MARKET IN MINUTES
Savills Research

Office Leasing

Office fundamentals firm, despite headwinds

Vacancy in the C5W tightened further and rents continued to push higher, though the pace of growth was more modest in Q3.

- Demand for Grade A stock in the Tokyo central five wards (C5W) remains strong. Average vacancy continues to push towards zero, having declined for nine consecutive quarters, and average rents are still trending upwards, albeit more slowly.
- Average passing rents for Grade A office space in the C5W grew to JPY36,386 per tsubo[1] per month, representing a gain of 0.8% quarter-on-quarter (QoQ) and 6.7% year-on-year (YoY).
- The average Grade A office vacancy rate in the C5W hit 0.2% in Q3/2019, dipping by 0.1 percentage points (ppts) QoQ and by 0.4ppts YoY.
- Average passing rents for large-scale Grade B office space rose to JPY27,904 per tsubo per month, growing by 1.0% QoQ and 7.0% YoY.
- The average large-scale Grade B office vacancy rate stands at 0.3%, falling 0.1ppts QoQ and 0.2ppts YoY.
- WeWork's ill-fated IPO has brought about increased caution towards co-working, though the subsector's prospects in Japan appear more stable than in other markets.
- Demand is sound and pre-leasing has swept up the majority of supply through 2020; however, macro concerns may be having an adverse effect on the market.

"Office vacancy remains extremely low and average C5W rents continue to increase, even as macro headwinds are rising. The overall outlook for rent and vacancy is still positive. However, pricier buildings in less popular areas are having some difficulty filling out space, which could indicate that macro prospects may have started to weigh on the market."

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

Matthew D'Elia
Manager, Research & Consultancy, Japan
+81 3 6777 5179
mdelia@savills.co.jp

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

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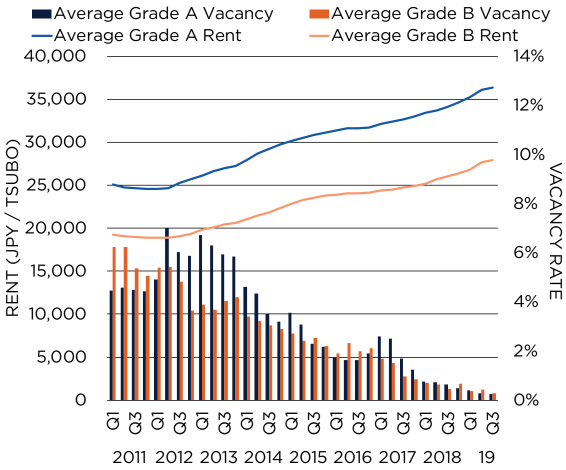
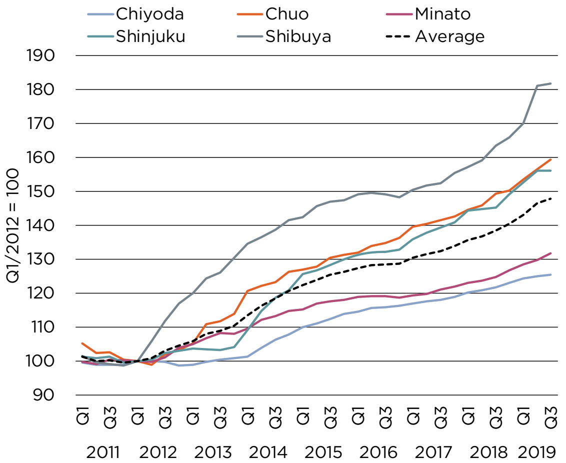
GRAPH 1: Office Rents And Vacancy In The C5W*, 2011 to Q3/2019



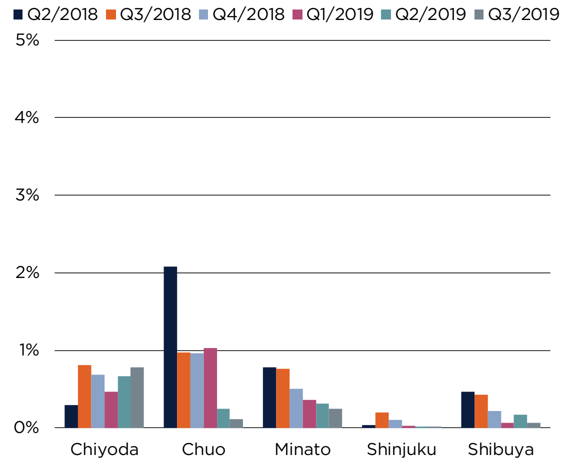
Source Savills Research & Consultancy
*Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index By Ward, 2011 to Q3/2019



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy By Ward, Q2/2018 to Q3/2019



Source Savills Research & Consultancy

GRADE A OFFICES

Grade A office rents rose 0.8% QoQ and 6.7% YoY in Q3/2019 to JPY36,386 per tsubo[2]. Vacancy fell 0.1ppts QoQ and 0.4ppts YoY to finish the quarter at 0.2%. Although the effects of the U.S.-China trade war, among other headwinds, has weighed on profitability and confidence among Japanese corporations, the Grade A market continues to perform well overall. Software companies in particular appear undeterred by higher rents and continue to sweep up space in premium locations, a trend that has been especially conducive to Shibuya's recent growth. Some firms in other industries, such as those that are more impacted by shifts in overseas demand, appear to be searching for discounts, even relocating beyond the C5W if necessary. That said, firms across industries continue to seek Grade A office space in convenient locations as a means to improve working conditions and collaboration among employees, though the lack of availability in existing buildings has largely restricted major tenants to pre-leasing new developments.

LARGE-SCALE GRADE B OFFICES

Large-scale Grade B office[3] rents rose by 1.0% QoQ and 7.0% YoY in Q3/2019, landing at JPY27,904 per tsubo. Vacancy stands at 0.3%, a drop of 0.1ppts QoQ and 0.2ppts YoY. Extremely limited availability in the Grade A market continues to be a boon to the Grade B market, with average rental growth in the latter market still outpacing that of the former. Indeed, last quarter's slight uptick in vacancy appears to have been just a blip in the overall bullish trend, as suspected. Even so, such mild fluctuations deserve scrutiny, as lower-grade buildings tend to have a larger share of tenants with fewer resources to weather a downturn.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

Chiyoda's Grade A vacancy rate rose by 0.1ppts QoQ and remained flat YoY, landing at 0.8%, while Grade A rents climbed by 0.4% QoQ and 3.0% YoY to JPY42,181 per tsubo. It has been rumoured that Hitachi will occupy the entirety of the office space available in the newly-completed Sumitomo Fudosan Akihabara First Building, which has an office NRA of 5,200 tsubo. MUFG Bank will reportedly relocate 2,000 employees to Sumitomo Fudosan Kojimachi Garden Tower, which is currently under construction, in March 2021, leasing up to 4,200 tsubo. MUFG intends to vacate the estimated 7,000 tsubo it is leasing in JP Tower, citing the move as an attempt to reduce rental costs while improving the working environment of its employees.

Chuo

Chuo's Grade A vacancy rate of 0.1% was 0.1ppts tighter than last period and 0.9ppts tighter YoY. Grade A rents grew 1.8% QoQ and 6.7% YoY, to JPY34,516 per tsubo, posting the strongest growth among the C5W this quarter. Game developer Konami Holdings will move to Konami Creative Center Ginza, which will be completed in November 2019 and owned by the company, occupying around 6,800 tsubo. The move follows its planned relocation from Tokyo Midtown East in Minato Ward, where it currently leases 10,900 tsubo. It has been rumoured that Konami will lease several thousand tsubo of additional space in a large office building in Chuo, though further details have yet to be revealed. It has also been reported that WeWork will establish a new collaboration office in Glass City Harumi, leasing four floors with an estimated area of 1,150 tsubo.

Minato

Minato's Grade A vacancy rate tightened slightly by 0.1ppts QoQ and 0.5ppts YoY to 0.2% at the end of the quarter. Grade A rents climbed by 1.6% QoQ and 5.7% YoY to JPY33,398 per tsubo. Japan Tobacco (JT) will relocate its headquarters into Kamiyacho Trust Tower, which will be completed in March 2020, leasing 5,800 tsubo on the 26th to 30th floors from January 2021. JT reportedly selected the location because it offers over 1,100 tsubo of leasable area per floor, which will improve communication and networking among employees. It has also been reported that WeWork will establish a collaboration office in the same building, leasing 4,600 tsubo across four floors. The opening date has not been specified but, as of late September 2019, WeWork was listing hot desks at this location for JPY75,000 per month.

Shibuya

Shibuya's Grade A vacancy rate fell by 0.1 ppts QoQ and 0.4ppts YoY to land at 0.1%. Grade A rents climbed by 0.3% QoQ to JPY38,833 per tsubo, growing by 11.2% YoY. Shibuya remains the second tightest market among the C5W, despite seeing the highest levels of supply relative to current stock in 2019. Rockin'on Holdings, a publisher, and X-Com Global, a telecom firm, will each lease one floor, or approximately 870 tsubo, in Shibuya Scramble Square. Scheduled to open on 1 November, the 47F mixed-use building has been fully pre-leased by tenants including CyberAgent, Mixi, and WeWork.

Shinjuku

Shinjuku's Grade A rents remained flat QoQ, sitting at JPY33,000 per tsubo, which is still

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.

TABLE 1: Tenant Relocations, Q3/2019

ORIGIN	Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other	DESTINATION	
	9	3	6	3	1	24		
	6					7	13	Chiyoda
	1	3	2		1	2	9	Chuo
	2		1	1		7	11	Minato
			1	2		1	4	Shibuya
						1	1	Shinjuku
			2			6	8	Other

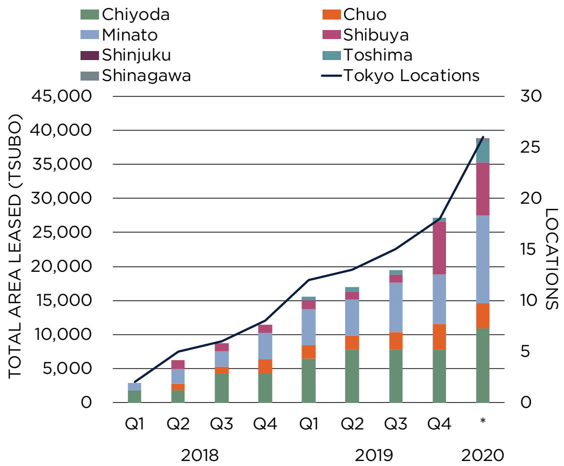
Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Q3/2019

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION	NEW LOCATION	APPROXIMATE SPACE TSUBO	APPROXIMATE SPACE SQ M
Konami Holdings	Entertainment/ Video Games	HQ Relocation	Midtown East Minato-ku	Konami Creative Center Ginza Chuo-ku	6,810	22,500
Japan Tobacco	Tobacco	HQ Relocation	JT Building Minato-ku	Kamiyacho Trust Tower Minato-ku	5,800	19,100
Hitachi	Conglomerate	Branch Office Relocation	Rise Arena Building Toshima-ku	Sumitomo Fudosan Akihabara First Building Chiyoda-ku	5,174	17,100
WeWork	Real Estate	Expansion	Various Various	Kamiyacho Trust Tower Minato-ku	4,640	15,300
MUFG Bank	Financial	Consolidation	JP Tower Chiyoda-ku	Sumitomo Fudosan Kojimachi Garden Tower Chiyoda-ku	4,200	13,800

Source Nikkei RE, Savills Research & Consultancy

GRAPH 4: Estimate Of Total Floorspace Leased By WeWork In Tokyo, 2018 to 2020



Source WeWork company website, Nikkei RE, Savills Research & Consultancy

* As of the end of September 2019, details for 8 WeWork locations set to open in 2020 have been revealed. Exact opening dates have not been disclosed for some locations in buildings that are due for completion in early 2020, such as Kamiyacho Trust Tower. For such instances, it has been assumed that WeWork's lease agreements will commence during the year.

7.6% higher YoY. The Grade A vacancy rate held at an extremely tight level, ending the quarter comfortably below 0.1%. It has been reported that a company in the Rakuten Group will move into Shinjuku Eastside Square, leasing around 3,600 tsubo over two floors. The Shinjuku market remains exceptionally tight, as no other leasing transactions were announced for the quarter.

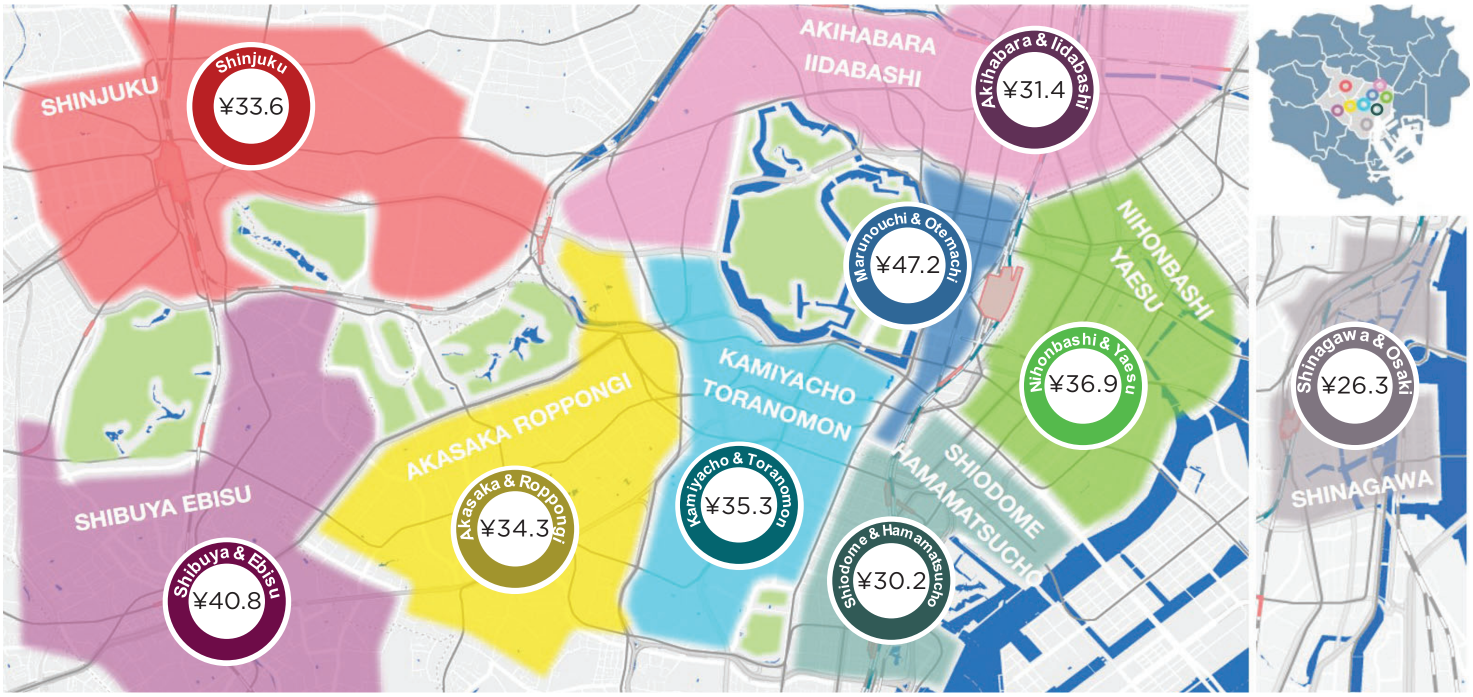
WEWORK WORRIES

Tokyo has been no exception to the recent global co-working phenomenon, and the rapid expansion of this sector has undoubtedly contributed to the market's robust performance. Not surprisingly, the unfolding drama precipitated by the IPO filing of the We Company (WeWork), co-working's most prominent player, has drawn renewed attention to the sector and its prospects. Specifically, the company's dubious financial position, namely its ballooning losses – especially in Asia Pacific – and the lack of a clear path to profitability, has led to justifiable concern regarding the long-term viability of not only WeWork's business model, but also that of the entire co-working sector.

In this context, it is worth observing the firm's position in Japan, which has expanded rapidly over the past two years. After opening its first location at Roppongi's Ark Hills South Tower in February 2018, WeWork is set to host a total of 26 locations[4] in Tokyo by the end of 2020 (Graph 4), in addition to several locations in top regional office markets. From the outset, many landlords have taken a more cautious approach to WeWork, with large developers generally being the lessor, and with each landlord having limited exposure to the

4 Based on disclosures as of September 30, 2019. The Financial Times has reported that WeWork signed a leasing agreement on September 26 for a property in Tokyo, the first since the firm reportedly implemented a moratorium on new leases; however, no further details regarding this agreement have been revealed as of the date of this report.

MAP 1: Average Rents Per Tsubo In Selected Submarkets, Q3/2019



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

co-working operator as a tenant. The key distinction of WeWork's position in Japan, however, is the local presence of its largest outside shareholder: SoftBank.

Entities of the SoftBank Group have invested over US$10 billion into the We Company, and all of its co-working sites in Japan are managed directly under WeWork Japan, a 50/50 joint venture among WeWork and the SoftBank Group. While WeWork's financial position is questionable, the SoftBank Group is seeing improved performance. Importantly, T-Mobile's US$26 billion purchase of a majority stake in Sprint would, if all regulatory processes are cleared, allow the SoftBank Group to remove US$40 billion in debt from its consolidated balance sheet, reducing the group's total debt by around 30% and freeing up capital to support other ventures. This spare capacity could be crucial if the We Company were to falter and SoftBank would like to assume more ownership of WeWork Japan.

Encouragingly, other domestic players appear confident in co-working's local prospects, generally adopting a more stable business model than WeWork. TKP Corporation, a rental conference room operator which is listed on the Tokyo Stock Exchange, acquired Regus Japan Holdings K.K. from IWG plc in April 2019 as part of a franchise deal, and now manages 150 locations under the Regus, OpenOffice, and Spaces brands as of July 2019. In its latest disclosure, TKP forecasted that its net income will increase by more than 50% over the previous fiscal year. The firm also successfully closed a secondary offering of equity in October to pay off debt associated with the Regus acquisition, which has led to a large increase in the firm's share prices amidst the expectation for further growth. Though yet to be tested during a recession, co-working appears to be catching on in Japan and is likely to grow, regardless of WeWork's prospects.

OUTLOOK

Overall, the office market remains strong, but there are signs of weakness in some areas. Japan's economy is by no means immune to the effects of the U.S.-China trade war, and the resulting drop in overseas demand has weighed on the profitability of Japanese firms in 2019. More positively, bolstered by domestic demand, GDP growth for the first two quarters exceeded expectations and the economy appears particularly resilient in comparison to regional peers. Indeed, Japan's political and economic stability stands out within the current global turmoil.

That said, some subsets of the Tokyo office market are showing mixed performance, which may be an early harbinger of a downward shift. Though many tenants, particularly software companies, are still willing to bear higher rents for newer, well-located buildings, certain tenants appear to be searching for discounts, in some cases even willing to relocate outside of the C5W. This has particularly impacted certain older buildings in less convenient locations, which are still relatively pricey. Some buildings in which existing tenant expansions have filled secondary vacancy are now listing space for the first time in a decade. Indeed, caution regarding macro prospects has caused some firms, particularly in the export-reliant manufacturing sector, to revise their annual forecasts downward, which has in turn weighed on investment.

Business sentiment aside, unemployment remains exceptionally low at 2.2% and companies are still actively hiring workforce and leasing the office space needed to accommodate them. As a result, around 80% of supply coming online over the next year has already been pre-leased. The consumption tax hike implemented on 1 October remains an immediate risk; however, any impact should be more subdued compared to the previous hike, as there was only a limited spike in sales just prior to its implementation. Tight vacancy and strong pre-leasing in the face of large supply are encouraging signs for the real estate market, indicating that rents are likely to increase marginally for the time being. Encouraging data aside, investors should still exhibit a degree of caution moving forward.

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.