savills

Briefing
Office sector

Q2 2014

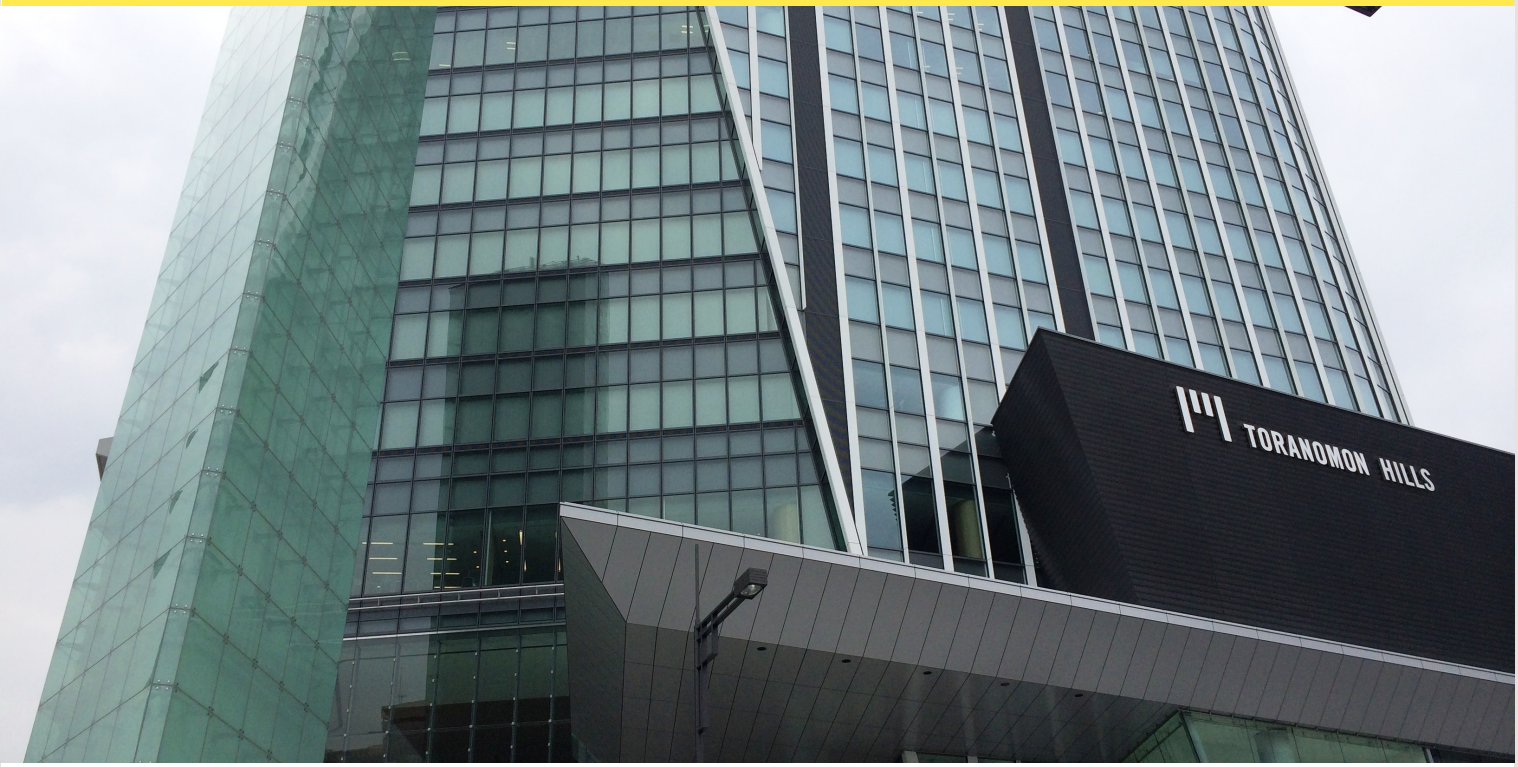


Image: Toranomon Hills, Minato Ward

SUMMARY

The Grade A vacancy rate fell to its lowest level since Q2/2009, supporting the view that leasing fundamentals are shifting in favour of landlords.

- Down for a fifth quarter in a row, the average Grade A office vacancy rate in Tokyo's central five wards reached a cyclical low of 4.3%, down 30 basis points (bps) quarter-on-quarter (QoQ) or 200 bps year-on-year (YoY).
- Average Grade A office passing rents meanwhile rose 2.8% QoQ to JPY28,660 per tsubo, up 7.5% YoY.
- While still characterised by office consolidations, a growing number of tenant relocations incorporated additional space for future headcount expansions.
- Shinjuku posted the strongest Grade A rental improvement at the ward level, buoyed by a sharp 220-bp fall in its vacancy rate.
- The average vacancy rate for large-scale Grade B office properties fell to 3.2%, marking its lowest level since Q3/2008.
- Large-scale Grade B office rents averaged JPY21,480 per tsubo, up 2.3% QoQ or 6.8% YoY.
- Competition among tenants for vacant units will sustain rental growth at high-grade assets, as well as drive pre-leasing at planned developments.

"Falling vacancy levels have supported prime rental growth, with achievable rents for Grade A office space rising a healthy 2.8% in the second quarter."

Will Johnson, Savills Research

Market summary

Grade A office segment

Prime vacancy in Tokyo's central five wards[1] fell to its lowest level since Q2/2009, supporting the view that leasing fundamentals are shifting in favour of landlords. Marking a fifth consecutive quarter of improvement, the average Grade A office[2] vacancy rate reached a cyclical low of 4.3%, down 30 bps QoQ or 200 bps on a YoY comparison. This healthy downward movement occurred despite several new prime buildings completing during the second quarter.

The average passing rent of Savills basket of Grade A office buildings in Tokyo's central five wards was JPY28,660 per tsubo[3] per month, inclusive of common area management fees. This represents an increase of 2.8% QoQ and a robust 7.5% improvement over the same period of last year.

As in recent quarters, large lease agreements were typically characterised by property upgrades, with companies across the major industry sectors taking space in prime buildings with large floorplates to facilitate office consolidations and business streamlining. Notably, an increasing proportion of these relocations incorporated additional space for future headcount expansion in light of Japan's strengthened economic outlook.

1 The central five wards that make up the Tokyo CBD are Chiyoda, Chuo, Minato, Shibuya and Shinjuku.
2 Grade A office refers to buildings located in the central five wards of Tokyo with a GFA of 30,000 sq m (9,000 tsubo) or higher and a building age of less than 15 years.
3 1 tsubo = 3.306 sq m or 35.583 sq ft.

Large-scale Grade B office segment

The average vacancy rate for large-scale Grade B office[4] properties fell for a third consecutive quarter to 3.2%, marking its lowest level since Q3/2008. The quarterly change was equivalent to 20 bps, or 44 bps on a YoY basis, supported by tenant demand for quality secondary space in Tokyo's central business district.

4 Grade B office refers to buildings with a GFA of 15,000 sq m (4,500 tsubo) with a building age of less than 25 years. Some buildings are included that do not fit this definition.

Absorption in this segment has predominantly been at the expense of older, small- to mid-scale rental buildings and outmoded owner-occupier stock. This divergence within the Grade B market has resulted in uncompetitive properties being removed from the market, either for refurbishment or redevelopment.

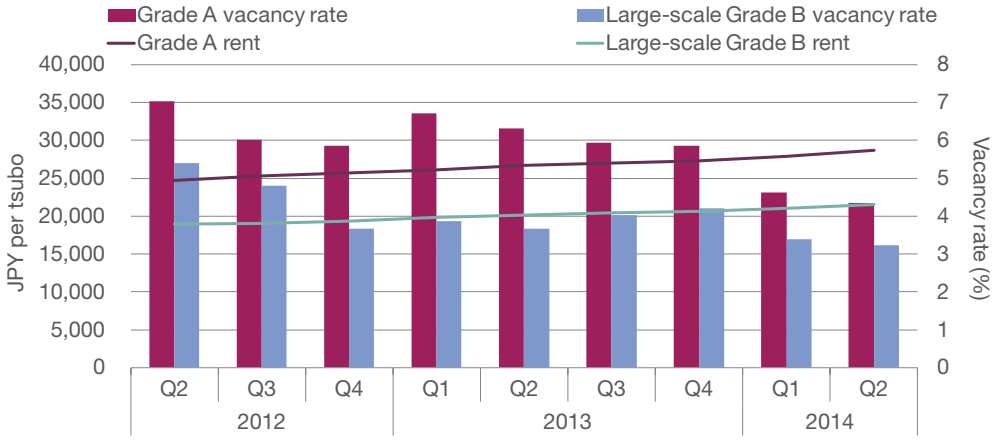
With a limited amount of space available for lease, landlords have taken a firmer stance on rents for available office units in recent quarters. Savills basket of large-scale Grade B office properties continued the stable growth trend recorded since Q3/2012, with passing rents for new leases up 2.3% QoQ to JPY21,480 per tsubo. On a YoY basis, the rental growth rate rose to 6.8%.

Nonetheless, higher rates of rental growth at Grade A offices have seen the relative spread between the two market segments increase gradually, up to approximately 33% in Q2/2014 from a cyclical low of around 25% in 2009.

Savills monitors rents and vacancy levels at more than 300 buildings located in Tokyo's central five wards with a GFA of 10,000 sq m or above. Unlike similar market information issued by other research institutions, the rental data provided relates to estimated passing rents as opposed to asking rents, whereas vacancy figures reflect current vacant space without the inclusion of 'expected' vacancy, or that reported prior to tenants vacating their premises. As a consequence, benchmark figures, particularly vacancy rates, tend to be lower than other market indices.

GRAPH 1

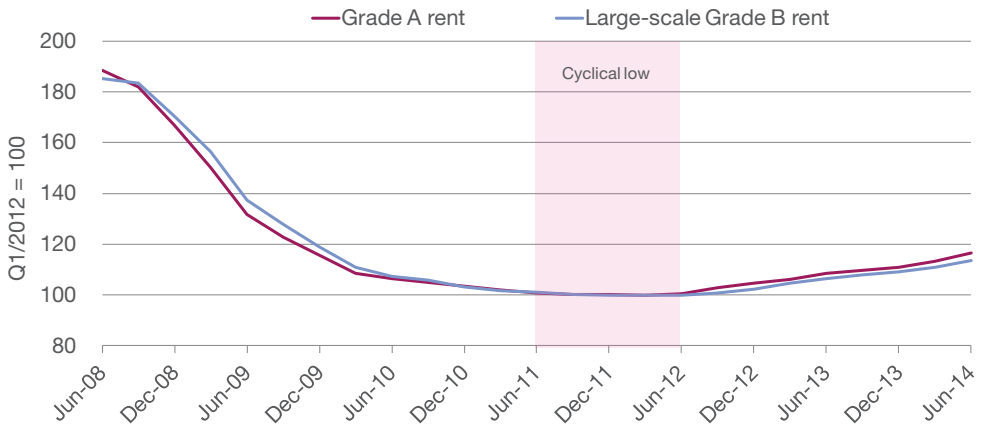
Office rents and vacancy rates in Tokyo's central five wards by grade, Q2/2012–Q2/2014



Source: Savills Research & Consultancy

GRAPH 2

Rental index: Office passing rents in Tokyo's central five wards by grade, Q2/2008–Q2/2014



Source: Savills Research & Consultancy

Grade A rents and vacancy rates by ward

Chiyoda

Chiyoda's average Grade A vacancy rate remained generally stable, ticking up 10 bps QoQ to 4.3%. On a YoY basis, the ward's prime vacancy rate contracted 90 bps and remained close to half of its recent peak level of 8.1% recorded in Q4/2012.

Grade A office passing rents in Chiyoda Ward averaged approximately JPY34,950 per tsubo in Q2/2014, posting growth of 1.2% QoQ, or 2.7% on a YoY basis.

Reflecting its status as Tokyo's most expensive office submarket,

Chiyoda commands a rental premium of approximately 22% relative to the five-ward average. However, comparatively faster rates of rental growth in neighbouring wards has caused this rental premium to fall steadily over recent years, compressing around 14 percentage points since its recent high of 36% in Q1/2012.

The largest deal of the quarter formed a pre-lease agreement by Yahoo Japan at the tentatively-named Kioicho Project, a mixed-use development scheduled to complete in 2016 on the former site of the Grand Prince Hotel Akasaka. The internet company is expected to lease 20 floors in the new tower complex, equivalent to approximately 20,000 tsubo (66,000 sq m). Yahoo Japan reportedly plans to bring together its headquarters in Midtown Tower and an office in Ark Hills South Tower, both in Minato Ward, and also accommodate increased personnel as its business expands.

Chuo
Chuo Ward's average Grade A vacancy rate demonstrated a sharp improvement in the second quarter, falling 260 bps QoQ to 3.0%. This figure is some 470 bps down compared with the same quarter of last year and marks the submarket's lowest level of prime vacancy since Q3/2012.

Large leasing agreements here include an agreement by Dentsu Digital Holdings to take approximately 2,840 tsubo (9,390 sq m) at Ginza Shochiku Square in Tsukiji. The move will see four group companies consolidated at one location in order to promote business collaboration.

The average Grade A passing rent in Chuo Ward stood at JPY26,460 per tsubo, up 3.1% QoQ and a strong 9.6% YoY as falling vacancy rates at existing buildings prompted landlords to expect higher rents for available spaces.

Minato
Despite the completion of two new Grade A buildings in the second quarter, Minato's Grade A vacancy rate fell back 50 bps QoQ to 5.8%. Mori Building's new landmark mixed-use tower, Toranomon Hills, opened with an occupancy rate of over 90%. This follows a string of lease agreements prior to completion to groups including pharmaceutical company Novartis.

Also benefiting from strong pre-completion leasing activity, Mitsubishi Estate's Nishi-Shinbashi Square development opened fully occupied. Deals at the scheme included large lease agreements by Hitachi Capital and Nippon Suisan to facilitate headquarters relocations.

The average Grade A office rent in Minato stood at approximately JPY28,430 per tsubo, up 2.9% QoQ or 6.6% YoY.

Shibuya
The Grade A vacancy rate in Shibuya continued to hover around the 2% level for a fifth consecutive quarter, rising a marginal 10 bps QoQ to 2.1%. Low vacancy rates in this submarket have encouraged landlords to demand higher rents for vacant office units.

Grade A passing rents in Shibuya stood at approximately JPY29,190 per tsubo in Q2/2014, up 2.6% QoQ or 11.3% YoY. Steady increases in average passing rents since 2012 saw Shibuya overtake Minato as the second most expensive ward for prime office space earlier this year.

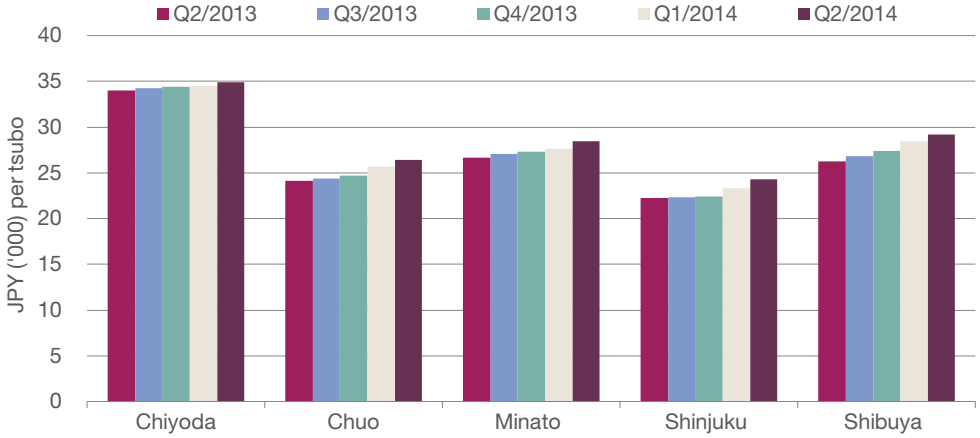
Shinjuku
Following a sharp improvement in Shinjuku's average Grade A vacancy rate in Q1, prime vacancy in the ward contracted a further 220 bps in the second quarter to 2.7%. This marks its lowest level since Q3/2008.

Much of this positive movement can be accredited to primary vacancies being filled at Shinjuku Eastside Square, which secured a number of new tenancy agreements through the first half of the year. Additionally, a handful of other prime buildings have achieved very high or full occupancy levels through recent leasing activity, including Shinjuku Front Tower and the Nittochi Nishi-Shinjuku Building.

As a result of Shinjuku's improved occupancy situation, prime passing rents recorded a second consecutive quarter of solid growth. The average Grade A rent reached approximately JPY24,270 per tsubo, representing an increase of 4.2% QoQ or 9.1% YoY. This contrasts with the modest advancement in rents posted in 2013, when high market vacancy rates held rental growth in check.

GRAPH 3

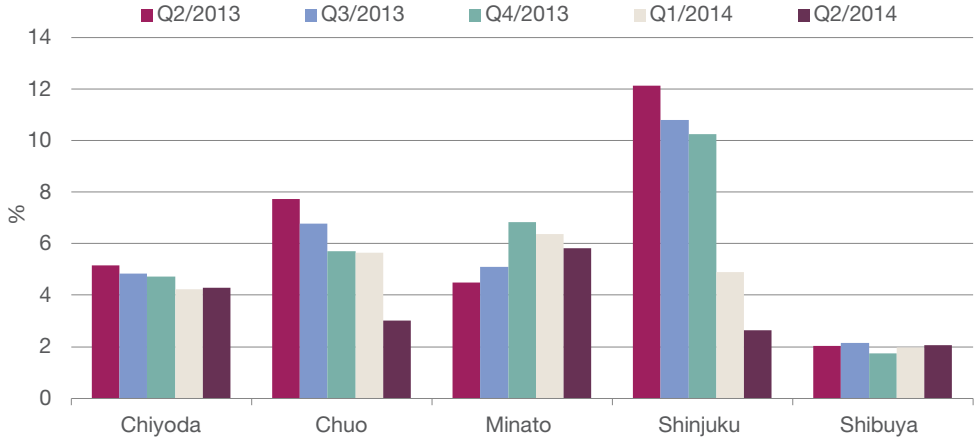
Average Grade A office rents by ward, Q2/2013–Q2/2014



Source: Savills Research & Consultancy

GRAPH 4

Average Grade A office vacancy rates by ward, Q2/2013–Q2/2014



Source: Savills Research & Consultancy

TABLE 1

Notable office leasing transactions, Q2/2014

Company	Business sector	Type	Former building(s)/ location	New building(s)/ location	Approximate space taken	
					tsubo	sq m
Yahoo Japan	Internet services	Headquarters relocation/ consolidation/ expansion	Midtown Tower, Ark Hills South Tower/ Minato Ward	Kioicho Project / Chiyoda Ward	20,000	66,116
Hitachi Capital	Financial services	Headquarters relocation/ consolidation	Hitachi Atago Annex/Minato Ward	Nishi-Shinbashi Square/Minato Ward	3,200	10,579
Konica Minolta Business Solutions	Business services	Headquarters relocation/ consolidation	Sumitomo Fudosan Nihonbashi Building/Chuo Ward	Hamamatsucho Building/Minato Ward	3,000	9,917
Dentsu Digital Holdings	Business services	Headquarters relocation/ consolidation/ expansion	Multiple locations in Chiyoda and Chuo wards	Ginza Shochiku Square/Chuo Ward	2,840	9,388
Nippon Suisan	Fishery industry	Headquarters relocation (existing building subject to redevelopment plan)	Nippon Building/ Chiyoda Ward	Nishi-Shinbashi Square/Minato Ward	1,600	5,289

Source: Savills Research & Consultancy

OUTLOOK

The prospects for the market

Strong demand for high-grade space has resulted in a reduced volume of whole floors available for lease. Given the relatively limited supply pipeline this year and next, this movement is expected to not only sustain rental growth as tenants compete for vacant units, but also support pre-leasing activities for planned developments.

Over the near term, Grade A assets will become increasingly expensive compared with both their cyclical low and the wider office market average. This will likely boost demand for quality Grade B properties from small- to mid-sized tenants, who may be deterred from Grade A properties due to the higher total costs required for occupancy.

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