savills

Briefing
Office sector

Q3 2014

Image: Shinjuku

SUMMARY

Sharply reduced levels of unoccupied stock saw Grade A rents rise 8.2% year-on-year (YoY), the fastest rate of growth since the global financial crisis.

- The average Grade A office vacancy rate in Tokyo's central five wards improved 80 bps quarter-on-quarter (QoQ) to 3.5% – its lowest level since Q1/2009.
- Average Grade A office passing rents increased 1.8% QoQ to JPY29,190 per tsubo, up 8.2% YoY.
- Driving leasing fundamentals in the third quarter was take up of remaining primary vacancies in 2012-vintage stock and strong absorption of secondary supply.
- Chiyoda Ward posted its strongest Grade A rental growth rate for this market cycle, up 4.4% YoY on the back of reduced vacancy levels.
- The average vacancy rate for large-scale Grade B office properties continued to improve, edging down 20 bps to a new cyclical low of 3.0%.
- Large-scale Grade B office rents averaged JPY21,820 per tsubo, up 1.6% QoQ, or 6.9% YoY.
- Vacancy rates are expected to remain at cyclical lows for some time, heightening competition for available space among tenants and fuelling rent appreciation.

"Tokyo's prime office leasing market is at a juncture where a robust rental recovery can be sustained through the near term." Will Johnson, Savills Research

Market summary

Grade A office segment

The Grade A office[1] vacancy rate in Tokyo's central five wards[2] fell for the sixth consecutive quarter to 3.5%, marking the lowest level of prime availability since Q1/2009. This figure represents a strong improvement of 80 bps QoQ, or 240 bps on a YoY comparison.

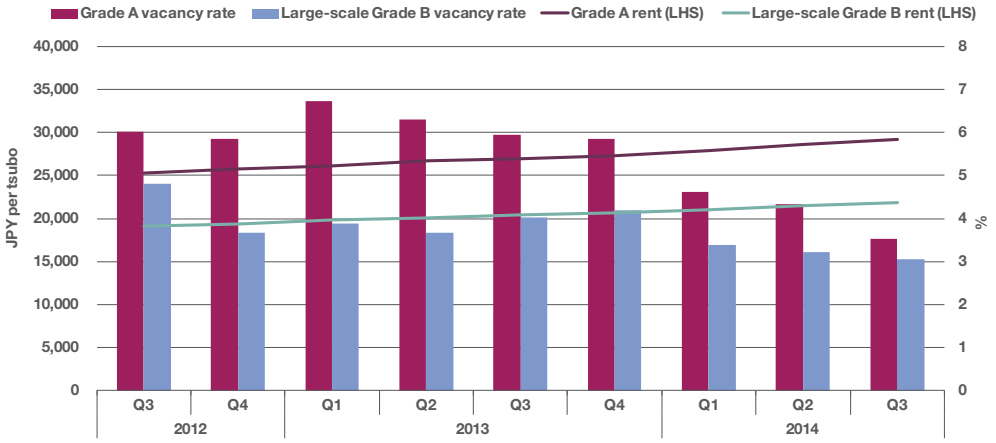
Sharply reduced levels of unoccupied stock supported the rental growth trend, with achievable rents for Grade A office space rising 1.8% over the quarter to JPY29,190 per tsubo[3] per month. This figure represents a healthy rental increase of 8.2% on a YoY basis, the fastest rate of growth since the global financial crisis.

Driving the reduction in market vacancy has been take up at previously unleased floors in 2012-vintage stock (the most recent peak supply year), as well as strong absorption of secondary supply, i.e. office space released back to the market by a previous tenant. These factors have been supported by tenants seeking to occupy superior-grade properties and improve office space efficiencies. Japan's improved economic outlook has also prompted some companies to take additional floor area for future headcount expansion. While this trend has been seen across a broad sector base, notable examples have included companies involved in the ICT and business services industries.

1 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.
2 The central five wards that make up the Tokyo CBD are Chiyoda, Chuo, Minato, Shibuya and Shinjuku.
3 1 tsubo = 3.306 sq m or 35.583 sq ft.

GRAPH 1

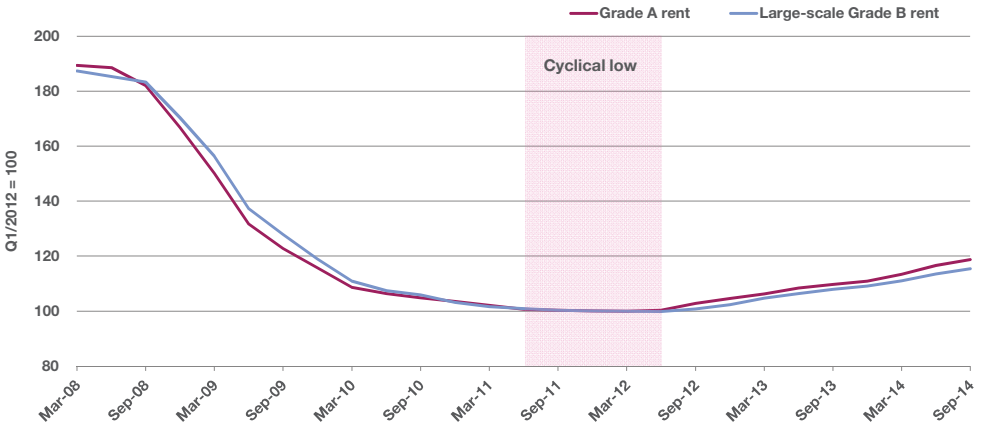
Office rents and vacancy rates in Tokyo's central five wards by grade, Q3/2012–Q3/2014



Source: Savills Research & Consultancy

GRAPH 2

Rental index: Office passing rents in Tokyo's central five wards by grade, Q2/2008–Q3/2014



Source: Savills Research & Consultancy

Large-scale Grade B office segment

The average vacancy rate for large-scale Grade B office[4] properties continued to improve, edging down 20 bps QoQ to a cyclical low of 3.0%. This figure is down 100 bps on a YoY basis and represents the lowest level of market vacancy since Q3/2008.

Availability in this segment has been on a relatively stable downward trend since early 2011, reflecting a flight to quality among tenants at the expense of older, small- to mid-scale rental buildings and outmoded owner-occupier stock. This bifurcation within the Grade B market has resulted in uncompetitive properties being removed from the market, for both refurbishment and redevelopment.

In response to robust demand and falling market vacancy rates in recent quarters, landlords are seizing the opportunity to boost rents where possible. Savills basket of large-scale Grade B office properties recorded a 1.6% QoQ increase in passing rents for new leases in Q3/2014, with the sector's average rent up 6.9% YoY to JPY21,820 per tsubo.

The rental premium for Grade A office space relative to the large-scale Grade B sector continued to widen gradually in the third quarter, reaching approximately 33.7%. This compares with 32% in the third quarter of last year and 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, 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 consequence, benchmark figures, particularly vacancy rates, tend to be lower than other market indices.

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.

Grade A rents and vacancy rates by ward

Chiyoda

Chiyoda's average Grade A vacancy rate recorded a sharp improvement, moving down 100 bps over the quarter to stand at a cyclical low of 3.3%. This is the lowest vacancy rate for the ward since Q4/2011. Occupancy levels increased in a number of buildings, including JP Tower in Marunouchi, a landmark property that was completed in May 2012 adjacent to Tokyo Station.

Grade A office passing rents in Chiyoda Ward averaged approximately JPY35,750 per tsubo in Q3/2014, posting growth of 2.3% QoQ, or 4.4% on a YoY basis. This marks the submarket's fastest rate of rental growth since before the global financial crisis.

Reflecting its status as Tokyo's most expensive office location, Chiyoda commanded a rental premium of around 23% relative to the five-ward average.

Chuo

Following a sharp improvement in the second quarter, Chuo Ward's average Grade A vacancy rate rose 110 bps QoQ to 4.1%, with space released back to the market by tenants at several buildings. Nonetheless, the vacancy rate remained 270 bps lower than the same quarter of last year, a result of a string of large lease agreements at recently completed and more established prime buildings.

The average Grade A passing rent in Chuo Ward stood at JPY26,710 per tsubo, up 0.9% QoQ and a strong 9.4% YoY. Upward pressure on rents reflects landlords taking a firmer stance on lease terms in light of steady tenant demand for quality space with good transport access.

Minato

Minato posted the strongest improvement of the five wards in terms of its Grade A vacancy rate, which fell 210 bps QoQ to 3.8%. This is the ward's lowest level of prime availability since Q1/2012.

Driving this quarterly change was the leasing of space formerly occupied by Sony at the Shinagawa Intercity C Building near JR Shinagawa Station. Here, in addition to a lease to mapping services company Zenrin DataCom, large tenancy agreements were concluded with Fujitsu Marketing (for approximately 4,242 tsubo; 14,023 sq m) and optical instruments manufacturer Nikon (for around 7,172 tsubo; 21,709 sq m). Both organisations are consolidating their headquarters operations from multiple sites across the capital.

The average Grade A office rent in Minato rose 1.0% QoQ to approximately JPY28,720 per tsubo, up 6.0% on a YoY basis.

Shibuya

The inclusion of renovated space previously occupied by Morgan Stanley at Ebisu Garden Place in the survey basket put a temporary halt to Shibuya Ward's generally flat vacancy trend since Q2/2013. The ward's average Grade A vacancy rate jumped 200 bps over the quarter to 4.0%, its highest level since Q1/2013.

Nonetheless, the limited level of prime space that is available across the market as a whole continued to spur landlords to push for higher rents in new lease agreements. Average Grade A passing rents in Shibuya rose 1.6% QoQ, or 10.6% YoY, to JPY29,650 per tsubo.

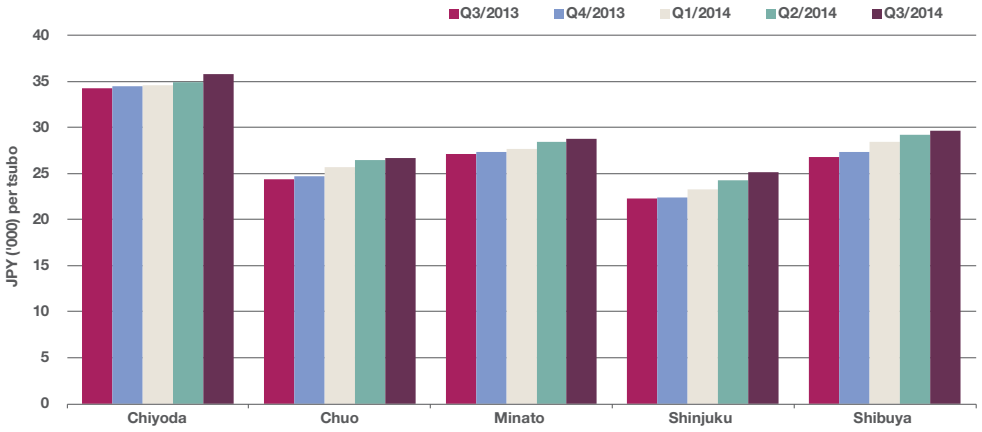
Steady increases in average passing rents since 2012 saw Shibuya overtake Minato as the second most expensive ward for prime office space earlier this year.

Shinjuku

After sharp improvements in prime occupancy levels in the first two

GRAPH 3

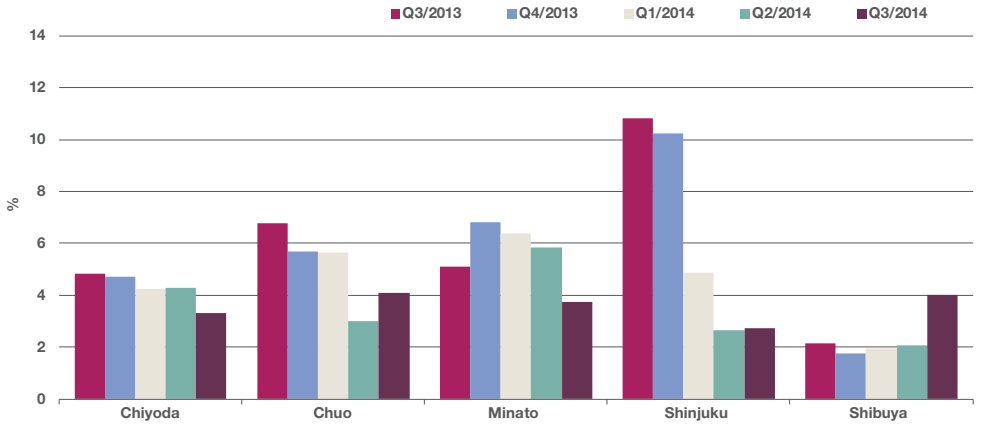
Average Grade A office rents by ward, Q3/2013–Q3/2014



Source: Savills Research & Consultancy

GRAPH 4

Average Grade A office vacancy rates by ward, Q3/2013–Q3/2014



Source: Savills Research & Consultancy

quarters of the year, Shinjuku's average Grade A vacancy rate remained flat in Q3/2014 at 2.7%.

Whereas Shinjuku lagged behind its neighbouring wards in terms of rental recovery in 2013, strong take up combined with the fall-off in prime availability in recent quarters has resulted in a rapid rebound in rental levels. In Q3/2014, the average Grade A rent reached approximately JPY25,090 per tsubo, representing an increase of 3.4% QoQ or a solid 12.5% YoY.

TABLE 1

Notable office leasing transactions, Q3/2014

Company	Business sector	Type	Former building(s)/ location	New building(s)/ location	Approximate space taken	
					tsubo	sq m
Nikon	Manufacturing	Headquarters relocation/ consolidation/	Multiple, incl. Shin Yurakucho Bldg/ Chiyoda Ward	Shinagawa Intercity Tower C/Minato Ward	7,172	23,709
Nishimura & Asahi	Legal services	Headquarters relocation	Ark Mori Building West Wing/ Minato Ward	Otemachi 1-1 Project Building A/Chiyoda Ward	5,000	16,529
Fujitsu Marketing	IT services	Headquarters relocation/ consolidation	Multiple, incl. Koraku Kajima Bldg/Bunkyo Ward	Shinagawa Intercity Tower C/Minato Ward	4,242	14,023
Metal One	Steel trading	Headquarters relocation	Celestine Shiba Mitsui Building/ Minato Ward	JP Tower/ Chiyoda Ward	2,420	8,000
Simplex Inc	IT services	Headquarters relocation following corporate reorganisation	Nihonbashi Itchome Building/ Chuo Ward	Toranomon Hills Mori Tower/ Minato Ward	2,000	6,612

Source: Savills Research & Consultancy

OUTLOOK

The prospects for the market

Tokyo's prime office leasing market is at a juncture where a robust rental recovery can be sustained through the near term. Vacancy rates have now fallen well below historical inflection points for rental growth, while the five-year supply pipeline currently presents a neutral outlook. Average large-scale office supply between 2014 and 2018 is in line with the benchmark 20-year annual average, suggesting it is absorbable under a base-case scenario and mitigating oversupply risk.

Vacancy rates are expected to remain at cyclical lows for some time, heightening competition for available space among tenants and fuelling rent appreciation. This will simultaneously encourage pre-leasing activities for planned schemes.

The rental spread between prime assets and secondary stock will steadily widen as the prevailing tenant 'flight to quality' continues. This will support demand for high quality Grade B properties from small- to mid-sized tenants, who may be priced out of top-tier properties as a result of the higher gross occupancy costs.

Please contact us for further information

Savills Japan

Christian Mancini
Representative Director, CEO
+81 3 5562 1717
cmancini@savills.co.jp

Savills Research

Will Johnson
Head of Research & Consultancy, Japan
+81 3 5562 1736
wjohnson@savills.co.jp

Hafiz Ismail
Associate, Research & Consultancy, Japan
+81 3 5562 1787
hismail@savills.co.jp

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