Briefing
Office sector

Q3 2017

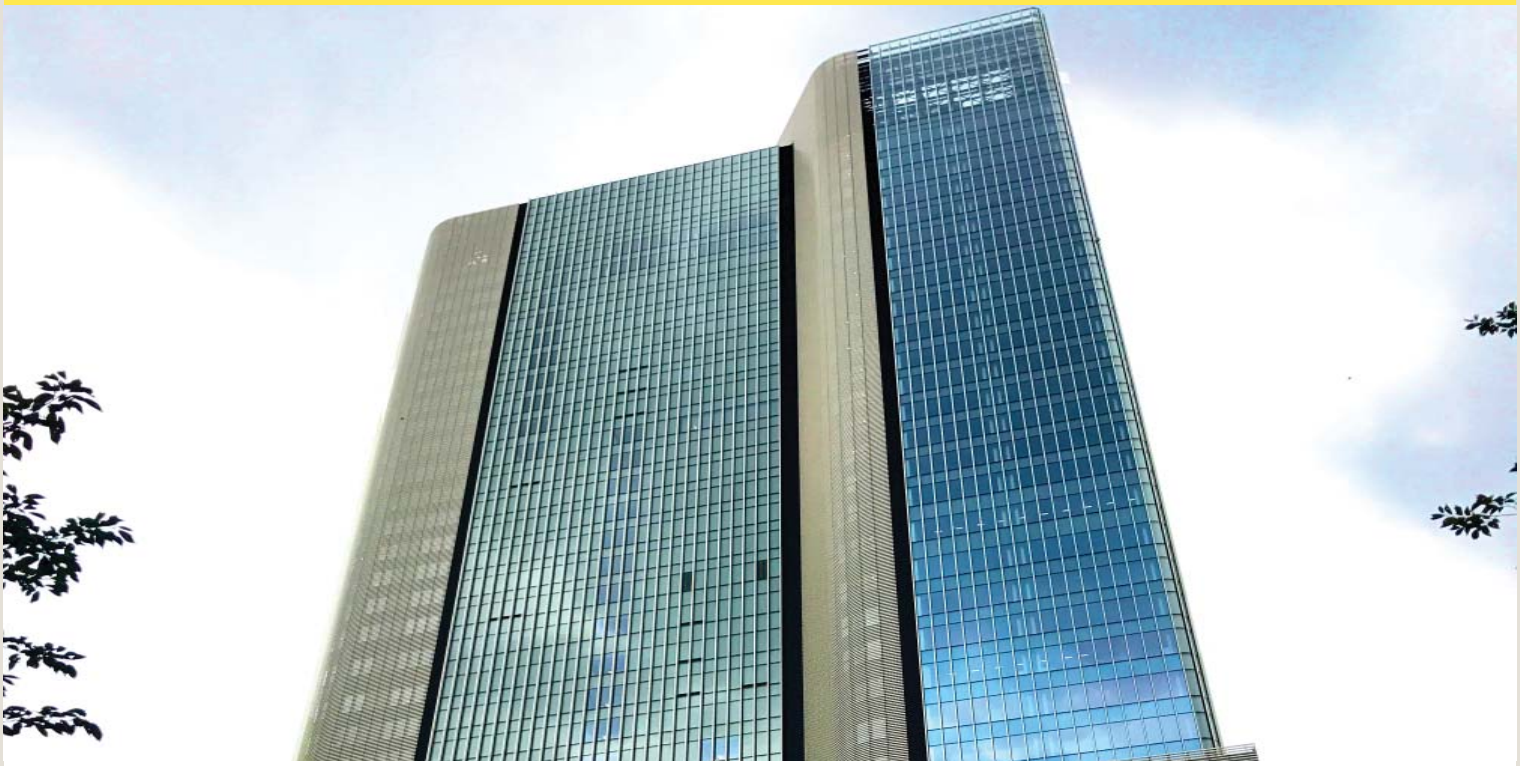


Image: Akasaka Intercity AIR, Minato

SUMMARY

Take-up has been much stronger than anticipated. Average rents in the C5W continued to gain through Q3/2017 as office demand sustains tight market conditions.

- Leasing deals for new office buildings have been robust. Pre-leasing activity for upcoming supply also continues to be strong.

- Average passing rents for Grade A office space in the central five wards (C5W) strengthened to JPY32,612 per tsubo[1] per month, representing a 0.7% rise quarter-on-quarter (QoQ) and a 3.1% increase year-on-year (YoY).

- The average Grade A office vacancy rate in the C5W held steady at 1.7%, representing a tightening of 0.8 percentage points (ppts) QoQ.

- Average passing rents for large-scale Grade B office space rose to JPY24,700 per tsubo, climbing by 0.8% QoQ and 2.7% YoY.

- The average vacancy rate for large-scale Grade B office properties tightened by 0.5ppts QoQ.

1 1 tsubo = 3.306 sq m or 35.583 sq ft

"Rental growth extended its climb in Q3/2017 as vacancy rates returned to below 2%. Pre-leasing for upcoming supply remains much stronger than expected, though more space will come in 2018 than in 2017. Gradual rental growth is likely to continue towards late 2018 or afterwards." Savills Research

Grade A offices

Grade A office fundamentals remain resilient amid Tokyo's influx of new supply. Newly-completed office spaces are seeing gradual absorption, and pre-leasing activity is also holding strong. Although availabilities temporarily increased after openings of new large offices, occupancy in the city remains very tight. Tokyo's vacancy has tightened below 2% once again after briefly rising in Q1/2017.

Grade A office rents strengthened another 0.7% QoQ to JPY32,612 per tsubo per month. On a YoY basis, rents increased 3.1%, the largest figure since Q2/2016. In light of the tight vacancy, landlords appear to be feeling confident in raising rents. Furthermore, new, high-spec offices are pulling up averages. Some newly-completed offices are able to charge near top rents.

Large-scale Grade B offices

The average vacancy rate for large-scale Grade B office[2] properties further tightened to 1.0%, the lowest level since we started our survey in 2008. Grade B offices have a large demand base due to their affordability. Limited supply in this grade also helps keep vacancy tight. In Q3/2017, four out of the five central wards saw vacancy rates less than 1% for Grade B offices, leaving virtually no room for relocation or expansion.

Grade B rental growth is generally continuing at a similar pace to that of Grade A. The average monthly rent for large-scale Grade B properties was JPY24,700 per tsubo in Q3. This represents a QoQ gain of 0.8% and a YoY gain of 2.7%.

Grade A rents and vacancy rates by ward

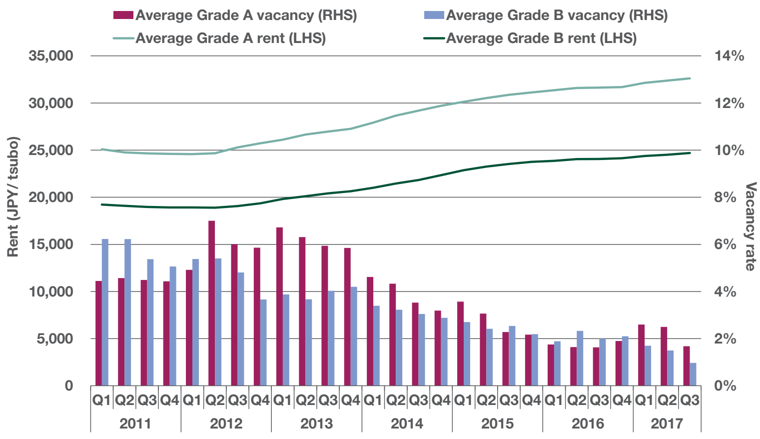
Chiyoda

The average Grade A vacancy rate in Chiyoda was 2.1% in Q3, representing a tightening of 0.5ppts QoQ but a softening 0.2ppts YoY. The QoQ tightening indicates that the Otemachi Park Building and Hibiya Park Front, which loosened the market in preceding quarters, are gradually filling remaining floors. The average Grade A passing rent in Chiyoda stood

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

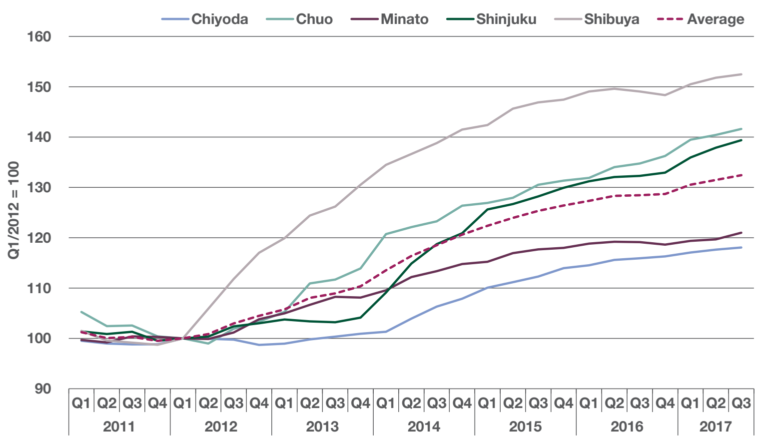
Office rents and vacancy in Tokyo's C5W*, 2011–Q3/2017



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

GRAPH 2

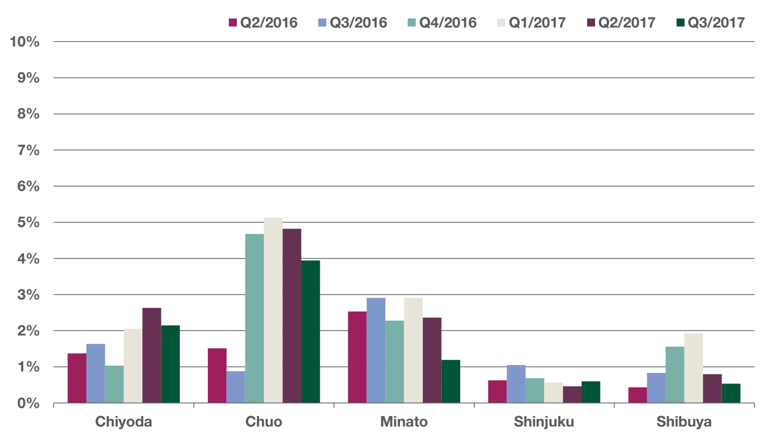
Grade A office rental index by ward, 2011–Q3/2017



Source: Savills Research & Consultancy

GRAPH 3

Grade A office vacancy by ward, Q2/2016–Q3/2017



Source: Savills Research & Consultancy

at JPY39,691 per tsubo, increasing by 0.3% QoQ and 1.8% YoY.

Relocation activity for newly-completed offices was active in Q3. The Nikkei reports that Japan Real Estate Asset Management plans to move to the Otemachi Park Building in December 2017. Additionally, Kansai Electric Power Company and Kenedix plan to move to Hibiya Park Front, though moving dates were not disclosed. EY Japan has also announced that it will lease an estimated 8,000 tsubo in Tokyo Midtown Hibiya, which is scheduled for completion in March 2018.

Chuo
Chuo's average Grade A vacancy rate tightened 0.9ppts QoQ to sit at 3.9% in Q3. Availabilities in Kyobashi Edogrand and Ginza Six are gradually filling, and the two buildings are about 80% occupied. Rents in Chuo strengthened 0.9% QoQ and 5.1% YoY due to a combination of the opening of new buildings and rental increases in the ward's established stock. The average Grade A passing rent in Chuo currently stands at JPY30,685 per tsubo.

Takihyo relocated its Tokyo branch to Ginza Six in August and occupies about 400 tsubo on the tenth floor. Altair Engineering, which currently leases 200 tsubo in Sunshine 60 in Toshima, will relocate its headquarters to Kyobashi Edogrand in December.

TABLE 1

Major tenant relocations, Q3/2017

Origin							Destination	
Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other			
8	5	11	3	0	10			
6	2				2	→	10	Chiyoda
	2	2			1	→	5	Chuo
1	1	8	2		3	→	15	Minato
		1			1	→	2	Shibuya
					1	→	1	Shinjuku
1			1		2	→	4	Other

Source: Nikkei RE, Savills Research & Consultancy

The Nikkei reported that the company's relocation is for improvement of security and work efficiency.

Minato
Average Grade A vacancy in Minato tightened 1.2ppts QoQ to sit at 1.2%. Grade A rents strengthened 1.1% QoQ and 1.6% YoY to JPY30,660 per tsubo. Akasaka Intercity AIR, which was completed in August, helped improve the market's average rent.

In Q3, the Nikkei reported on five different companies planning to relocate to Akasaka Intercity Air, including NTT Docomo, Sky Perfect JSAT, Accenture, Royal Bank of Canada, and Okamura. NTT Docomo's relocation has been rumoured since early 2017, but details were unknown. This time, the Nikkei reported that NTT Docomo may lease over 10,000 tsubo, mainly relocating its operation currently located in the Kokusai Akasaka Building. Sky Perfect JSAT and Accenture are expected to lease about 2,000 tsubo. Additionally, Mitsubishi Motors will relocate its headquarters to msb Tamachi Station Tower, which is slated for completion in May 2018. The company will lease about 6,500 tsubo in the building.

Shibuya
After three consecutive quarters, Shibuya is again the tightest Grade A office market in Tokyo. In Q3,

TABLE 2

Notable office leasing transactions, Q3/2017

Company	Business sector	Type	Former/current location		New location	Approximate space	
						tsubo	sq m
NTT Docomo	Telecommunication	Consolidation	Various Various	→	Akasaka Intercity Air Minato	10,000	33,000
EY Japan	Consulting	Consolidation	Various Various	→	Tokyo Midtown Hibiya Chiyoda	8,000	26,400
Mitsubishi Motors	Manufacturing	Relocation	Dai-Ichi Tamachi Building Minato	→	msb Tamachi Station Tower Minato	6,500	21,500
Haseko Reform & Haseko Smile Community	Real Estate	Relocation	Various Minato	→	Shiba Ni-chome Building Minato	2,800	9,300
Sky Perfect JSAT	Satellite TV	Relocation	Dai-35 Kowa Building Minato	→	Akasaka Intercity Air Minato	2,400	7,900

Source: Nikkei RE, Savills Research & Consultancy

Shibuya's vacancy rate tightened 0.3ppts both QoQ and YoY to 0.5%. Grade A rents increased 0.4% QoQ and 2.3% YoY to JPY32,571 per tsubo. Technology companies in this area appear to underpin the strong demand.

Although Shibuya's extremely tight conditions limit tenant activity, the new Jingumae Tower Building has given some breathing room. Beams is relocating to the tower and will lease about 1,500 tsubo. Additionally, Investors Cloud will move to the building from Minato.

Shinjuku

Shinjuku's Grade A vacancy rate softened by 0.1ppts QoQ but tightened by 0.5ppts YoY to 0.6%. Grade A rents in Shinjuku climbed by 1.1% QoQ and 5.4% YoY to reach JPY29,455 per tsubo, encouraged by extremely tight vacancy.

The Nikkei has only reported one leasing deal in Shinjuku in Q3. Kanro, a confectionery company, will move its headquarters to Tokyo Opera City in February 2018. The company's move is for business expansion and streamlining of operations.

Absorption remains strong

Despite investors' concern over the supply glut, market fundamentals held strong through Q3. New offices opened in 2017 are either fully leased or are gradually filling availabilities. Akasaka Intercity Air, the largest project completed in 2017, opened fully leased in August, highlighting sound office demand in the Tokyo market.

Additionally, demolition of old offices appears to be partially picking up the slack caused by new supply. For instance, according to the Japan Real Estate Institute, about 210,000 tsubo of space was removed from the existing stock in Tokyo's 23 wards during 2016. This represents 60% of supply volume added in the same year, creating a buffer for the upcoming supply shock, though we need to consider the time lag of development and demolition.

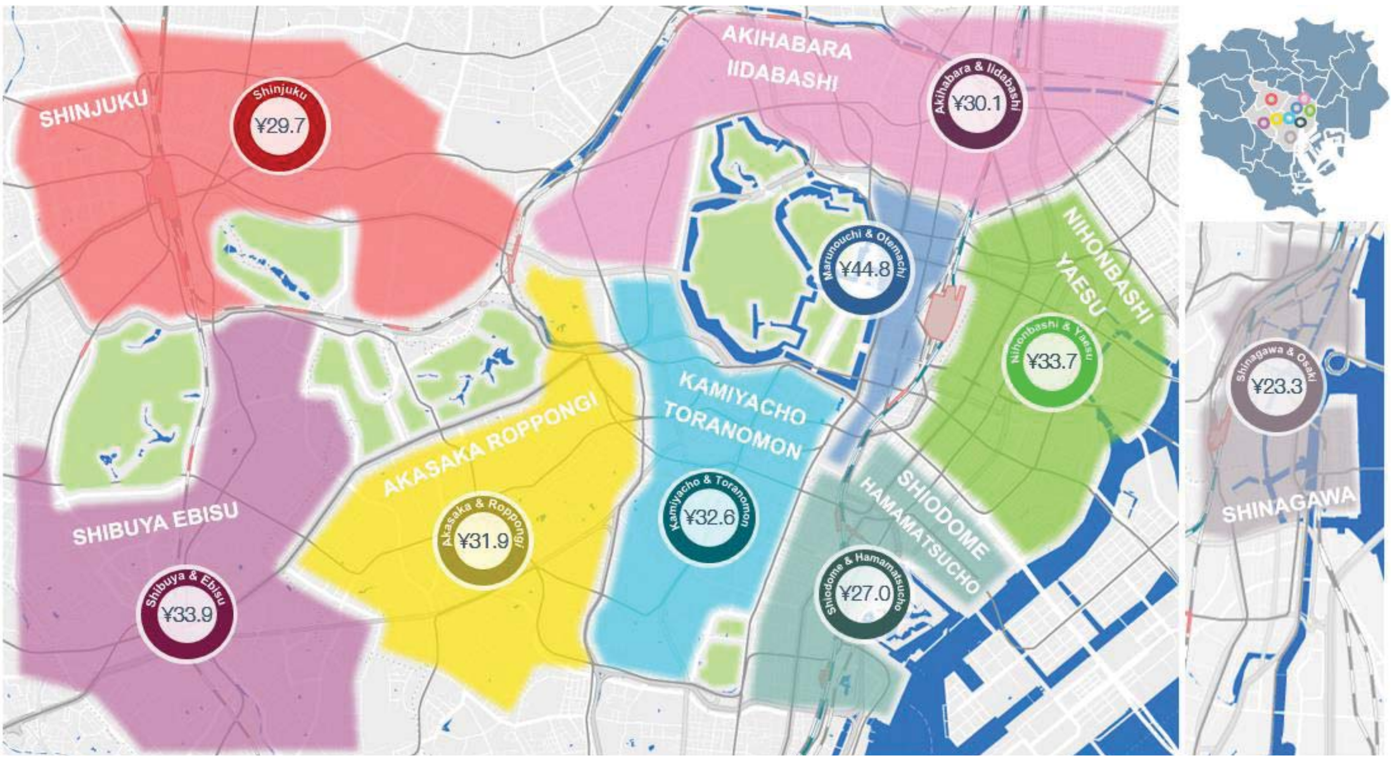
Although 2018 supply is expected to overshadow that of 2017, pre-leasing activity remains strong. Relocation and expansion demand from tenants remain sound, and pre-leasing activity appears to be going smoothly for most of new offices slated for completion in late 2017 and 2018.

Major projects scheduled for completion in 2018, such as Tokyo Midtown Hibiya, redevelopment projects in Nihonbashi Ni-chome and Otemachi Ni-chome Tower B, and the Marunouchi 3-2 Project, appear to have already filled the majority of floors. In Shibuya, Shibuya Stream is likely to open fully leased in summer 2018.

In the Shinagawa & Osaki area, the Sumitomo Fudosan Osaki Project and msb Tamachi Station Tower S will expand the market by about 60,000 tsubo. Due to the size of the supply and their distance from the city centre, pre-leasing for these buildings is slightly slower. However, considering the area's rapidly tightening vacancy and growing rents, underlying office demand is strong, and thus, the supply is likely to be absorbed smoothly.

MAP 1

Average rents per tsubo in selected submarkets, Q3/2017



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

OUTLOOK

The prospects for the market

Tokyo Grade A and Grade B offices have shown improvement for another quarter. Vacancy rates remain tight as newly-opened offices are filling up. Rental growth is also driven by the combination of the opening of new buildings and rental increases in existing stock.

Although large supply in 2018-2020 will likely soften the market, pre-leasing is thus far maintaining strong momentum. Over the coming years, older and smaller offices may see some tertiary vacancy due to heightened competition. However, sound market fundamentals support the outlook that gradual rental growth could continue towards late 2018 or even longer.

The current trend is contrary to the bleak outlook expressed by many market participants at the beginning of 2017, when factors such as the new US president, political turmoil in Europe, and China's economic slowdown concerned investors. As the uncertainty dissipates, capital market conditions have become more positive and improved the real estate market. This might imply, however, that a future reversal in the direction of capital markets could also abruptly soften real estate conditions.

Supply impact will vary by neighbourhood. The Toranomon area, for example, will see a surge of new space starting from 2019. The area might struggle to find tenants that can afford high rents expected for new, high-spec buildings. If pre-leasing activity does not go smoothly, the Toranomon submarket might see temporary softness.

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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