savills

Briefing
Office sector

Q1 2012

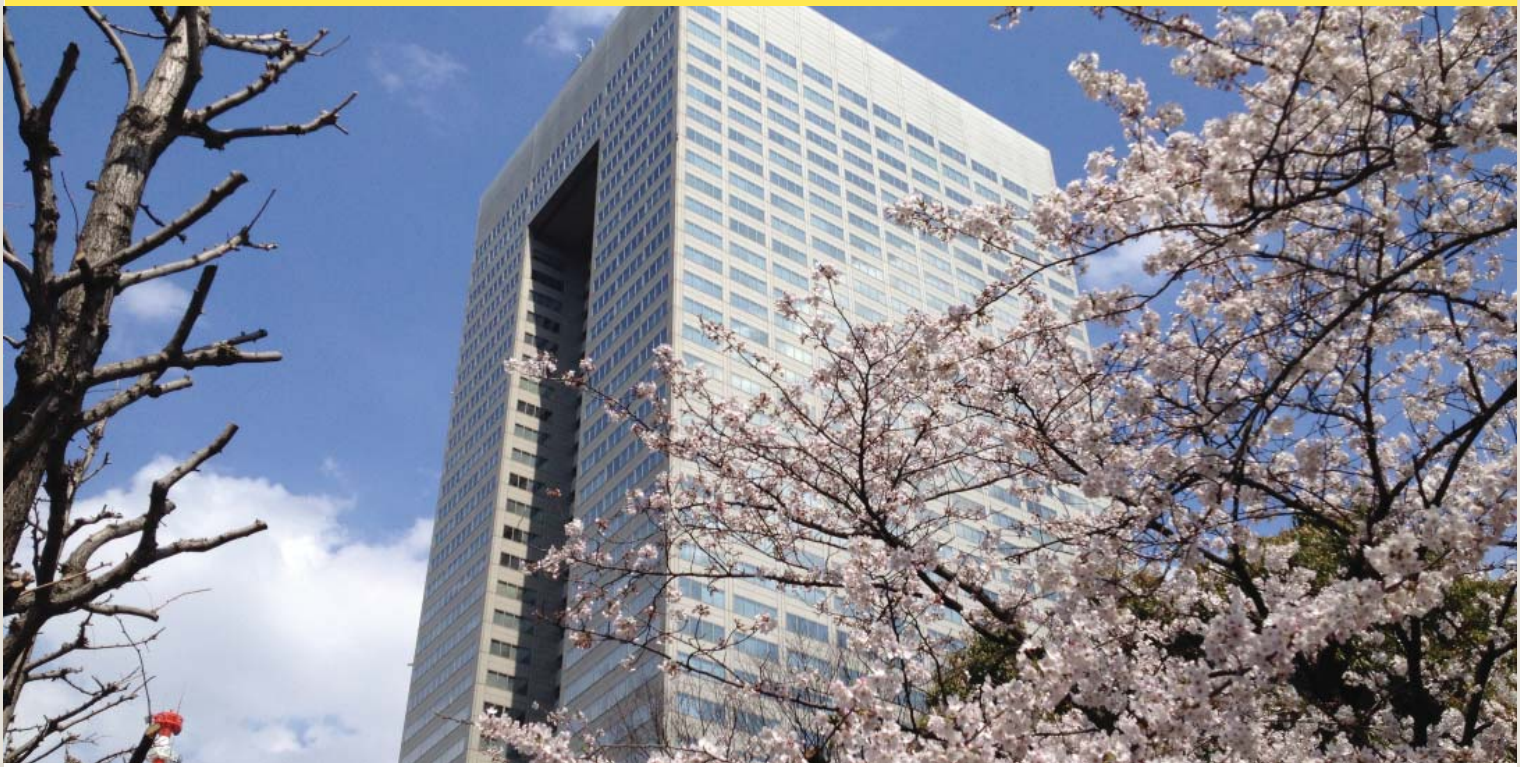


Image: Toshiba Building, Minato Ward

SUMMARY

Q1/2012 survey data supports the view that Tokyo prime rents have reached their nadir.

- Historically low rents combined with demand for consolidation space and property upgrades prompted strong take-up across all unit sizes, with several large deals reported at new or soon-to-complete properties.

- Quarterly rental movement demonstrated further stabilisation, with the average Tokyo Grade A rent slipping a marginal 0.1% and with the Grade B rent virtually unchanged.

- Grade A rental growth was recorded in two of the central five wards, equivalent to 0.9% quarter-on-quarter (QoQ) in Shibuya and 0.7% in Chiyoda.

- The average Grade A vacancy rate remained stable at 4.4% while Grade B vacancy rose 40 basis points (bps) to 5.1%.

- At the ward level, prime vacancy in Chiyoda rose approximately 90 bps to 3.0%. QoQ change in the remaining four wards was more positive, with average vacancy rates moving in between 10 and 40 bps.

- Large property transactions picked-up in number, spurred in part by investors' desire to close deals before the end of the financial year and a general view that pricing has bottomed-out.

"With quarterly movement in Grade A rents hovering close to the 0% threshold, anticipation of future growth stimulated investor appetite for well-positioned assets in Q1/2012. Tenants, meanwhile, supported prime occupancy levels through property upgrades and consolidations."
Savills Research & Consultancy

Tokyo leasing market

Leasing demand drivers

As of Q1/2012, Grade A rents in the central five wards demonstrated a peak-to-trough fall of more than 50% over Q4/2007, while the average all-grade rental level was down almost 25%. Recent leasing evidence suggests that prime rents have reached the bottom of the current cycle. Nonetheless, the average all-grade vacancy rate has continued to hover at historical highs with a sizable volume of new speculative supply still to come online over the coming quarters. The Tokyo office leasing market going into 2012 therefore remained, in many respects, a tenant's market.

For tenants in highly sought-after locations or those locked into a fixed-term lease at above-market rents for an extended period, leverage for negotiation with landlords is limited. However, for tenants renting under a standard Japanese lease structure or on a fixed-term lease which is set to expire in the next year or two, the current favourable market environment provides an opportunity to renegotiate existing terms, gain some concessions or relocate.

Leasing evidence in Q1/2012 suggests that tenant demand for this latter option, office relocation, is strong. Some of the key drivers behind this include:

1) Tenants' desire to occupy premises which conform to the latest seismic building codes.

Since the Great East Japan Earthquake, a demand premium has been placed on new or recently renovated buildings equipped with advanced structural design features, such as seismic isolation systems and back-up power generators. Older commercial properties constructed to out-dated building codes and so-called 'pencil buildings' (those with narrow floorplates disproportionate to their height) have conversely become less competitive.

2) Requirements for space to facilitate consolidations and business streamlining.

Many domestic corporations occupy multiple premises in Tokyo, with divisions and group companies spread across different locations. Historically low market rents have enabled tenants to consolidate offices within larger and often more modern premises without incurring prohibitive rental increases.

3) Scope for facility or location upgrades.

In many cases tenants have been able to move from older, outmoded properties to more modern premises or from fringe submarkets to centrally-located business districts. This has been facilitated by rental discounting in recent years, which has resulted in Grades A and B rents becoming relatively cheap from an historical perspective.

4) Landlords' willingness to subdivide Grade A floorplates.

In addition to requirements for large-scale office consolidations, landlords have been able to capture demand from small- and mid-sized occupiers via the subdivision of floorplates in Grade A buildings. This is in marked contrast to the previous down cycle, when landlords generally refrained from splitting floors.

5) Demand for expansion space.

Although in the minority, some office tenants have taken advantage of the current market environment to source competitively-priced expansion space. Notable examples in Q1/2012 included occupiers from the online retail and software development sector. Looking forward, the widely anticipated recovery in the national economy may see more Japanese firms shift employment strategies from contraction to expansion in the short to mid term. A gradual movement towards international work-space standards over the longer term may also act to increase the floor space-per-head ratio in new lettings.

Recent leasing activity

The number of mid- to large-scale leasing transactions increased in Q1/2012 compared with the preceding quarter, with deals characterised by tenants taking space to facilitate the consolidation of divisions separated across multiple locations or offices split across floors. As in recent quarters, many of the larger leases were signed at new or recently completed Grade A properties. These have been situated both in the traditional CBD and business districts of the surrounding wards.

Two notable leasing transactions were reported at Nakano Central Park, a large-scale redevelopment project in Nakano Ward led by developer Tokyo Tatemono, where staged completion is due between March and May. At the scheme's 151,580-sq m South building, beverage manufacturer Kirin Holdings took just over 26,000 sq m for its new headquarters. The firm intends to streamline its business operations by consolidating three group companies at one location, thereby increasing efficiency and reducing travel costs. It also aims to provide a seismically-secure work environment for its staff through the choice of this new, technologically-advanced building. Separately, Kurita Water Industries took approximately 11,000 sq m at the scheme's 39,000-sq m East building. The water-treatment facilities operator will relocate its headquarters from a building it owns in Nishi-Shinjuku, which is said to be deteriorating due to age.

Two other large deals at brand-new or soon-to-complete developments involved Square Enix Holdings and Nippon Paper Group. The former is reported to have taken over 23,000 sq m of space at Mitsubishi Estate's Shinjuku Eastside Square, a 170,300-sq m office-led development scheduled to complete in April close to Higashi-Shinjuku Subway Station. The computer games developer will relocate its headquarters functions to the property from the nine-year-old Shinjuku Bunka Quint Building in the nearby Yoyogi district of Shibuya Ward. Nippon Paper Company is believed to have taken approximately 16,500 sq m at Ochanomizu Sola City, a 102,000-sq m mixed-use tower in Kanda-Surugadai, Chiyoda Ward, which is set for completion in April 2013. The paper manufacturer will reduce the footprint of its headquarters while upgrading its facilities via its planned relocation from a 42-year-old property which it exclusively leases in nearby Hitotsubashi.

Another recent case study is indicative of the trend of office

consolidation and upgrade, as well as tenant movement at secondary space. Electronics manufacturer Sharp has agreed to take approximately 22,000 sq m of space currently occupied by general contractor Shimizu at the Seavans S Building in Shibaura, Minato Ward. Shimizu plans to relocate from the 21-year-old property to a new purpose-built headquarters office in Kyobashi, Chuo Ward, upon its completion in July. Sharp will thereafter consolidate multiple offices across Tokyo within the vacated space, including operations currently located at the Sumitomo Fudosan Shibakoen Building in Hamamatsucho, a 17,300-sq m property which was completed in 1985.

Rents and vacancy rates in Tokyo's central five wards

According to Savills property survey data, the average estimated passing Grade A rent[1] for Tokyo's central five wards[2] stood at approximately JPY24,585 per tsubo[3] per month in Q1/2012. Although downward pressure on rents persisted, the rate of rental decline QoQ remained nominal, easing from 0.2% in Q4/2011 to just 0.1% in the first quarter. The average rent for Tokyo's Grade B market[4] was virtually unchanged at approximately JPY18,920 per tsubo per month. On a year-on-year (YoY) basis, the decline in estimated passing rental levels moderated for the tenth consecutive quarter, with Grade A rents falling 2.0% and Grade B rents slipping 1.6%. This compares with YoY declines of 6.1% and 8.4% respectively in Q1/2011 and falls close to 30% in Q1/2010.

The average Grade A office vacancy rate remained stable over the previous quarter in Q1/2012 at 4.4%. Average vacancy in Grade B properties meanwhile rose approximately 40 bps to stand at 5.4% – its first rise in six quarters. In terms of YoY movement, the Grade A vacancy rate remained virtually flat, whereas the Grade B market shifted inward by approximately 80 bps.

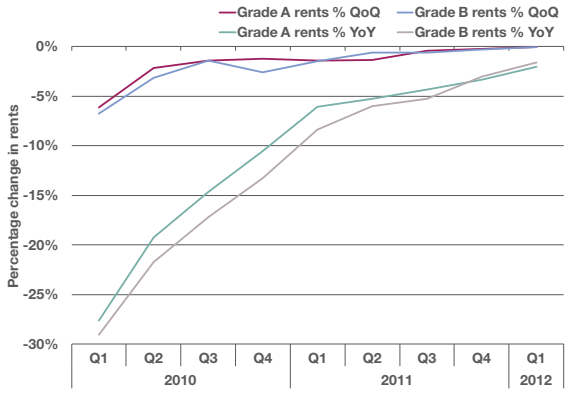
At the ward level, Grade A rental levels performed strongest in Shibuya, where achievable passing rents increased by 0.9% QoQ to approximately JPY21,320 per tsubo. Chiyoda Ward similarly recorded nominal rental growth through the quarter, with average Grade A rents rising by 0.7% to approximately JPY33,490 per tsubo. This marks the second consecutive quarter of modest rental appreciation in the ward, which as Tokyo's most expensive office location, commands an average rental premium of more than 33% over the other central wards.

In contrast to the positive rental movement seen in Shibuya and Chiyoda, rents in Chuo and Shinjuku wards recorded a decline of

[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] Chiyoda, Chuo, Minato, Shibuya and Shinjuku wards.
[3] 1 tsubo = approximately 3.3 sq m or 35.6 sq ft
[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 which do not fit this definition.

GRAPH 1

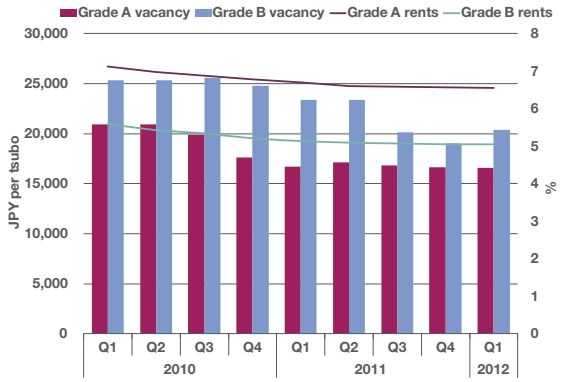
Percentage change in Grades A and B office rents in Tokyo's central five wards, Q1/2010–Q1/2012



Source: Savills Research & Consultancy

GRAPH 2

Average Grades A and B office rents and vacancy rates in Tokyo's central five wards, Q1/2010–Q1/2012



Source: Savills Research & Consultancy

TABLE 1

Notable office leasing transactions, Q1/2012

Company	Former location/ward	New location/ward	Approximate space taken		Type
			tsubo	sq m	
Kirin Holdings	Kirin Holdings HQ Building, etc/Chuo	Nakano Central Park South/Nakano	7,950	26,280	HQ relocation/ consolidation
Square Enix Holdings	Shinjuku Bunka Quint Building/Shibuya	Shinjuku Eastside Square/Shinjuku	7,000	23,140	HQ relocation
Sharp	Sumitomo Fudosan Shibakoen Building, etc/Minato	Seavans S Building/Minato	6,700	22,150	Relocation/ consolidation
Nippon Paper Group, Inc	Sumitomo Corp. Takebashi Building/ Chiyoda	Ochanomizu Sola City/Chiyoda	5,000	16,530	HQ relocation/ consolidation
Chartis Far East Holdings	Arca West, etc/Sumida	Kamiyacho MT Building/Minato	4,500	14,880	HQ relocation/ consolidation
Amazon Japan	Shibuya Cross Tower, etc/Shibuya	Aruko Tower Annex/Meguro	3,920	12,960	HQ relocation/ consolidation and expansion
Sega	Sega HQ Building Ichigokan, etc/Ota	Canal Side Building/Shinagawa	3,400	11,240	HQ relocation/ consolidation
Kurita Water Industries	Kurita Water Industries HQ Building/ Shinjuku	Nakano Central Park East/Nakano	3,340	11,040	HQ relocation

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

approximately 1.0% QoQ. Meanwhile, the average Grade A rental figure in Tokyo's second most expensive office location, Minato Ward, slipped approximately 0.3% to stand at JPY25,370 per tsubo.

Grade A vacancy rates improved in all but one of Tokyo's central five wards during the first quarter of 2012, with in-movement ranging between 10 bps and 40 bps. Minato Ward witnessed the largest contraction in vacant space, reflecting units being taken off the market at a number of buildings, including Atago Green Hills Mori Tower. The only ward to record a rise was Chiyoda, where the average vacancy rate increased by approximately 90 bps to 3.0%. The increase – the ward's first in seven quarters – is largely attributable to the completion of the Palace Building and the Marunouchi Eiraku Building in the Tokyo Station area. Despite both having occupancy levels close to 75% at completion, vacant space in the two buildings totalled approximately 31,000 sq m as of March 2012.

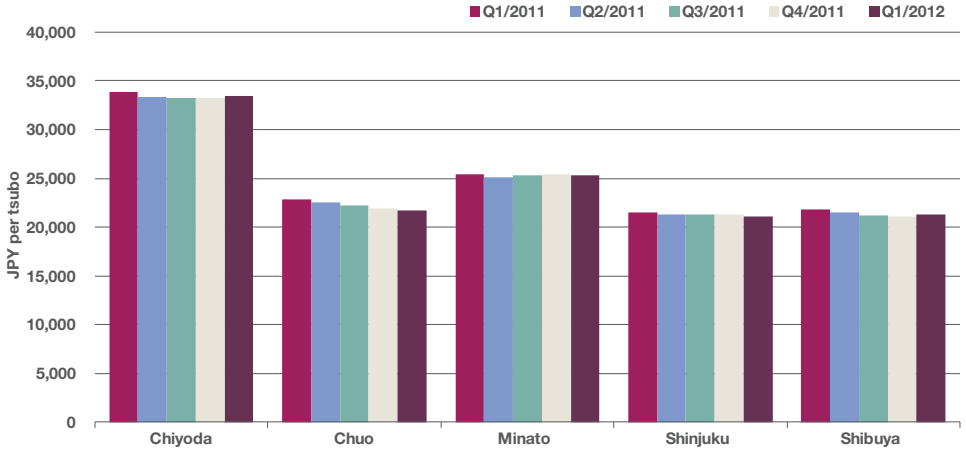
Savills monitors rents and vacancy levels in over 280 buildings located in Tokyo's central five wards with a GFA of 10,000 sq m or above. Unlike similar market information issued by other research institutions, the rental data provided relates to estimated passing rents as opposed to asking rents, whereas 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.

Short-term market outlook

Average Grades A and B passing rents are now at historical lows and the scope for further rental discounting is limited. That said, the majority of tenants remain reluctant to increase occupancy costs in the current uncertain economic climate. Generous incentive packages in the form of free-rent periods and contributions towards relocation or fit-out costs continue to be offered by landlords across the market. This trend is expected to last through the course of the year as landlords seek to fill vacancies, both in existing stock and newly constructed properties.

GRAPH 3

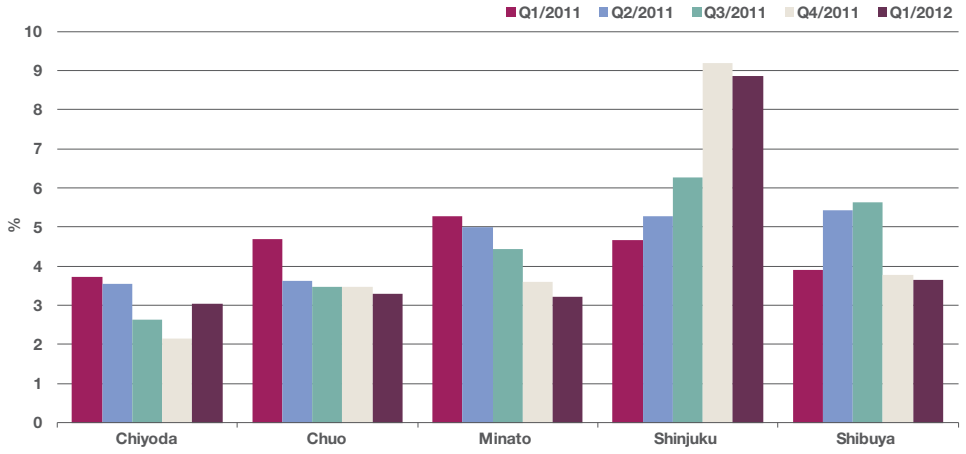
Average Grade A rents by ward, Q1/2011–Q1/2012



Source: Savills Research & Consultancy

GRAPH 4

Average Grade A vacancy rates by ward, Q1/2011–Q1/2012



Source: Savills Research & Consultancy

An estimated 1.1 million sq m of new office floor space is scheduled to complete in Tokyo's central five wards during 2012, of which an estimated 810,000 sq m can be defined as net rentable area. Interviews with landlords and tenants suggest that over 60% of this new supply is subject to pre-commitments. As such, the volume of vacant rentable space due to come online is reduced to around 300,000 sq m – a level which is considered to be absorbable in the near term given recent leasing activity levels. The average Grade A vacancy rate is, however, expected to shift upward moderately going into the second half of the year, with pockets of oversupply in certain submarkets.

Barring any significant external shocks, the impact of the planned new supply on prime rents in 2012 is expected to be limited. Extensive leasing incentives will, nonetheless, remain an often-deployed tool to attract tenants to large contiguous vacant spaces.

A proportion of the secondary space vacated as a result of office relocations and upgrades will inevitably come off the market, as outmoded properties become the focus of redevelopment projects. Heightened market bifurcation is, however, anticipated. The ongoing flight to quality, fed by competitive pricing and drivers such as those listed previously, will be at the expense of lower-Grade B and Grade C properties, which are likely to see continued

pressure on rents and occupancy levels in the short to mid term.

Tokyo investment market

Large property transactions picked-up in number compared with the preceding quarter in Q1/2012, spurred in part by investors' desire to close deals before the end of the financial year. Investment appetite was also bolstered by a pick-up in business sentiment, prompted by a temporary easing of concerns relating to the European debt crisis and a moderate weakening of the yen.

Major domestic corporations, developers and blue-chip J-REITs accounted for the buyers in most landmark transactions in the first quarter. The largest purchase comprised Sapporo Holdings' JPY40.5 billion acquisition of the 15% interest in Ebisu Garden Place held by Morgan Stanley Capital. The brewing company now owns the 284,780-sq m multi-purpose complex in Shibuya Ward outright.

Office acquisitions by developer-owners in prime locations included Mitsubishi Estate and Sankei Building's purchase of compartmentalised ownership at Otemachi Financial City North Tower in Chiyoda Ward, relating to approximately 8,412 sq m of floor space. The 110,000-sq m office development is scheduled for completion in October 2012 and the sellers were the Urban Renaissance Agency and Japan Financial Corporation. Another notable transaction saw Hulic acquire the 19,791-sq m Ginza Seven Building in Chuo Ward from publisher Recruit for JPY10.0 billion. The property was completed in 1962 and given its prime Ginza location, is likely to be redeveloped in the future.

J-REITs remained an active buying force in the market, having been involved in both direct and indirect office asset transactions. In Chiyoda Ward's prime Tokyo Station area, Japan Prime Realty purchased the 11,035-sq m site of the Otemachi 1-6 Project for JPY36.0 billion. A 70-year lease has been agreed for use of the land, on which a new 198,000-sq m high-rise office and hotel complex is due to complete in 2014. The sellers were two of the REIT's sponsor companies, Tokyo Tatemono and Taisei Corporation, and the NOI yield in the transaction equated to 3.6%. Leased-land transactions are attractive to J-REITs as depreciation expenses for buildings are not applicable; as a result, a greater proportion of rental income can be distributed back to investors through dividends.

A more typical property transaction saw J-REIT Nippon Building Fund acquire an approximate 38% interest in Higashi Gotanda Square, a three-year-old, 27,564-sq m property in Shinagawa Ward, from its sponsor Mitsui Fudosan. The price tag in the transaction was JPY8.3 billion, which equates to an expected NOI yield of 5.1%.

The largest reported Tokyo office acquisition by an overseas investor in Q1/2012 involved the 62,540-sq m Kioicho Building in Chiyoda Ward. US-based fund Angelo Gordon and Orix Real Estate acquired compartmentalised ownership in the building and land equivalent to just over 70% of the entire property, with the latter reported to have been a minority interest partner. The 26-storey office-led tower was completed in 1989, while the transacted ownership had originally been purchased by the seller, Mori Building, from Morgan Stanley back in May 2008.

Although in many cases a gap between buyer and seller pricing expectations remains an impediment in negotiations, the number of core/core-plus investors actively seeking new acquisitions in Tokyo appears to be steadily increasing. In addition to domestic real estate companies, corporations and listed funds, which have been the mainstay of investment activity in recent years, demand from overseas groups, particularly private funds, is expected to heighten over the coming quarters. The main catalyst of this momentum is the general view that the market is at or close to its nadir, therefore presenting scope for future growth.

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