Savills World Research
Tokyo

Briefing
Office sector

Q2 2018

Image: Tokyo office landscape

SUMMARY

Occupancy levels are approaching 100% in much of the C5W, which is benefiting surrounding submarkets, and driving up average rents which registered another gain in Q2/2018.

- As new offices continue to attract tenants in the central five wards (C5W), Grade A and Grade B vacancy continue to reach new lows.
- Average passing rents for Grade A office space in the C5W strengthened to JPY33,653 per tsubo[1] per month, representing a 0.8% rise quarter-on-quarter (QoQ) and a 3.9% increase year-on-year (YoY).
- The average Grade A office vacancy rate in the C5W edged down to 0.7%, a narrowing of 0.1 percentage points (ppts) QoQ and 1.7ppts YoY.
- Average passing rents for large-scale Grade B office space rose to JPY25,643 per tsubo, climbing by 1.8% QoQ and 4.6% YoY.
- The average vacancy rate for large-scale Grade B office properties tightened to 0.6%, dropping 0.1ppts QoQ and 0.8ppts YoY.
- The Shinagawa office market has recently taken off, with average YoY Grade A and Grade B rental growth exceeding that of the C5W.

"Tokyo office rents continue to rise while vacancy remains airtight. As demand fundamentals maintain their strength, these trends should persist until tertiary vacancy begins to weigh on the market."
Savills Research

1 1 tsubo = 3.306 sq m or 35.583 sq ft

Grade A offices

The Tokyo Grade A office market strengthened further in Q2/2018, albeit at a somewhat slower pace than in the previous quarter. Grade A office rents in the C5W grew 0.8% QoQ to JPY33,653 per tsubo per month, tracking slightly lower than the 1.3% QoQ growth posted in the first quarter. On a YoY basis, growth in Q2/2018 was 3.9%, on par with that of Q1/2018. Vacancy continued to tighten in Q2/2018 and reached 0.7% in the C5W, a drop of 1.7ppts YoY.

New, high-specification offices are continuing to see steady absorption and generally achieve high rents, though some landlords are reportedly more cautious in setting high initial rents for new buildings. With an increasingly competitive labour market, employers are prioritising conveniently located office space in order to secure talent. In the C5W, however, availability is extremely limited for high-grade offices located near stations. This also presents a risk of expanding tertiary vacancy when new office space comes online in more desirable locations. Currently, the lack of availability for prime locations in the C5W appears to be benefiting surrounding submarkets, notably Shinagawa.

Large-scale Grade B offices

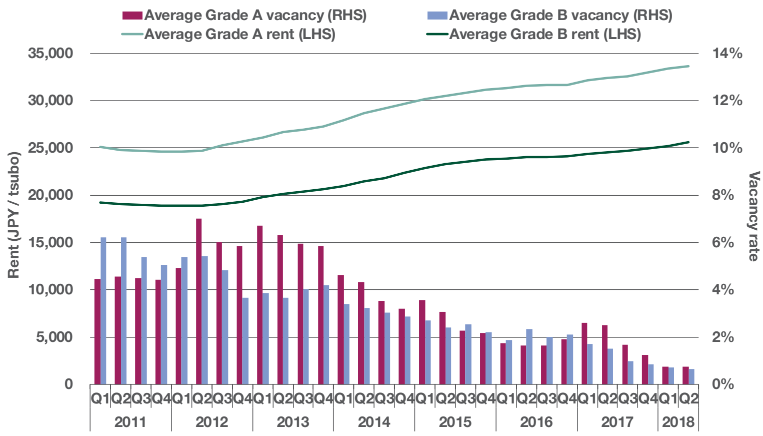
The average vacancy rate for large-scale Grade B office[2] properties sat at 0.6%, continuing to reach record lows, tightening by 0.1ppts QoQ and 0.8ppts YoY. Grade B rental growth YoY has outpaced that of Grade A for the first time since Q1/2016. The average monthly rent for large-scale Grade B properties reached JPY25,643 per tsubo, representing a QoQ gain of 1.8% and a YoY gain of 4.6%, outpacing Q1's gains of 1.0% QoQ and 3.4% YoY.

A lack of affordable space in the Grade A market may have bolstered tenant interest in Grade B property, although availability and new supply in the market has remained more limited. This has in turn given landlords room to increase rents, which still show an average discount of JPY8,000 per tsubo over the Grade A market. The Grade B market also appears to be strengthening outside of the C5W.

2 "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.

GRAPH 1

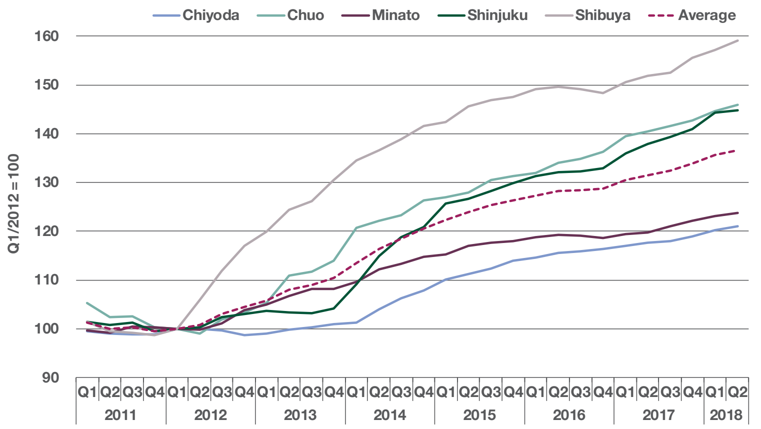
Office rents and vacancy in Tokyo's C5W*, 2011–Q2/2018



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

GRAPH 2

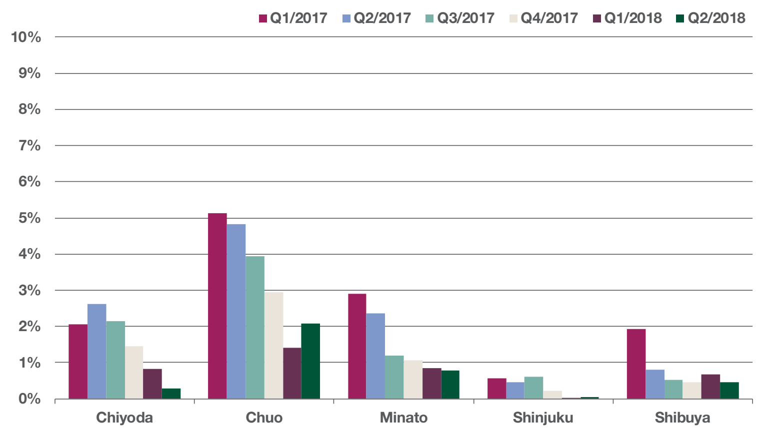
Grade A office rental index by ward, 2011–Q2/2018



Source: Savills Research & Consultancy

GRAPH 3

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



Source: Savills Research & Consultancy

TABLE 1

Major tenant relocations, Q2/2018

Origin: Chiyoda	Origin: Chuo	Origin: Minato	Origin: Shibuya	Origin: Shinjuku	Origin: Other		Destination	
8	5	19	5	3	17			
3	2	4	1	2	2	→	14	Chiyoda
3	3	3		1	4	→	14	Chuo
1		12	1		5	→	19	Minato
			2		2	→	4	Shibuya
						→	0	Shinjuku
1			1		4	→	6	Other

Source: Nikkei RE, Savills Research & Consultancy

Grade A rents and vacancy rates by ward

Chiyoda

Average Grade A vacancy in Chiyoda tightened 0.5ppts QoQ and 2.3ppts YoY to 0.3%. The average Grade A passing rents in Chiyoda stood at JPY40,679 per tsubo, increasing by 0.6% QoQ and 2.8% YoY.

WeWork will establish its sixth—and largest—Tokyo collaboration office in Hibiya Parkfront in Uchisaiwaicho. The company will lease four floors in the building, around 2,500 tsubo in total, and prepare 1,900 desks. The monthly rent per desk for one person at the new location starts at JPY68,000 while private two-person offices are listed at JPY250,000 per month. After receiving investment from SoftBank and entering the Japanese market in early 2017, WeWork is aiming to operate 10–12 locations by the end of 2018.

Chuo

Chuo's average Grade A vacancy rate increased 0.7ppts QoQ to sit at 2.1% in Q2. Rents, on the other hand, strengthened 1.0% QoQ and 3.9% YoY. The average Grade A passing rent in Chuo now stands at JPY31,625 per tsubo. While vacancy increased for a few buildings in our sample selection, demand for space in Chuo still appears robust as recent disclosures indicate a net movement of nine major tenants to the ward.

Toyota Research Institute Advanced Development (TRI-AD), Toyota's automated driving unit, will lease 6,500 tsubo of a new building in Nihonbashi-Muromachi 3-Chome Project Block A. The building is scheduled for completion in March 2019 and TRI-AD intends to relocate in July of that year. TEPCO Energy Partner, a subsidiary of Tokyo Electric Power Company Holdings (TEPCO), will lease 3,200 tsubo and relocate its headquarters to the Ginza Mitsui Building in January 2019. The company will reportedly consolidate two other offices into the new headquarters, with the aim of streamlining its business operations and bringing the firm closer to TEPCO's headquarters located in Uchisaiwaicho, Chiyoda.

Minato

Average Grade A vacancy in Minato tightened 0.1ppts QoQ and 1.6ppts YoY to sit at 0.8%. Grade A rents strengthened 0.6% QoQ and 3.4% YoY to JPY31,370 per tsubo.

Indeed Japan will establish a new office in Tamachi Station Tower South nearby JR Tamachi Station. The company will lease around 2,800 tsubo from the 17th to 19th floors of the building to establish a new base for its engineers. The new base is likely due to Indeed's business expansion in the Asia Pacific region, as the firm will maintain its current offices in Oak Meguro, located in Kami-Osaki, Shinagawa, and Yebisu Garden Place in Shibuya. The company will begin moving into the office in early 2019.

TABLE 2

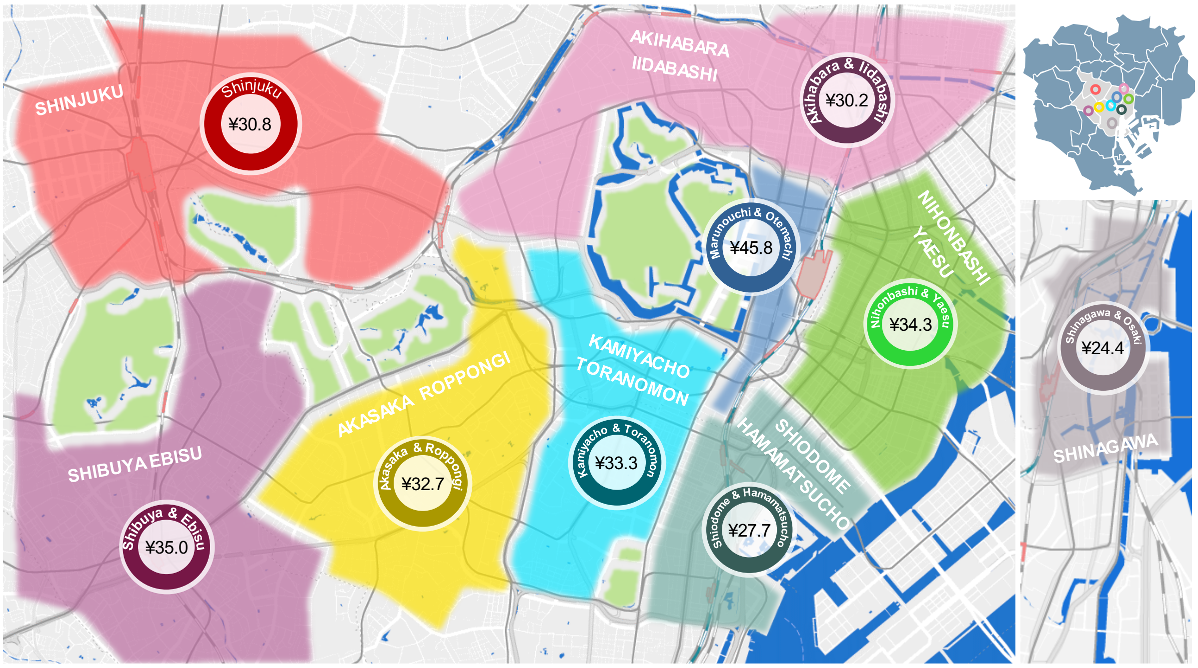
Notable office leasing transactions, Q2/2018

Company	Business sector	Type	Former/current location		New location	Approximate space: tsubo	Approximate space: sq m
Toyota Research Institute Advanced Development	Automotive	Expansion	Nihonbashi Mitsui Tower, Chuo-ku	→	Nihonbashi-Muromachi 3-Chome Project Block A, Chuo-ku	6,500	21,400
GMO Internet	IT	Consolidation	Various, Various	→	Dogenzaka Itchome Station Front, Chuo-ku	4,800	15,800
TEPCO Energy Partner	Energy	HQ relocation	New Pier Takeshiba North Tower, Minato-ku	→	Ginza Mitsui Building, Chuo-ku	3,200	10,500
Indeed Japan	IT	Expansion	Various, Various	→	msb Tamachi Tamachi Station Tower South, Minato-ku	2,800	9,200
WeWork	Real Estate	Expansion	Various, Various	→	Hibiya Parkfront, Chiyoda-ku	2,500	8,200

Source: Nikkei RE, Savills Research & Consultancy

MAP 1

Average rents per tsubo per month in selected submarkets, Q2/2018



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

Shibuya
The average Grade A vacancy rate in Shibuya sat at 0.5%, down 0.2ppts QoQ and 0.3ppts YoY. Grade A rents increased 1.3% QoQ and 4.8% YoY to JPY34,000 per tsubo, the highest QoQ gain of the C5W, with YoY growth falling just short of Shinjuku's.

Digital Garage, a web marketing and settlement services provider listed on the First Section of the Tokyo Stock exchange, will lease 4,400 tsubo of the Shibuya Parco Reconstruction Project, which is currently under construction. The relocation is meant to aggregate its offices around the Ebisu area into one location.

Shinjuku
Shinjuku's Grade A vacancy rate inched up by a fraction of a percentage point, but remains airtight at just above 0.0%. Grade A rents moved up 0.3% QoQ and 5.0% YoY to stand at JPY30,591 per tsubo.

Shinjuku has seen both the weakest QoQ rental growth and the strongest YoY growth of the C5W. It is possible that extreme lack of availability, and therefore a lack of new tenants, has held down rental growth for the quarter. Indeed, with airtight occupancy and little supply, no major leasing transactions for Shinjuku office space were reported in Q2/2018 while it has been reported that a few firms will move out of the ward.

Shinagawa office market takes off

As conveniently located space in the C5W is essentially unavailable, tenants have been increasingly looking outside of central Tokyo to find office space. Shinagawa ward appears to be one of the primary beneficiaries of this trend, with its market heating up considerably in recent years. To wit, the growth rate of high-grade rents in the Shinagawa office market has outpaced that of the C5W while vacancy rates, particularly in the Grade B market, have tightened greatly over the past year.

Grade A rents in Shinagawa now stand at approximately JPY21,000 per tsubo, gaining 4.5% YoY, exceeding the average growth rate of the C5W and outpacing that of Chiyoda, Chuo and Minato. Grade B rental growth pushed even further, reaching 6.8% YoY and now standing around JPY22,000 per tsubo, posting a larger increase than Grade B rents in any of the C5W submarkets. Grade A vacancy rates now sit at 0.3%, dropping 1.4ppts YoY. The average Grade B rate also stands at 0.3%, tightening by a whopping 2.7ppts over the prior year.

Rents in the ward vary widely depending on the submarket, with the highest passing rents occurring around Meguro and Osaki stations. Moreover, buildings around Shinagawa Station, which is technically located in the Minato ward, also tend to have much higher rents. On the other hand, the eastern and southern areas of the ward, such as Tennozu Isle, generally see lower rents. Office buildings in these areas also tend to have larger floor plates and are thus considered Grade A office property. Despite offering more space, the location of these buildings tends to bring down passing rents.

Overall, Shinagawa is easily accessible from increasingly popular residential areas, such as Ota and Setagaya, as well as Kawasaki and the residential districts of Yokohama. The convenience of the location and the relative affordability and availability compared to office space in the C5W has drawn increasing interest, especially for firms looking to set up bases for back and middle office functions. In fact, the Shinagawa market has now become so tight that some tenants are considering moving further outward to the Toshima and Edogawa wards.

OUTLOOK

The prospects for the market

The Tokyo office market is becoming exceptionally tight, making tenant relocation competitive.

Even with large upcoming supply looming into view, Tokyo Grade A and Grade B rents continue to post QoQ and YoY growth while vacancy steadily contracts. These conditions may have been a boon for surrounding wards, such as Shinagawa, which has seen a large increase in passing rents and a significant tightening in vacancy over the past year.

Rental growth has maintained much of its strength as demand remains solid and vacancy rates continue to tighten across Tokyo's central markets. Large firms appear to be steadily consolidating disparate offices, minimising distances between office locations, reportedly to improve collaboration and intrafirm synergies. However, firms are having difficulty locating sufficient space in the C5W, particularly Shinjuku, which has prompted some to look beyond.

Demand fundamentals appear strong as corporate profits soar and hiring is still robust.

Based on reports from the financial media, aggregate operating profit margins of publicly-listed Japanese firms have moved from 4% to 6% since Abenomics began, now largely on par with that of Germany. This is striking considering that Japan's population is now decreasing. With Tokyo's job-to-application ratio hovering around two to one for the past year and the national unemployment rate at 2.2%, firms appear to be utilising these profits to attract talent in an ever-tightening labour market. As such, the need for office space shows little sign of changing in the near-term, as revealed by a steady stream of office expansions.

On the other hand, global economic risks, including a potential trade war and political uncertainty in Europe, could threaten Japan's economic prospects and weaken demand in the office market. Moreover, the current market cycle is well extended, giving rise to an air of caution among certain landlords who are reportedly setting relatively moderate rents for some new buildings in the C5W. For now, however, most market players appear unfazed. Looking ahead, upcoming supply in late 2018 and 2019 is likely to marginally increase average vacancy rates, while office rents should continue to see gains at least through 2018.

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.

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