Office

Q1/2011

"Both the Tokyo office leasing and investment markets demonstrated a healthy recovery in Q1 prior to the tragic natural disasters of 11 March. Looking ahead, while the Tokyo market is likely to witness a notable dip in activity in the short term, the longer-term prospects for investment-grade office assets remain sound."

Image: Tokyo Midtown

- Several large leasing deals were reported in Q1, with demand characterised by existing tenants taking space to facilitate office consolidations or bring about cost-savings.
- Savills rental survey data suggests that the quarterly rate of decline in average Grade A rents in Tokyo's central five wards was approximately 1.4% in Q1 - an increase of 20 bps over the previous quarter. This rise is considered a reflection of the addition of new buildings into the sample group, rather than of heightened downwards pressure on rents.
- Average rents for Grade B properties demonstrated signs of recovery, with the rate of decline moderating to 1.5% from approximately 2.6% in Q4/2010.
- Grade A office vacancy levels in the central five wards remained relatively steady, with the average figure rising nominally to approximately 4.8%. The average Grade B vacancy rate remained unchanged over the quarter at approximately 6.6%.
- The impact of Great East Japan Earthquake on tenant sentiment will likely see a shift away from submarket-led demand to asset-specific demand. Newly built or recently renovated properties conforming to full seismic codes are expected to achieve a demand premium.
- More than 30 office asset transactions priced above JPY1 billion were reported in Q1; four commanded a price tag of over JPY40 billion. While likely subject to a dip in Q2/2011, investor appetite for well-positioned assets is expected to hold up in the longer term.

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Tokyo leasing market update

It is too early to assess the full impact of the Great East Japan Earthquake and Tsunami of 11 March on Tokyo's office leasing market. Indeed, having hit late in the quarter, the market trends surveyed in Q1 do not indicate any significant signs of movement as a result of the tragedy that beset the Tohoku region. While data for Q2 is likely to offer a comparatively fuller picture of the effect of recent events on office demand, this report will provide some initial observations as to the future outlook, as well as a summary of the latest market developments.

Although details of most leasing transactions in Japan are not publically disclosed, a handful of large deals were reported during the first three months of 2011. As seen in previous quarters, office demand for larger floor plates was characterised by existing office occupiers in the Greater Tokyo region taking space to facilitate office consolidations and/or bring about cost-savings. One positive indicator, however, is an increase in the number of office expansions – a sign that business sentiment was gradually improving prior to March's devastating natural disasters.

Two leasing deals of over 17,000 sq m (5,000 tsubo) were reported between January and March involving existing occupiers in Tokyo's central five wards. The largest of these saw trading company Sojitz Corporation agree to take around 23,000 sq m (7,000 tsubo) at the new Iino Building, which is scheduled for completion in June this year in Uchisaiwaicho, Chiyoda Ward. Approximately 2,500 employees are expected to move from the firm's headquarters at the 21-year old Kokusai Shin-Akasaka East and West Buildings in Minato Ward to the 104,000 sq m office-led tower in the summer of 2012. The second largest deal of the quarter also comprised a head office relocation to a brand new building as Sony Computer Entertainment (SCE) is reported to have taken the entire SSJ Shinagawa Building in Konan, Minato Ward. The building, which reached completion in February, has a gross floor area of nearly 30,000 sq m (9,000 tsubo) and a rentable floor area of around 17,500 sq m (5,300 tsubo). With 18 storeys, the building is located close to Sony City, the headquarters of SCE's parent company Sony Corporation, where it temporarily relocated of its in August 2010. According to market sources, SCE also currently leases office space totalling approximately 12,900 sq m (3,900 tsubo) in the Akasaka Oji and Aoyama Yasuda Buildings in Minato Ward. The three offices are set to be consolidated at the SSJ Shinagawa Building in the near term.

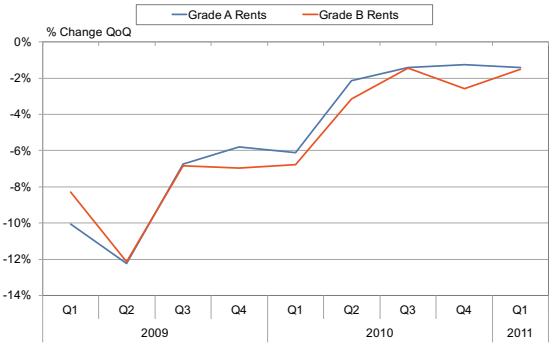
Notable office leasing transactions, Q1/2011

Company	Former Locations	New Locations	Ward (Former / New)	Area (tsubo/ sq m)	Type
Sojitz Corporation	Kokusai Shin-Akasaka Building (East & West Wings)	Iino Building	Minato / Chiyoda	7,000 / 23,800	Consolidation / Cost-saving
Sony Computer Entertainment (SCE)	TK Minami-Aoyama Building	SSJ Shinagawa Building	Minato	5,300 / 17,500	Relocation
Hitachi Information & Control Solutions	ORIX Shinagawa Building	Akihabara Daiei Building	Minato / Taito	2,500 / 8,265	Expansion
Kawasaki Kisen Kaisha (K Line)	Central Building, Nishi-Shinbashi	Iino Building	Minato / Chiyoda	2,100 / 6,900	Expansion
Dainippon Sumitomo Pharma	Sumitomo Seimei Yaesu-Higashi Building	Sumitomo Shoji Yaesu Building	Chuo	2,000 / 6,600	Relocating / Cost-saving
Yamato System Development	YSD Toyocho Office	SIA Toyosu Prime Square	Koto	1,800 / 6,000	Consolidation / Expansion

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

Savills rental survey data suggests that the quarterly rate of decline in average Grade A rents in Tokyo's central five wards was approximately 1.4% in Q1, equivalent to an increase of 20 bps over the previous quarter[1].

QoQ change in Grade A and B office rents in Tokyo's central 5 wards, Q1/2009 – Q1/2011



Source: Savills Research & Consultancy

Although prime Tokyo rents are still considered to be in the process of bottoming out, the nominal dip in rents during the first quarter is considered to largely reflect the addition of new buildings into the sample group, rather than heightened downward pressure on rents. Average rents for Grade B properties surveyed in the central five wards similarly demonstrated signs of recovery, with the rate of decline moderating to 1.5% from approximately 2.6% in Q4/2010[2].

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 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.

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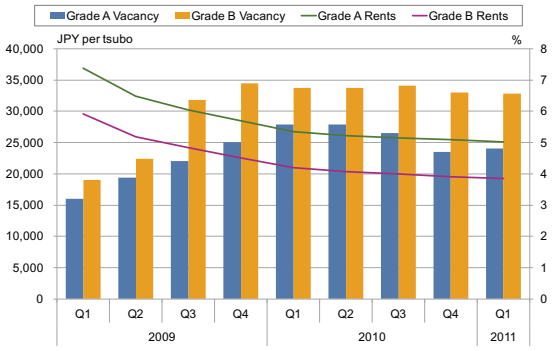
As of Q1/2011, the average monthly rent for Grade A office space in Tokyo's central five wards was approximately JPY25,100 per tsubo (JPY7,600 per sq m). The average Grade B office rent during the quarter is estimated to be approximately JPY19,200 per tsubo (JPY5,800 per sq m). Having fallen some 46% from Q1/2008 rental prices, current average rents are deemed to represent the bottom of the market cycle, with further depreciation expected to be minimal. While the rental premium for Grade A compared with Grade B stock has remained relatively stable over recent years at around 20% to 24%, the rent differential in terms of yen value has fallen by around 47%. Average Grade A rents are therefore currently less than average Grade B rents prior to Q2/2009. The upshot of this for the leasing market is that existing tenants in secondary or tertiary office buildings may be able to upgrade to higher quality premises without incurring a significant increase in operating costs. This is likely to encourage more office relocation and expansion in the near term.

Average Grade A and B office rents and vacancy in Tokyo's central 5 wards, Q1/2009 – Q1/2011

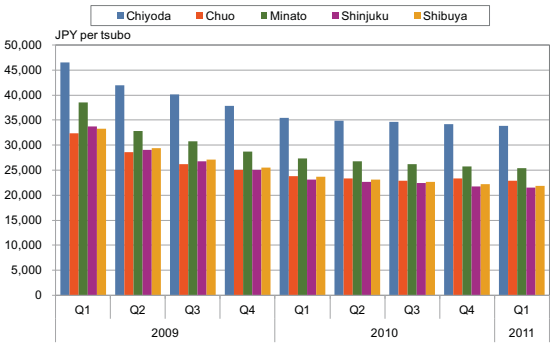


Source: Savills Research & Consultancy

Grade A office vacancy levels in the central five wards remained relatively stable in Q1, with the average figure rising nominally by 20 bps to approximately 4.8%. The average Grade B vacancy rate remained unchanged over the quarter at approximately 6.6%. At the ward level, the largest upward movement in vacancy rates was a 60 bps rise in the Chuo Grade A market. The biggest contraction in available stock was witnessed by the Minato Grade B market, where average vacancy fell by 40 bps.

When looking at Grade A rents at the ward level, moderate quarterly declines were recorded in all of the five core wards. The most significant fall – equivalent to approximately 1.7% – occurred in Chuo and Shibuya, while the ward with the slowest rate of decline was Chiyoda at 1.1%. The average prime rent in Chiyoda stood at approximately JPY33,800. Reflecting its reputation as Tokyo's prime office district, the ward commands a rental premium of 26% over the five-ward average and some 37% over central Tokyo's least expensive ward, Shinjuku.

Average Grade A rent by ward, Q1/2009 – Q1/2011



Source: Savills Research & Consultancy

Savills monitors rents and vacancy levels in over 280 buildings located across 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 achievable rents as opposed to asking rents, while 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 somewhat lower than other market indices.

Tokyo leasing market outlook

The impact of Great East Japan Earthquake on tenant sentiment will likely see a shift away from submarket-led demand to asset-specific demand. Although it is still too early to assess the longer-term effects of recent events on the office leasing market, a move away from pencil building structures (floor plates of around 50 tsubo / 165 sq m or below) to larger, more robust floor plates (200 tsubo / 660 sq m and above) is anticipated in the short to medium term.

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Newly built or recently renovated properties conforming to full seismic codes and located away from bayside areas in particular are expected to achieve a demand premium. Moreover, some companies located in the outer 23 wards and surrounding areas of Tokyo are expected to relocate into the central five wards, which are considered safer and have been less disrupted by power outages.

To date, Grade A and Grade B buildings have not benefited from any direct rental uplift as a result of the elevated demand. This is in part due to a cultural consideration of the tragedy but also reluctance by tenants to increase their operating budgets if avoidable. However, initial indications suggest that incentives such as rent-free periods are being negotiated downwards. While much will depend on the strength of the economic recovery, assuming that the Fukushima nuclear situation can be brought under control without too much disruption to trade and distribution routes, average rents of Grade A and good-quality Grade B properties in Tokyo's central five wards are expected to continue to bottom out over the coming quarters. A rental recovery may, however, be subject to some delay. In contrast, lower quality Grade B and C properties built prior to 1981, when the seismic design codes in the Building Standard Law of Japan were comprehensively revised, are likely to suffer as a result of the recent events.

Tokyo investment market update

Prior to the devastating natural disasters that struck the Tohoku region on 11 March 2011, the Tokyo real estate investment market had demonstrated a healthy recovery. Transactional demand was led by domestic corporates and blue-chip J-REITs, which benefitted from improved sentiment and access to capital on the back of the Bank of Japan's JPY50 billion allocation to the REIT market in October. According to Real Capital Analytics and other market sources, more than 30 office asset transactions priced above JPY1 billion were reported in Q1; four of these commanded a price tag of over JPY40 billion.

Shortly after the earthquake, an SPC of Mitsubishi Estate completed the largest acquisition of the quarter when it purchased the east and west wings of the Kokusai-Shin Akasaka complex, as well as an adjacent hotel, from US investment fund Lone Star. Media reports suggest that the overall purchase price was around JPY90 billion. The transacted office floor space totals approximately 80,000 sq m and the entire land area is equivalent to just over 14,300 sq m. Current tenants at the complex include the headquarters of trading company Sojitz Corporation, which has announced plans to move to the new Iino Building currently under construction in Chiyoda Ward in 2012. After Sojitz completes its relocation, it is expected that Mitsubishi will redevelop the site as a multi-purpose commercial facility.

Separately, in a deal worth just over JPY72 billion, Mitsui Fudosan and Mitsui Co., Ltd acquired the Otemachi PAL Building in Chiyoda Ward from owner-occupier Promise. The 28,000 sq m building is located directly above Otemachi Subway Station and was originally purchased by the seller, a consumer finance company, for around JPY40 billion in 2004. Elsewhere, in the Tokyo Bay area, IHI repurchased the Toyosu Centre Building from a related special purpose company (SPC) for JPY40.8 billion. The 100,000 sq m office building was completed in 1992 and is located adjacent to Toyosu Subway Station in Koto Ward. The ship builder had originally sold the property to the SPC for approximately JPY30 billion in 2004 in order to balance-off its assets.

The largest J-REIT transaction comprised Nippon Building Fund (NBF)'s acquisition of approximately 60% sectional ownership in the Mitsubishi Heavy Industries Building for approximately JPY36.3 billion. The purchase was made via a joint venture with an undisclosed domestic investor and the total acquisition price is reported to be in the order of JPY60.5 billion. The 29-storey building is located five minutes' walk from JR Shinagawa Station and offers just under 60,000 sq m of rentable office space. Based on estimated NOI, the cap rate in the NBF transaction was 4.3%.

Office

Looking ahead, the Great East Japan Earthquake will inevitably present some immediate challenges for the Japanese investment market. These will include the need to marry revised buyer and seller valuation estimations as well as increased competition for bank financing from affected businesses and the reconstruction effort. Potential volatility in the capital markets will also have a substantial impact on J-REITs both in terms of unit pricing and the secondary offering environment, which could hamper their ability to raise additional capital. While some core/core-plus investors are postponing closings given the short-term uncertainty, opportunistic investors and hedge funds are reported to be eyeing the market for potential buying opportunities. The prospects for Japanese real estate investment in the longer term remain sound and investor appetite for well-positioned assets is expected to hold up after a short-term lag. In particular, it is believed that domestic investors, who took the lead in the nascent recovery prior to the earthquake, will remain active.

For further information, please contact:

japan

Christian Mancini
Managing Director, CEO

+81 3 5562 1717
cmancini@savills.co.jp

japan

Koji Naito
Associate Director, Research

+81 3 5562 1733
knaito@savills.co.jp

research & consultancy, asia pacific

Simon Smith
Senior Director

+852 2842 4573
ssmith@savills.com.hk

address

Savills Japan Co., Ltd.
CR Kamiyacho Building 10F
1-11-9 Azabudai,
Minato-ku, Tokyo 106-0041
Japan
T: +81 3 5562 1700
F: +81 3 5562 1705

corporate website

www.savills.com

savills
savills.com

ASIA PACIFIC HEADQUARTERS

23/F Two Exchange Square, Central, Hong Kong
Tel: (852) 2842 4400 Fax: (852) 2868 4386

Robert McKellar - CEO, Asia Pacific
Raymond Lee - CEO, Greater China
Chris Marriott - CEO, South East Asia
Charles Chan - MD, Valuation & Professional Services, Greater China

HONG KONG SAR

Savills (Hong Kong) Limited
23/F Two Exchange Square , Central, Hong Kong
Tel: (852) 2842 4534 Fax: (852) 2869 6738
Contact: Raymond Lee E-mail: rlee@savills.com.hk
EA Co. Licence: C-002450

Savills Valuation and Professional Services Limited
28/F Two Exchange Square, Central, Hong Kong
Tel: (852) 2801 6100 Fax: (852) 2501 5810
Contact: Charles Chan E-mail: ccchan@savills.com.hk
EA Co. Licence: C-023750

Savills Property Management Holdings Limited
8/F Cityplaza One, 1111 King's Road, Taikoo Shing, Hong Kong
Tel: (852) 2534 1688 Fax: (852) 2851 1249
Contact: Kendrew Leung E-mail: kleung@savills.com.hk
EA Co. Licence: C-002993

Savills Guardian (Holdings) Limited
7/F Cityplaza One, 1111 King's Road, Taikoo Shing, Hong Kong
Tel: (852) 2512 1838 Fax: (852) 2887 3698
Contact: Peter Ho E-mail: peterho@savillsguardian.com.hk

MACAU SAR

Savills - Macau
Savills (Macau) Limited
Suite 1310, 13/F Macau Landmark, 555 Avenida da Amizade, Macau
Tel: (853) 8506 6288 Fax: (853) 2878 1805
Contact: Franco Liu E-mail: fliu@savills.com.mo

CHINA

Savills - Shanghai
20/F Shanghai Central Plaza, 381 Huaihai Middle Road, Shanghai 200020, China
Tel: (86) 21 6391 6688 Fax: (86) 21 6391 6699
Contact: Albert Lau E-mail: albert.lau@savills.com.cn

Savills - Beijing
2101 East Tower, Twin Towers, B-12 Jianguomenwai Avenue, Chaoyang District
Beijing 100022, China
Tel: (86) 10 5925 2288 Fax: (86) 10 5925 2299
Contact: Billy Chau E-mail: billy.chau@savills.com.cn

Savills - Guangzhou
Room 906, R & F Centre, No. 10 Hua Xia Road, Zhu Jiang New Town,
Guangzhou, 510623, China
Tel: (86) 3892 7168 Fax: (86) 3892 7030
Contact: Woody Lam E-mail: woody.lam@savills.com.cn

Savills - Shenzhen
Unit A, 5/F, Anlian Plaza, 4018 Jintian Road, Futian District, Shenzhen 518026, China
Tel: (86) 755 8828 5707 Fax: (86) 755 8828 5676
Contact: Woody Lam E-mail: woody.lam@savills.com.cn
Offices in Chengdu, Chongqing, Dalian, Hangzhou, Shenyang, Tianjin, Xiamen, and Zhuhai

ASIA

Savills - Indonesia
PT. Procon Indah
19/F Indonesia Stock Exchange Building, Tower 2, Jl Jenderal Sudirman Kav
52-53, Jakarta 12190 Indonesia
Tel: (62) 21 515 3777 Fax: (62) 21 515 3232
Contact: Lucy Rumantir E-mail: lucy.rumantir@procon.co.id

Savills - Japan
Savills Japan Co., Ltd.
CR Kamiyacho Building 10F, 1-11-9 Azabudai, Minato-ku,
Tokyo 106-0041, Japan
Tel: (81) 3 5562 1700 Fax: (81) 3 5562 1705
Contact: Christian Mancini E-mail: cmancini@savills.co.jp

Savills - Korea
Savills Korea
11/F Seoul Finance Center, 84 Taepyungro-1-ga,
Chung-gu, Seoul, Korea 100-768
Tel: (82) 2 2124 4201 Fax: (82) 2 2124 4188
Contact: Moonduck Kim E-mail: mdkim@Savills.co.kr

Savills - Malaysia
Savills Rahim & Co
Level 17, Menara Uni. Asia, 1008 Jalan Sultan Ismail, 50250
Kuala Lumpur, Malaysia
Tel: (60) 3 2691 9922 Fax: (60) 3 2691 0096
Contact: Robert Ang E-mail: robertang@savillsrahim-co.com

Savills - Singapore
Savills (Singapore) Pte Ltd.
2 Shenton Way, #17-01 SGX Centre 1, Singapore 068804
Tel: (65) 6536 5022 Fax: (65) 6538 5540
Contact: Chris Marriott E-mail: cjmarriott@savills.com.sg

Savills - Taiwan
Savills (Taiwan) Limited
17F-1, Exchange Square, No. 89, Sung Ren Road
Xin-Yi District, Taipei, Taiwan
Tel: (886) 2 8789 5828 Fax: (886) 2 8789 5929
Contact: Cynthia Chu Email: cchu@savills.com.tw

Savills - Thailand
Savills (Thailand) Limited
26/F Abdulrahim Place, 990 Rama IV Road,
Silom, Bangrak, Bangkok 10500, Thailand
Tel: (66) 2 636 0300 Fax: (66) 2 636 0339
Contact: Robert Collins E-mail: robertc@savills.co.th

Savills - Vietnam
18/F, Fideco Tower, 81-85 Ham Nghi Street,
District 1, Ho Chi Minh City, Vietnam
Tel: (84) 8 3823 9205 Fax: (84) 8 3823 4571
Contact: Brett Ashton E-mail: bashton@savills.com.vn
Office in Hanoi

AUSTRALIA

Savills - Australia
Savills (Aust) Pty Ltd.
Level 7, 50 Bridge Street, Sydney, Australia
Tel: (61) 2 8215 8888 Fax: (61) 2 8215 8899
Contact: Paul McLean E-mail: pmclean@savills.com.au
Offices throughout Sydney, Adelaide, Brisbane, Canberra, Gold Coast, Liverpool, Melbourne, Parramatta, Perth and Sunshine Coast.

NEW ZEALAND

Savills - New Zealand
Barfoot & Thompson
Level 5, 50 Kitchener Street, Auckland, New Zealand
Tel: (64) 9 307 5523 Fax: (64) 9 303 1689
Contact: Peter Thompson E-mail: peter@barfoot.co.nz

NORTH AMERICA

Savills - New York
Savills LLC
599 Lexington Avenue, 36th Floor, New York, NY 10022
Tel: (1) 212 328 2800 Fax: (1) 212 328 2828
Contact: John D. Lyons E-mail: jlyons@savills.com

UNITED KINGDOM / EUROPE / SOUTH AFRICA

Savills - Europe
20 Grosvenor Hill, London W1K 3HQ, U.K.
Tel: (44) 207 499 8644 Fax: (44) 207 495 3773
Contact: Jeremy Helsby E-mail: jhelsby@savills.com
Offices throughout the United Kingdom, Belgium, France, Germany, Hungary, Italy, Netherlands, Poland, Spain and Sweden. Associate offices in Austria, Greece, Norway, Portugal, Russia, Turkey and South Africa.

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