MARKET IN MINUTES
Savills Research

Office Leasing

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Office market beats expectations in 2018

Vacancy remains extremely low and pre-leasing appetite is strong. If capital market volatility lingers, it may weigh on the currently strong office market.

- Tokyo's Grade A office market appears to be in a comfortable state with strong pre-leasing commitments through 2019. Barring an exogenous shock, average rents should continue to rise for the time being.
- Average passing rents for Grade A office space in the C5W grew to JPY34,592 per tsubo[1] per month, representing a gain of 1.4% quarter-on-quarter (QoQ) and 4.9% year-on-year (YoY).
- The average Grade A office vacancy rate in the C5W hit 0.5% in Q4/2018, dipping by 0.1 percentage points (ppts) QoQ and by 0.7ppts YoY.
- Average passing rents for large-scale Grade B office space rose to JPY26,376 per tsubo per month, growing by 1.3% QoQ and 5.7% YoY.
- The average large-scale Grade B office vacancy rate is 0.7%, 0.2ppts higher QoQ but 0.2ppts lower YoY.
- Co-working demand in 2018 was robust and is likely to pick up pace in 2019, but is yet to be proven sustainable.
- Large supply in 2018 did not soften the office market. Even so, the upward phase of the property cycle is well extended and some economic headwinds are gathering.

"The Tokyo office market has outperformed expectations in 2018 as rents have risen strongly and vacancy has continued to mark record lows. The outlook for property in 2019 is positive, though the macroeconomic environment is uncertain."

SAVILLS RESEARCH & CONSULTANCY

1 1 tsubo = 3.306 sq m or 35.583 sq ft.

Savills team

Please contact us for further information

JAPAN

Christian Mancini
CEO, Asia Pacific
(Ex Greater China)
+81 3 6777 5150
cmancini@savills.co.jp

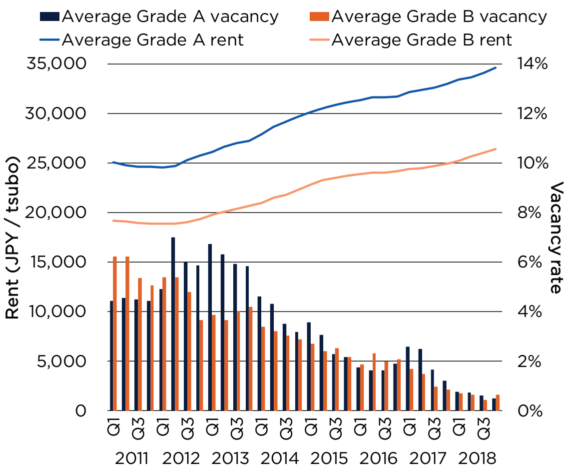
RESEARCH

Tetsuya Kaneko
Director, Head of Research & Consultancy, Japan
+81 3 6777 5192
tkaneko@savills.co.jp

Yoshihiro Kanno
Associate, Research & Consultancy, Japan
+81 3 6777 5142
ykanno@savills.co.jp

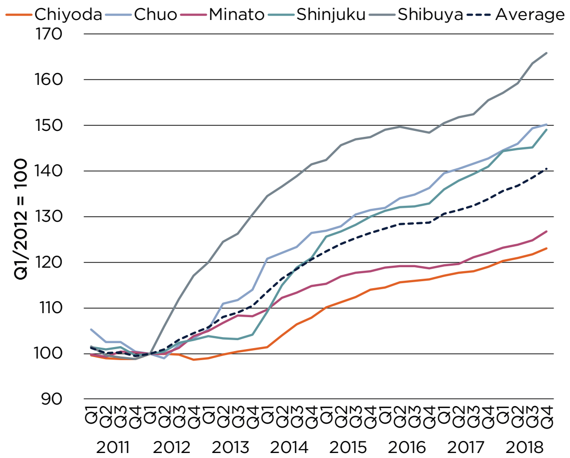
Simon Smith
Senior Director
Asia Pacific
+852 2842 4573
ssmith@savills.com.hk

GRAPH 1: Office Rents And Vacancy In Tokyo's C5W* 2011 to Q4/2018



Source Source: Savills Research & Consultancy
*Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index By Ward 2011 to Q4/2018



Source Savills Research & Consultancy

GRADE A OFFICES

Grade A office rents rose 1.4% QoQ and 4.9% YoY in Q4/2018 to JPY34,592 per tsubo[2]. Vacancy fell by 0.1ppts QoQ and 0.7ppts YoY, finishing the year at 0.5%. Demand from tenants is strong, keeping vacancy low despite elevated supply levels. Prudent landlords are more eager to retain creditable tenants than raise rents, leading to only mild rental increases despite extremely tight occupancy. This moderate rental growth should help protect capital values when an unexpected speedbump appears.

LARGE-SCALE GRADE B OFFICES

Large-scale Grade B office[3] rents rose 1.3% QoQ and 5.7% YoY in Q4/2018, to JPY26,376 per tsubo. Vacancy rose 0.2ppts QoQ but dipped 0.2ppts YoY to finish the year at 0.7%, moving wider than the Grade A market for the first time since the beginning of 2017. Large-scale Grade B offices continue to attract a deep, diverse pool of tenants as corporate profitability soars and demand spills over from the tight Grade A market. Minato, which has the most vacant space, has seen vacancy dip to just 0.7ppts. Chuo was the only ward which saw increased vacancy, rising 1.5ppts QoQ and bringing the YoY change up to 1.4ppts.

Large-scale Grade B supply remains lacklustre, as developers attempt to minimise land acquisition and construction costs through economies of scale and strive to meet tenant demand for newer and larger floor plate buildings. With a low volume of expected supply and a wide demand base – consisting of both large and small tenants – the outlook for large-scale Grade B offices is steady.

2 Throughout the report, "per tsubo" is shorthand for "per tsubo per month".
3 "Large-scale Grade B office" 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 are included that do not fit this definition.

GRADE A RENTS AND VACANCY RATES BY WARD

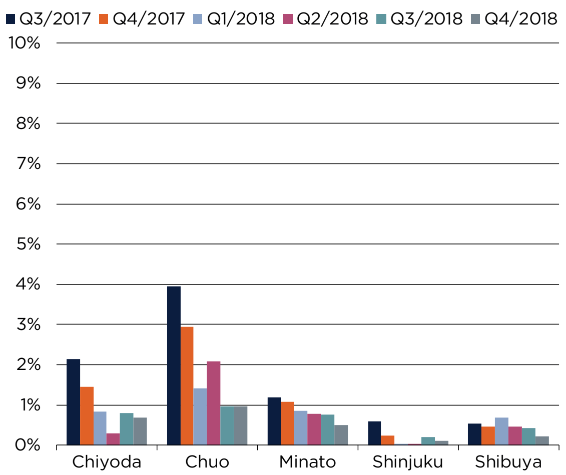
Chiyoda

Chiyoda's Grade A vacancy rate of 0.7% was 0.1ppts tighter QoQ and 0.8ppts tighter YoY. Grade A rents climbed by 1.1% QoQ and 3.4% YoY to JPY41,388 per tsubo. In Q1/2019 WeWork will establish a location at the recently completed Tokyu Yotsuya Building, preparing approximately 1,300 seats on the third to the ninth floors. San-Ai Oil will relocate its headquarters to the tenth floor of Otemachi Place East Tower in April 2019. It intends to strengthen collaboration among its group companies by integrating them onto one floor. Dyson will relocate its office to the Sumitomo Fudosan Fukuoka Hanzomon Building in Kojimachi, leasing two floors with an estimated floor area of approximately 800 tsubo.

Chuo

Chuo's Grade A vacancy rate of 1.0% was mostly flat this quarter but has tightened by 2ppts YoY. Grade A rents grew 0.5% QoQ and 5.2% YoY to JPY32,534 per tsubo. Sumitomo Chemical intends to relocate its Tokyo headquarters to Tokyo Nihonbashi Tower in 2H/2021, leasing just under 5,000 tsubo with enough space for 1,400 employees. Boston Consulting Group will relocate its Tokyo office to Nihonbashi-Muromachi Mitsui Tower, taking approximately 3,900 tsubo over three floors, a significant increase from its existing space of 2,600 tsubo. Several of Mitsui Fudosan's satellite offices will also move into the building in August 2019. Shinsei Bank is considering leasing 2,400 tsubo over four floors in the Tokyo Dia Building 5-gokan in Shinkawa, as part of an attempt to consolidate offices that are dispersed across different locations.

GRAPH 3: Grade A Office Vacancy By Ward Q3/2017 to Q4/2018



Source Savills Research & Consultancy

TABLE 1: Major Tenant Relocations Q4/2018

ORIGIN						DESTINATION	
Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other		
7	9	9	4		16		
6	1	1			2	10	Chiyoda
1	8				2	11	Chuo
		5	2		5	12	Minato
			2			2	Shibuya
					2	2	Shinjuku
		3			5	8	Other

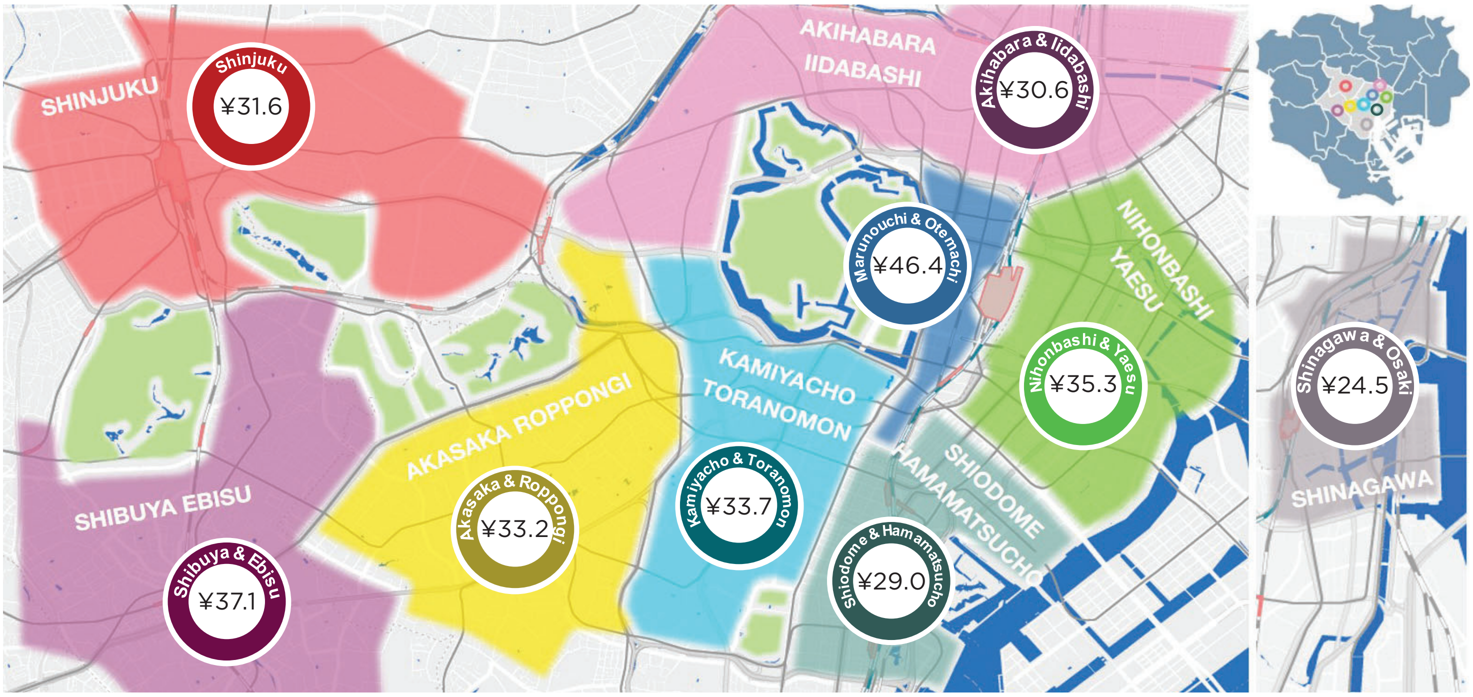
Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions Q4/2018

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION	NEW LOCATION	APPROXIMATE SPACE TSUBO	APPROXIMATE SPACE SQ M
Line	Information Technology	Expansion	JR Shinjuku Miraina Tower, Shinjuku-ku	Yotsuya Station Redevelopment Project, Shinjuku-ku	6,400	21,200
Sumitomo Chemical	Chemicals	HQ relocation	Tokyo Sumitomo Twin Building East, Chuo-ku	Tokyo Nihonbashi Tower, Chuo-ku	5,000	16,500
Boston Consulting Group	Consulting	HQ relocation	New Otani Garden Court, Chiyoda-ku	Nihonbashi-Muromachi Mitsui Tower, Chuo-ku	3,900	12,800
Nippon Light Metal	Manufacturing	HQ relocation	Tennozu Yusen Building, Shinagawa-ku	Urbannet Uchisaiwaicho Building, Minato-ku	3,630	12,000
Shinsei Bank	Financial services	Consolidation	Multiple locations, Multiple locations	Tokyo Dia Building 5-gokan, Chuo-ku	2,400	7,900

Source Nikkei RE, Savills Research & Consultancy

MAP 1: Average Rents Per Tsubo In Selected Submarkets Q4/2018



Source Nikkei RE, Savills Research & Consultancy
Grade A buildings, average passing rent + CAM per tsubo per month in thousand JPY. Coloured areas for illustrative purposes only.

Minato

Minato's Grade A vacancy rate tightened 0.3ppts QoQ and a more substantial 0.6ppts YoY, ending the quarter at 0.5%. Grade A rents climbed by 1.6% QoQ and 3.8% YoY to JPY32,098 per tsubo. WeWork will lease 1,390 tsubo across the 19th to 21st floors in Shiroyama Trust Tower, Toranomon, offering 1,000 seats. Mori Trust, the owner of the building, has announced it will work to vitalise the area together with WeWork. Nippon Light Metal Holdings will relocate its headquarters to the Urbannet Uchisaiwaicho Building in Shinbashi in 2H/2019, taking 3,600 tsubo over 11 floors, hoping to promote communication among group companies in the process. Macnica Fuji Electronics Holdings will move a number of subsidiary companies' offices to Shinagawa Heart in Konan, leasing about three floors with an estimated floor area of just under 1,000 tsubo.

Shibuya

Shibuya's Grade A vacancy rate dipped by 0.2ppts QoQ and 0.3ppts YoY to sit at 0.2%. Grade A rents climbed by 1.4% QoQ to JPY35,438 per tsubo, growing by 6.6% YoY. Leverages, a staffing company, will relocate its headquarters from Shibuya Hikarie to Shibuya Scramble Square as the business expands. The company also aims to improve its corporate brand image and recruiting capability by moving to a famous building. Inglewood, an e-commerce business operator, will relocate its headquarters to the tentatively-named Nanpeidai Project, citing a desire to remain close to JR Shibuya Station as one reason for the choice of location.

Shinjuku

Shinjuku's Grade A rents climbed by 2.7% QoQ and 5.8% YoY to JPY31,500 per tsubo. The Grade A vacancy rate tightened marginally by 0.1ppts QoQ and 0.1ppts YoY, reaching 0.1% at the end of the year. Line intends to take 6,400 tsubo in the tentatively-named Yotsuya Station Area Category I Urban Redevelopment Project, due to complete in 2020. Before that time, it will temporarily lease around 1,120 tsubo in the Shinjuku Station South Exit Area Project, expected to complete at the end of August 2019. Totec Amenity, an independent systems integrator, will move its Tokyo head office to the Shinjuku Mitsui Building in Nishi-Shinjuku in February 2019. The company aims to integrate its offices from three locations across Tokyo.

CO-WORKING TAILWIND

Co-working's explosive expansion undoubtedly contributed to the robust performance of the Tokyo office market this year. WeWork alone, for example, took up around 5% of new supply in the C5W in 2018 through eight locations. WeWork recently unveiled plans to double the pace of its expansion by the end of 2019 and has already announced three locations. Other co-working operators have also announced growth plans, albeit at more moderate scales.

The model currently looks popular, but co-working has yet to prove its sustainability, especially during an economic slowdown. Many end clients still seem to be evaluating the proposition and could decide the leasing model is not ideal. Only after a few years will the market see the extent of real, longer-term demand. Then this tailwind may become a headwind.

OUTLOOK

2018 has progressed better than expected, with the market absorbing a historically large volume of supply without much sign of indigestion. Robust corporate profits, a strong employment market and voracious pre-leasing activity put the market in a good position as it enters 2019. This momentum looks set to continue. For example, Mitsubishi Estate has announced that all of its expected completions through 2019 have been fully pre-leased, and landmark office buildings such as Shibuya Scramble Square are approaching full capacity months before their completion. More importantly, C5W supply in 2019 is only three quarters of that in 2018.

Co-working demand was robust in 2018, and WeWork looks set to double its pace of expansion in 2019. Co-working demand is likely to support steady growth in the office market for the next few years. However, currently strong co-working demand may backfire during or after 2020 if operators keep expanding aggressively and the initial enthusiasm or economy cools down. Further ahead, if overall demand were to remain sound until the significant drop in supply expected in 2021 and 2022, then the outlook for the market would be more stable.

Even so, the upward phase of the property cycle is well extended and some economic headwinds are gathering. In an October survey by the Japan Real Estate Institute, three quarters of respondents placed the Tokyo office market near the peak of the cycle. Moreover, the planned consumption tax increase in October 2019 has the potential to scupper Japan's steady performance, though it has been flagged well in advance and government policies should help limit the fallout.

Economic uncertainty stemming from the on-going trade war or political confusion in the U.S. and Europe is also weighing on risk appetite, but the Japanese property market should remain somewhat insulated and some corporations could even benefit from it. Real estate tends to lag capital markets. As such, some of this year's volatility should filter through. However, conservative behaviour by landlords should mitigate volatility in the market.

Savills monitors rents and vacancy levels at more than 450 buildings located in Tokyo's central five wards with a GFA of 3,000 tsubo (10,000 sq m) or above. Unlike similar market information issued by other research institutions, the rental data provided relates to estimated passing rents, inclusive of common area management fees, as opposed to asking rents. Meanwhile, vacancy figures reflect current vacant space without the inclusion of 'expected' vacancy, or that reported prior to tenants vacating their premises. As a result, benchmark figures, particularly vacancy rates, tend to be lower than other market indices.