**SUMMARY**

Prime rents continued to firm up in the core markets.

- Historically low rents translated into healthy take-up in the small to mid-size bands, while larger deals were recorded at new or recently completed properties.
- Quarterly rental declines continued to moderate, with average Tokyo Grade A and Grade B rents dipping by a nominal 0.2% and 0.3% respectively.
- Prime rents in Minato again performed the strongest of the central five wards, rising 50 basis points (bps) over the preceding quarter to approximately JPY25,460 per tsubo.
- The average Grade A office vacancy rate showed further improvement, contracting approximately 10 bps to 4.4%. The average Grade B vacancy rate fell 30 bps to 5.1%.
- At the ward level, the average vacancy rate was lowest in Chiyoda at 2.2%. Quarter-on-quarter (QoQ) movement was, however, greatest in Shinjuku and Shibuya.
- Investment activity in Q4/2011 was stymied by a shortfall in purchasing opportunities, with the larger reported trades dominated by the J-REITs.

“Although yet to enter a growth scenario, quarterly decline in Tokyo’s prime office rent is now close to 0%. Robust tenant demand for consolidation space and property upgrades has also led to reduced vacancy in most submarkets.”

Savills Research & Consultancy
Tokyo leasing market

As in recent quarters, leasing demand for units in the small and medium size-bands was strong in Q4/2011, supported by requirements for consolidation space from private domestic companies and TSE-listed corporations. Improving the cost effectiveness of occupied office space remained the primary driver behind most new leases and many tenants have positioned themselves to benefit from the currently advantageous timing in the market cycle. Those relocating have been able to capitalise on historically low rents, with some receiving attractive incentive packages from landlords to secure lease agreements, such as generous free-rent periods and contributions towards relocation or fit-out costs.

While weighing occupancy costs against a preferred location premium remains ever important in tenants’ choice of rental property, heightened focus has been placed on the structural grade of candidate buildings in the wake of the Great East Japan Earthquake of March 2011. Factors for consideration include the age of the building and the seismic design code it conforms to, the structural-control systems implemented in the construction (ie, seismic dampening or isolation) as well as the building’s height and structural footprint. Office relocations by small- to mid-sized occupiers to higher grade premises have been facilitated by an increased willingness on the part of landlords to subdivide floor plates in Grade A buildings – a trend which was less pronounced in previous down cycles.

The largest reported leasing deals of the fourth quarter were characterised by firms taking space to facilitate the consolidation of multiple locations or offices split across floors. In terms of building grade and location, the larger deals have involved a number of new or recently completed properties situated in the core business districts of the central five wards.

The largest example of consolidation reported in Q4/2011 involved IT Holdings, a major IT systems developer. The TSE-listed firm signed an agreement to take approximately 34,000 sq m (10,400 tsubo1) of space over 13 floors at a newly completed office-led development in Nishi-Shinjuku, Shinjuku Ward. By late February 2012, approximately 7,000 employees from eight subsidiary companies are expected to relocate to the Sumitomo Fudosan Shinjuku Grand Tower from various locations across Tokyo. The 40-storey building, which officially opened on 1 December, is located about three minutes’ walk from Nishi-Shinjuku Subway Station and offers approximately 91,800 sqm of rentable office space. Reflecting the motivation behind many recent tenant relocations, the company intends to enhance business efficiency through concentrating its offices in one location, while also reducing transport and other related costs. As a result of this lease agreement and other pre-commitments, the occupancy rate at the time of building completion was reported to be around 70%.

Three other leasing deals of note were announced during the quarter involving new or soon-to-complete buildings. Two Japan Post Group companies, Japan Post Insurance and Japan Post Bank, decided to partially relocate their headquarters operations to the new Iino Building, taking a combined office area of approximately 16,500 sq m across seven floors. The 27-storey building reached completion in September in Chiyoda Ward’s Uchisaiwaicho district and has a GFA of almost 104,000 sq m. Following other pre-lease agreements at the building to businesses such as trading company

Table 1: Notable office leasing transaction, Q4/2011

<table>
<thead>
<tr>
<th>Company</th>
<th>Former location(s)/ward(s)</th>
<th>New location/ward</th>
<th>Area</th>
<th>Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>IT Holdings</td>
<td>9 locations inc. Hibiya Daibirusu/Chiyoda</td>
<td>Sumitomo Fudosan Shinjuku Grand Tower/Shinjuku</td>
<td>10,300 34,000</td>
<td>HQ relocation/ consolidation</td>
</tr>
<tr>
<td>Japan Post Insurance and Japan Post Bank</td>
<td>Daido Seimei Kasumigaseki Building, etc/Chiyoda</td>
<td>Iino Building/Chiyoda</td>
<td>5,000 16,500</td>
<td>Relocation of some HQ functions</td>
</tr>
<tr>
<td>Japan Science and Technology Agency</td>
<td>Kojimachi Crystal City East Building, Kojimachi Square, Sanbancho Building, JS Ichigaya Building/Chiyoda</td>
<td>K’s Gobancho Building/Chiyoda</td>
<td>2,700 9,000</td>
<td>HQ relocation/ consolidation</td>
</tr>
<tr>
<td>Nittobo (Nitto Boseki)</td>
<td>Kudan First Place, etc/Chiyoda</td>
<td>Kojimachi Ni-Chome Building (tentative name)/Chiyoda</td>
<td>2,500 8,300</td>
<td>HQ relocation/ consolidation</td>
</tr>
<tr>
<td>Asonaro Aoki Construction</td>
<td>ORIX Shiba 2-chome Building/Minato</td>
<td>Mita (formerly Kowa Mita) Building/ Minato</td>
<td>2,000 6,600</td>
<td>HQ relocation/ consolidation</td>
</tr>
<tr>
<td>Panasonic Health Care</td>
<td>Tokyo Panasonic or Sanyo Electric offices/Minato, Bunkyo, Taito</td>
<td>Nishi-Shibashis MF Building/Minato</td>
<td>1,660 5,500</td>
<td>Post-merger consolidation</td>
</tr>
<tr>
<td>Cisco Systems</td>
<td>Shinjuku Mitsui Building, etc/Shinjuku</td>
<td>Tokyo Midtown Tower/Minato</td>
<td>1,500 5,000</td>
<td>Consolidation</td>
</tr>
<tr>
<td>Opt</td>
<td>Hittosubashi SI Building/Chiyoda</td>
<td>Tokyo Bancho Building/Chiyoda</td>
<td>1,500 5,000</td>
<td>HQ relocation/ expense</td>
</tr>
</tbody>
</table>

Source: Press releases, Nikkei Real Estate Market Report, Savills Research & Consultancy

1 Tsubo is a traditional unit of Japanese land measurement, equal to 3.3058 square meters.
Sojitz and shipping firm K-Line, the building is now fully occupied.

Elsewhere, the Japan Science and Technology Agency is reported to have taken approximately 9,000 sq m at the K’s Gobancho Building in Gobancho, Chiyoda Ward, where construction was completed in January 2011. The national research institution will occupy all ten floors of the building in order to combine offices spread across four locations in the ward and reduce its overall rental costs. Fabric manufacturer Nittobo has similarly agreed to take space in a new project to facilitate streamlining of its Tokyo operations. The firm has taken approximately 8,300 sq m at the tentatively named Kojimachi Ni-Chome Building, a 14-storey office redevelopment of around 24,000 sq m which is scheduled to complete in March.

**Rents and vacancy in Tokyo’s central five wards**

According to Savills property survey data, the average estimated passing Grade A rent for Tokyo’s central five wards stood at approximately JPY24,600 per tsubo per month in Q4/2011. Although downward pressure on rents persisted, the rate of quarterly rental decline demonstrated continued moderation, easing from 40 bps in Q3 to just 20 bps in the fourth quarter. The average rent for Tokyo’s Grade B market was approximately JPY18,925 per tsubo per month. The rate of depreciation in this grade class has similarly slowed steadily over recent quarters, with rents slipping 30 bps QoQ in Q4 after a 60-bp dip in Q3. On a year-on-year (YoY) basis, estimated passing rental levels moderated for the ninth consecutive quarter, with Grade A rents declining by 3.3% and Grade B rents decreasing by 3.0%. This is compared with declines of 10.5% and 13.3% respectively in the last quarter of 2010 and falls exceeding 30% in Q4/2009.

The average Grade A office vacancy rate continued to show improvement in Q4/2011, contracting by approximately 10 bps quarter-on-quarter to stand at 4.4%. Average vacancy in Grade B properties stood at 5.1% after witnessing a fall of 30 bps from the Q3/2011 figure. YoY, vacancy in these markets shifted inwards by 30 bps and 154 bps respectively.

When looking at Grade A rents at the ward level, Minato performed the strongest of the central five wards for the second consecutive quarter in Q4/2011. Following a 70-bp increase in Q3/2011, the ward’s average estimated passing rent rose 50 bps to approximately JPY25,460 per tsubo. Chiyoda Ward also demonstrated a marginal upturn, with average rents rising 10 bps to stand at JPY33,250 per tsubo. In contrast with this positive movement, rents in Chuo Ward fell approximately 130 bps over the previous quarter to JPY21,900 per tsubo. This decline was largely attributable to the discounting of average rental levels in the Harumi district, where recent tenant relocations have led to an increase in available floor space. Rental declines over the quarter in the more westerly wards of Shibuya and Shinjuku were more nominal; estimated passing rents in the

“Prime rents continued to stabilise while vacancy rates in most submarkets demonstrated improvement.” Savills Research & Consultancy
former slipped 50 bps to JPY21,120, while the latter recorded a 20-bp dip to average JPY21,280 per tsubo.

Grade A vacancy rates improved or remained stable in four of the five central wards of Tokyo in the fourth quarter. In the capital’s most sought-after commercial postcode, Chiyoda Ward, average vacancy in prime stock fell for the sixth consecutive quarter, contracting 50 bps to approximately 2.2%. Minato Ward also chalked up its fourth consecutive improvement, with the volume of vacant space decreasing 80 bps to 3.6%. Elsewhere, the average vacancy rate in Chuo Ward remained flat at approximately 3.5%, while Shibuya Ward demonstrated a notable 190-bp decrease to approximately 3.8%. This sharp fall in available space in Shibuya Ward, where Grade A stock is comparatively limited, reflects space coming off the market in two of its landmark buildings, Ebisu Garden Place Tower and Cerulean Tower.

Shinjuku Ward was the only submarket to record an increase in Grade A vacancy in Q4/2011. The ward’s prime vacancy rate rose some 290 bps to reach approximately 9.2%. This movement reflects the availability of over 28,000 sq m of newly completed space at Shinjuku Front Tower throughout the three-month period, as well as smaller units being released to the market at older developments.

Savills monitors rents and vacancy levels in over 280 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, while vacancy figures reflect current vacant space without the inclusion of ‘expected’ vacancies, 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.

Tokyo investment market

Landmark acquisitions involving Tokyo office properties were limited in the last quarter of 2011 as a shortfall in investment opportunities stymied open market trades – movement which has been exacerbated by a latent gap between buyer and seller pricing expectations. Economic uncertainty arising from the European sovereign debt crisis and the historically strong yen also acted to temper cross-border demand, particularly from within the eurozone. As in recent quarters, the J-REITs were the protagonists in many of Tokyo’s larger office transactions in Q4/2011. This trend has been facilitated, for the most part, by sponsor-company pipelines and related-party asset transfers.

The largest reported office transaction of the quarter was one such deal involving Japan Real Estate Investment Corporation and its sponsor, Mitsubishi Estate. The REIT acquired the office-led Akasaka Park Building in Minato Ward from

“J-REITs and their blue-chip sponsors acted to drive the office transaction market in an otherwise quiet quarter.”

Savills Research & Consultancy

Graph 3

Average Grade A rents by ward, Q4/2010–Q4/2011

Graph 4

Average Grade A vacancy rates by ward, Q4/2010–Q4/2011
the TSE-listed real estate developer for JPY60.8 billion. The 30-storey, 97,489-sq m tower development was completed in 1993 and is located approximately five minutes’ walk from Akasaka Subway Station. The office and retail floors have a net rentable area (NRA) of 45,031 sq m and were 99.7% occupied at the time of acquisition, while the residential floors provide an NRA of 10,780 sq m and had an occupancy rate of 76.2%. Mitsubishi Estate and its group company, Mitsubishi Real Estate Service, will master-lease the office and residential floors respectively in their entirety. Based on expected NOI, the investment yield generated in the transaction was 4.7%. Recent market comparables suggest that this cap rate is in line with achievable pricing for at-arms-length deals involving prime Tokyo assets.

A portfolio transaction involving Kenedix Realty Investment Corporation, a J-REIT sponsored by Kenedix, Inc., is also worthy of particular note due to 1) its high total transfer price, and 2) the nature of the seller. The REIT purchased eight office buildings for JPY28.55 billion; four of the properties were located in Tokyo and accounted for JPY15.47 billion, or 54.2%, of the overall acquisition price. The sale was a non-related party trade from the Japanese arm of AIG Edison Life Insurance which, along with AIG Star Life Insurance, was taken over by Prudential Financial earlier in the year. Of the eight properties, the most expensive was the Kabutocho Nikko Building, an 11,705-sq m office located in Nihonbashi-Kabutocho, Chuo Ward. The 14-year-old building is exclusively leased to SMBC Nikko Securities and was purchased for JPY11.27 billion. Based on expected NOI, the cap rate in the transaction was 4.6%.

Although a sharp rebound in investment volume is unlikely to be seen during the first half of 2012, market sentiment suggests that investors’ appetite for well-positioned investment opportunities in Tokyo remains strong, and is in fact growing. Moreover, the financing environment for investment transactions is reported to have loosened in recent quarters, both for domestic and international firms. These factors, combined with some lenders’ need to recapitalise existing debt structures, should act to increase market activity in the near term.

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1 tsubo = approximately 3.3 sq m or 35.6 sq ft
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 Chiyoda, Chuo, Minato, Shibuya and Shinjuku wards.
4 Grade B office refers to buildings with a GFA of 15,000 sq m (4,500 tsubo) and a building age of less than 25 years. Some buildings are included that do not fit this definition.