yields.

Large-scale Grade B offices

The average vacancy of Grade B offices in the C5W was 0.6% in Q2/2018, tightening 0.8 percentage points (ppts) year-on-year (YoY). Graph 1 shows that demand for Grade B is strong across the C5W, with all but Minato recording lower than 1% vacancy. In Q2/2018, the average vacancy of Grade B was even slightly tighter than that of Grade A.

The average Grade B office rent in the C5W was about JPY25,500 per tsubo in Q2/2018, more than 35% higher than the post-crisis low in 2012 (Graph 2). Even considering such growth, the average rent of Grade B is still about 25% lower than that of Grade A, thereby appealing to a larger tenant pool.

Grade B offices in Shinjuku and Shibuya have performed especially well, with rents increasing about 50% over the same period. In Q2/2018, average rents were about JPY24,500 and JPY25,500 per tsubo, respectively. Robust growth is likely to continue because of limited supply in these submarkets. Fast growing technology firms concentrated in Shibuya also fuel rental growth.

Average rents in Chuo and Minato have increased over 30% since 2012. In Q2/2018, average Grade B office rents were about JPY24,000 and JPY24,500 per tsubo, respectively. In Chuo, offices in central areas such as Nihonbashi and Yaesu have performed particularly well. Even in the Grade B market, top rents in this ward can reach as high as JPY40,000 per tsubo. Top rents in Minato fall between JPY30,000 and JPY35,000, with relatively new offices in the popular Aoyama district leading the market. Minato Grade B vacancy has significantly tightened since the beginning of 2017, when the submarket happened to observe departures of multiple large tenants. Given that vacancy is almost non-existent in other submarkets, Minato's vacancy should further tighten.

The average rent in Chiyoda was about JPY29,500 per tsubo in Q2/2018, while top rents can exceed JPY40,000 per tsubo. Chiyoda consistently commands the highest average rents among the C5W, although its premium has been shrinking as broad-based demand spreads throughout central Tokyo, with rents supported by a robust supply pipeline. Chiyoda's prime location, however, should ensure that the ward maintains its premium around the historical average. The discount from Grade A in Chiyoda is 27%, the largest in the C5W.

Strong fundamentals for Grade B

Sound demand for Grade B offices is supported by strengthening corporate performance. As illustrated in Graph 3, corporate profits at companies of all sizes have been steadily rising since a trough in 2009. Small- and medium-sized companies have also posted improved results, albeit with intermittent lags. Small- and medium-sized companies especially, which face severe labour constraints, could be adding bottom-up pressure to office demand: competition for talent is high, as Japan's unemployment rate stood at 2.4% in June 2018, and being short-staffed, they are strongly incentivised to move to conveniently-located, high quality Grade B offices to provide attractive amenities for their employees.

Grade B offices are also somewhat insulated from supply impacts, as the majority of new offices are Grade A and will not directly compete with

Grade B. Although many market participants were initially worried about secondary vacancy in Grade B offices after tenant relocations to new office spaces, a loosening of Grade B vacancy has not been observed. Indeed, Miki Shoji's data shows that vacancy continues to tighten across all grades, supported by sound office demand. Given that pre-leasing activity is strong for the large supply in the pipeline in 2018, office vacancy is likely to remain tight.

Although the current market conditions appear to limit the possibility of a downturn triggered by oversupply, a slowdown in the domestic economy could pose a greater risk to Grade B than to Grade A. Smaller companies, generally younger enterprises with smaller and less stable revenues than larger, well-established companies, are less likely to survive an economic recession. If the economy takes a turn for the worse, Grade B rents could suffer as these tenants withdraw demand from the market. Smaller offices that cannot accommodate larger companies are likely to suffer the most in such a scenario, while large-scale Grade B is expected to fare better as it has some ability to accommodate displaced Grade A demand. The increasing trend of large corporations consolidating their branch offices could also reduce demand for smaller Grade B offices.

Grade B investment market

In addition to the positive conditions of the Grade B market, limited acquisition opportunities of Grade A offices and their compressing cap rates has prompted some investor interest to shift to Grade B offices, in search of relatively untapped opportunities and better yields.

Small- and medium-sized offices also offer investment opportunities that are generally not available in the high-grade office market. A study published by Xymax in 2017 found that a large proportion of small- and medium-sized office owners were sole traders with ageing stock. Without a sufficient budget, they are unable to renovate or demolish and rebuild. Investors with spare capital could buy up such ageing stock and renovate, for a tidy increase in rents. The caveat to such a strategy, which carries potentially large rewards, is that it is dependent on a continuation of current economic conditions. For now at least, this seems likely as current economic policies appear set to continue.

Outlook

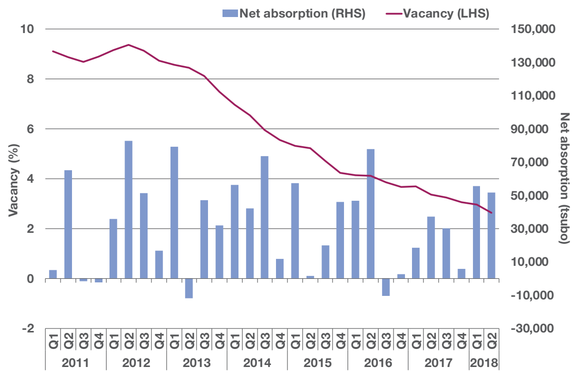
Due to limited acquisition opportunities in Grade A and relatively higher yields in Grade B, investors are keen on Grade B offices. Considering that office supply in the pipeline mainly consists of Grade A offices, Grade B is less likely to directly compete with this new stock and suffer from a loosening of vacancy. Further, strong profitability of small- and medium-sized companies and fierce competition for talent are reinforcing demand for quality offices.

On a cautionary note, the economic cycle is well extended and a potential downturn could abruptly reverse the current positive office market trend. Although the domestic economy appears stable, global economic prospects are becoming increasingly uncertain, for instance, as the U.S.-China trade war unfolds. Small offices relying on relatively small corporate tenants are riskier as they are less likely to ride out a recession.

1 "Large-scale Grade B office" typically refers to buildings with a GFA of 4,500 tsubo (15,000 sq m) and a building age of less than 25 years. Some buildings that do not fit this definition are included.
2 Chiyoda, Chuo, Minato, Shinjuku, and Shibuya.

GRAPH 4

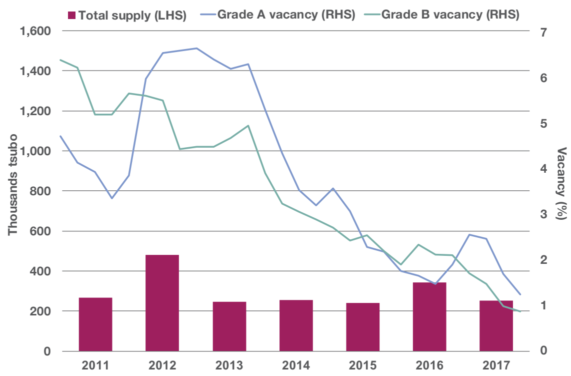
All-grade office vacancy and net absorption, Q1/2011 – Q2/2018



Source: Miki Shoji, Savills Research & Consultancy

GRAPH 5

Average vacancy for Grade A and Grade B and office supply, 2011 – 2017



Source: Miki Shoji, Savills Research & Consultancy

TABLE 1

Large-scale Grade B office transactions by J-REITs in the C5W, 1H/2018

Property	Ward	Price (JPY/US$)	Cap rate	Buyer	Announced
Nishi-Shinjuku Prime Square	Shinjuku	34.8 bn/ 320 mn	3.6%	Invesco Office J-REIT	April
Cross Place Hamamatsucho	Minato	20.7 bn/ 180 mn	3.5%	Kenedix Office J-REIT	May
Kojimachi Crystal City	Chiyoda	6.4 bn/ 59 mn	3.7%	Invesco Office J-REIT	April

Source: J-REIT disclosures, Nikkei Real Estate, Savills Research & Consultancy

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