savills

Briefing
Office sector

Q2 2012

Image: Marunouchi, Chiyoda Ward

SUMMARY

With the Grade A market seemingly at bottom, an increasing rental cost divergence between prime and secondary stock may be expected going forward.

- As witnessed in Q1/2012, the leasing market remains active, resulting from the combination of historically low rents and robust demand for consolidation space.
- Rents for Grade A space experienced a quarterly increase of 0.4% – their first since Q1/2008 – whereas Grade B rents slipped by 0.1% over the same period.
- Quarterly rental growth was recorded in three of the central five wards, equivalent to 0.1% in Chiyoda, 0.4% in Shinjuku and 2.4% in Shibuya.
- Due to the sheer quantum of Grade A office projects completed during the quarter, prime vacancy jumped to a new high of 7.0%. The Grade B vacancy rate meanwhile remained flat at 5.4%.
- At the ward level, Grade A vacancy rates rose in three of Tokyo's central five wards. This trend was most prominent in Shinjuku where vacancy reached 16.4%. Despite this, both Chuo and Shibuya saw vacancy rates move in by 50 and 40 bps respectively.
- Q2 saw strong investment interest from overseas funds and J-REITs, however a lack of suitable product combined with an expectations gap has kept volumes in check.

"Average Grade A rents rose marginally within Tokyo's CBD for the first time in four years while investment activity was sustained through Q2/2012. With new supply peaking over the quarter, the vacancy rate for prime office space meanwhile jumped 2.1 ppts QoQ. This looks set to fall back over coming quarters as new supply recedes." Savills Research & Consultancy

Tokyo leasing market

Introduction

Grade A rents[1] in Tokyo's central five wards[2] appear to have finally reached their nadir, having crept, albeit marginally, into positive territory in the second quarter. After falling some 51% from the peak of Q2/2007, passing rents are now at a historical low. This combined with the incentive packages currently on offer for new lease agreements, presents an opportunity for many tenants to upgrade premises in terms of grade or location, unencumbered by a heavy rent increase. Indeed, for tenants with leases signed during previous up-cycles, a considerable reduction in fixed occupancy costs is likely achievable.

Although average passing rents at prime buildings look to have hit bottom, Q2/2012 represented a new peak in Grade A supply, with several large-scale properties coming online with multiple vacant floors. This so-called 'tenant's market' therefore looks likely to continue in the near term as pent-up demand from existing Tokyo occupiers chips away at the newly supplied vacant stock.

For more detailed commentary on current leasing demand drivers, please refer to our Q1/2012 publication.

Recent leasing activity

Healthy volumes of leasing activity continued to be seen in Q2/2012, with mid-to-large scale deals characterised by tenants taking space to facilitate headquarters relocations. Many of these deals involved the consolidation of corporate divisions separated across multiple locations or offices split across floors. Examples of floor space expansions meanwhile demonstrated a notable increase, as corporate occupiers took advantage of the competitive rents on offer to facilitate natural growth that has been curtailed since the global financial crisis.

As in recent quarters, many of the larger leases were signed at new or recently completed Grade A properties. These have been situated predominantly in the traditional central five ward CBD area but also at prime developments in the surrounding wards.

The largest publically reported leasing transaction of the second quarter saw Morgan Stanley MUFG Securities take approximately 33,000 sq m of space at the Otemachi Financial City South Tower in Chiyoda Ward. The brand new 35-storey office tower has a total floor area of 132,500 sq m and is scheduled to complete in September this year. It is reported that the company will move to the new location in early 2014 from its current base at Yebisu Garden Place Tower, a 40-storey office tower in Shibuya that was completed in 1994.

Also moving to the Otemachi Financial City South Tower is audit company KPMG Azsa LLC, which took 16,770 sq m for its new headquarters. The company will relocate offices from the 10-year-old Tokyo Sankei Building in Otemachi and the Azusa Center Building in Tsukudocho, Shinjuku Ward.

Another tenant planning to vacate from the Tokyo Sankei Building and elsewhere is SAP Japan, who agreed to take the entire Sumitomo Fudosan Hanzomon Ekimae Building in Kojimachi, Chiyoda Ward, for its new head office. The 17,236 sqm building was completed in March 2011 and around 900 of the German software development company's Japan-based staff are expected to work there. The relocation will also see staff move from the company's office at Across Shinkawa, an 18-year-old office building neighbouring Chuo Ward.

Rents and vacancy: Tokyo central five ward area

According to comprehensive property surveys conducted by Savills, the average passing rent for Grade A offices in Tokyo's central five wards stood at approximately JPY24,670 per tsubo[3] per month. This figure represents its first quarterly rise since Q1/2008, albeit by a nominal rate of 0.4% QoQ. On a YoY comparison, the estimated average prime rent remained virtually flat, slipping just 0.3% from Q2/2011.

The average passing rent for Tokyo's Grade B market[4] stood at

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 = 3.306 sq m or 35.583 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 that do not fit this definition.

TABLE 1

Notable office leasing transactions, Q2/2012

Company	Former location(s)/ward(s)	New location/ward	Approximate space taken		Type
			tsubo	sq m	
Morgan Stanley MUFG Securities	Yebisu Garden Place Tower/Shibuya	Otemachi Financial City South Tower/ Chiyoda	10,000	33,060	HQ relocation
SAP Japan	Tokyo Sankei Building/Chiyoda; Across Shinkawa Building/Chuo	Sumitomo Fudosan Hanzomon Ekimae Building/Chiyoda	5,214	17,236	HQ relocation/ expansion/ consolidation
KPMG Azsa LLC	Tokyo Sankei Building/Chiyoda; Azusa Center Building/Shinjuku	Otemachi Financial City South Tower/ Chiyoda	5,073	16,770	Consolidation
Kawasaki Heavy Industries	World Trade Center Building/Minato; Kawasaki Heavy Industries Tokyo Office/Koto	Hamamatsucho Building (tentative name)/Minato	4,790	15,836	Consolidation
Cyber Agent	Various/Shibuya	Sumitomo Fudosan Shibuya Garden Tower; Shibuya First Place/Shibuya	3,540	11,700	Consolidation/ expansion
TOTO	Sakura-Shinmachi Building/Setagaya; Toranomon Building/Minato; TOTO Shinjuku Building/Shinjuku	Shiodome Building/Minato	3,366	11,128	Consolidation

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

approximately JPY18,890 per tsubo per month in Q2/2012. This represents a quarterly decline of 0.1% and a fall of 1.1% YoY. Although rental depreciation persisted, the rate of decline over the same period of the preceding year moderated for the eleventh consecutive quarter.

Reflecting the completion of a handful of large Grade A office projects during the quarter, the average Grade A office vacancy rate jumped by 2.1 ppts during Q2/2012 to a new high of 7.0%. Average vacancy in Grade B properties meanwhile remained flat at approximately 5.4%. In terms of YoY movement, the Grade A vacancy rate increased by a margin of 2.5 ppts, whereas vacancy in the Grade B market shifted inwards by approximately 82 bps. However, unlike Grade A properties that are expected to recover from this temporary increase in vacancy, lower quality space is likely to suffer over coming quarters, lagging the trend in prime buildings as property upgrades lead to secondary space being released back to the market.

Ward-level analysis: Grade A rents

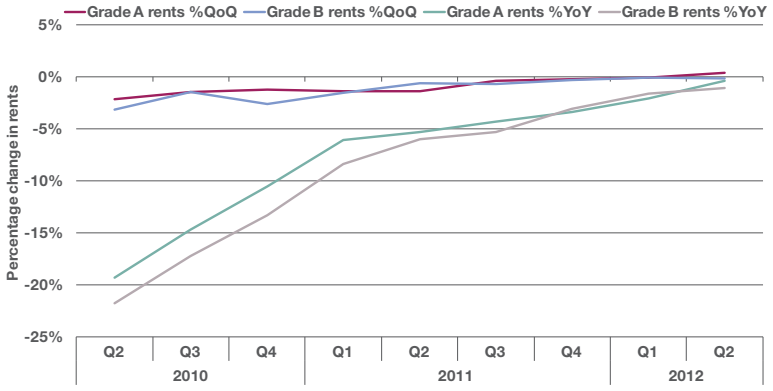
Grade A office rental movement at the ward level was most notable in Shibuya, where estimated passing rents increased 2.4% QoQ to reach approximately JPY21,830 per tsubo. This rise can be principally attributed to the completion of Tokyu Land's landmark Shibuya Hikarie building, which acted to bolster the rental average across this survey area.

The quarterly rental variance in the other four core commercial wards was more moderate. Chiyoda and Shinjuku wards recorded nominal rental growth equivalent to 0.1% and 0.4% respectively, with new large office completions similarly pulling up average rental levels for the submarkets as a whole. By contrast, average rents in Minato and Chuo wards marginally remained in negative territory, dipping by 0.4% and 0.6% respectively from the previous quarter.

Prime office space in Chiyoda Ward, Tokyo's most expensive location on average at JPY33,535 per tsubo, maintained a 33% premium over the remaining four central wards. This rental premium has move out approximately 80 bps from the second quarter of 2011, partly as a result of the high rents being commanded by new developments completed in the ward. Rents in the second most expensive ward, Minato, stood at around JPY25,295 per tsubo in Q2/2012, averaging around 25% lower than Chiyoda.

GRAPH 1

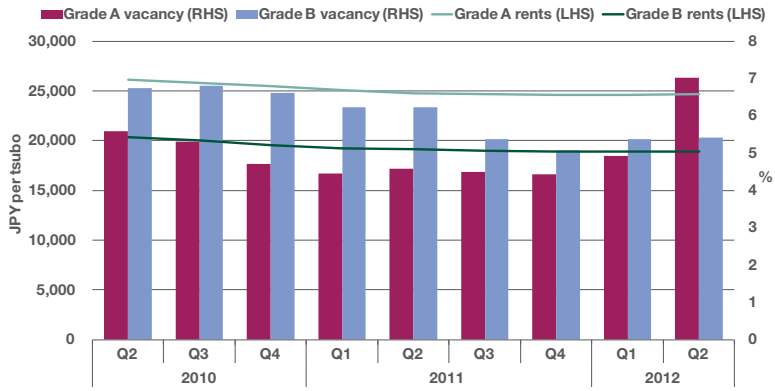
Percentage change in Grade A and B office rents in Tokyo's central five wards, Q2/2010–Q2/2012



Source: Savills Research & Consultancy

GRAPH 2

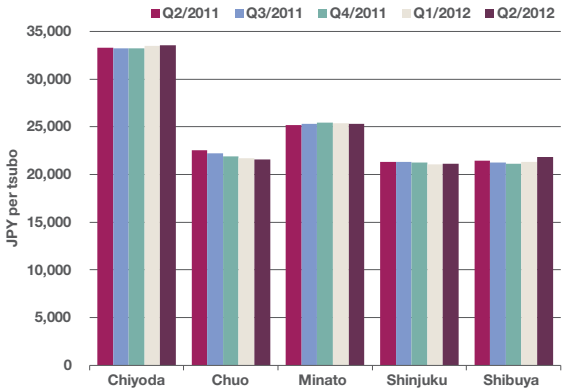
Average Grade A and B office rents and vacancy in Tokyo's central five wards, Q2/2010–Q2/2012



Source: Savills Research & Consultancy

GRAPH 3

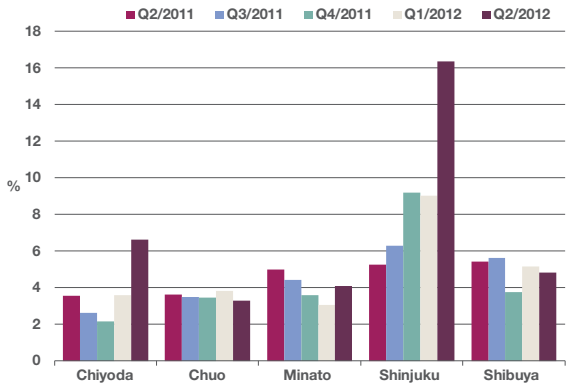
Average Grade A rents by ward, Q2/2011–Q2/2012



Source: Savills Research & Consultancy

GRAPH 4

Average Grade A vacancy rates by ward, Q2/2011–Q2/2012



Source: Savills Research & Consultancy

The most inexpensive ward in terms of Grade A space continued to be Shinjuku, where estimated passing rents averaged approximately JPY21,155 per tsubo. This is just 1.8% lower than fourth-place Chuo Ward and 3.2% below third place Shibuya Ward, where the rental average exceeded that of Chuo for the first time since Q4/2009.

Ward-level analysis: Grade A vacancy

Grade A vacancy rates rose in three of Tokyo's central five wards during the second quarter of 2012, principally due to the completion of new developments with sizable volumes of available floor space. By far the largest spike in vacancy was recorded by Shinjuku Ward, where average vacancy rose 7.3 ppts to reach a high of 16.4%. This was ascribable to the completion of Mitsubishi Estate's Shinjuku Eastside Square, which had yet to secure lease agreements for approximately 74% of its 112,000 sq m net rentable area as of Q2. One large deal to a financial institution that is expected to close in the third quarter should, however, act to boost occupancy levels here in the near term.

Elsewhere, the average Grade A vacancy rate in Chiyoda Ward rose 3.0 ppts on both a QoQ and YoY basis to reach 6.6%. This was principally attributable to the completion of Japan Post's 38-storey JP Tower development in Marunouchi in May. As of Q2/2012, over two-thirds of the multi-purpose building's 93,000-sq m net rentable area was reported as available. The overall volume of available space in Minato Ward also witnessed a rise as a result of new Grade A space coming online, moving out 1.0 ppt over the preceding quarter to 4.1%. This was spurred by the addition of around 15,500 sq m of rentable space at the new mixed-use Mita Bellju Building.

Vacancy movement in Shibuya Ward marks an interesting contrast to the three wards listed above: Despite the completion of the almost 38,000 sq m of new high-specification office space at the 34-storey Hikarie Building in April, the building's high level of pre-commitments (over 90%) combined with space coming off the market at existing schemes saw overall vacancy fall 40 bps to 4.8%. Chuo Ward, where no major schemes completed during the quarter, similarly benefited from healthy take up at existing buildings, resulting in its vacancy rate decreasing by 50 bps QoQ to 3.3%.

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.

Leasing market outlook

Q2/2012 represented a quarterly peak in new Grade A supply, both in terms of gross area completed and the volume of net available space brought to the market. Whereas an estimated 190,000 sq m of un-leased space came online at newly completed properties through the first half of the year, a lower figure of around 60,000 sq m is expected over the next two quarters. The average vacancy rate for Tokyo's central five wards is therefore expected to gradually move in from its current historical high as landlords secure new tenancy agreements amid robust leasing demand for relocation and consolidation space.

The recent tentative shift in Grade A quarterly rental movement from negative to positive territory is reflective of the strong tenant demand seen in recent months for high-quality buildings. New and existing landmark developments in some of Tokyo's most prime locations have been able to command a relative rental premium, as historically low rents across the market facilitate the 'flight-to-quality' that was kick-started by the Great East Japan Earthquake of March 2011. In the near term, continued cost-consciousness on the part of tenants combined with strong competition among landlords to fill large contiguous vacancies will likely weigh on achievable rents across the market as a whole. Incentive packages in the form of free-rent periods and contributions towards relocation or fit-out costs will also remain a marketing tool deployed by many landlords.

Research conducted by Savills suggests that historically low levels of new Grade A office completions are scheduled for 2013 and 2014, which should help to ease the supply-demand balance going forward. A degree of rental recovery in the prime market can therefore be expected in the mid-term. Heightened market bifurcation is, however, anticipated. The ongoing flight to quality, fed by competitive pricing and tightened business contingency plan (BCP) requirements, will chiefly be at the expense of lower-Grade B and C properties, which are likely to see continued pressure on rents and occupancy levels in the short-to-mid term.

Conversely, 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.

Tokyo office investment market

While Tokyo continues to attract strong interest from overseas funds, a lack of suitable product combined with a latent gap between buyer and seller price expectations has had a dampening effect on transaction volumes. This trend has been exacerbated by the degree to which forbearance has been shown towards non-performing loans by domestic lenders since the global financial crisis.

As in recent quarters, blue-chip J-REITs were the main protagonists in many of the larger transactions recorded during Q2/2012. The listed REIT sector has proven particularly competitive in the core sector, both in terms of spending capacity and their required return threshold. Moreover, J-REITs' ability to secure investment pipelines via sponsor company relationships provides them access to a range of off-market investment opportunities, overcoming the deal sourcing hurdle faced by many private investors.

The JPY170 billion transfer of 18 seed assets from developer Tokyu Land to its newly established REIT, Activia Properties, accounted for approximately 60% of all J-REIT acquisitions nationwide during the second quarter on a pricing basis. Seven of these properties were office

TABLE 2

Selected large investment transactions, Q2/2012

Month	Property	Location	Price (approx. JPY bil)	NOI yield (%)	Buyer	Seller	Related-party trade?
April	Atago Green Hills Mori Tower (sectional ownership)	Atago, Minato Ward	25.6	4.7	Mori Hills REIT	Mori Building	Yes
June	TIX Tower Ueno (sectional ownership)	Higashi-Ueno, Taito Ward	22.0	4.6	Japan Real Estate Investment Corp. (J-REIT)	SPC of Tokyo Tatemono, Itochu and Itochu Property Development	No
June	A-PLACE Ebisu Minami	Ebisu-Minami, Shibuya Ward	9.6	4.9	Activia Properties (REIT)	Tokyu Land	Yes
June	Aoyama Plaza Building	Kita-Aoyama, Minato Ward	8.8	5.0	Activia Properties (REIT)	GK Luge	Yes
June	Ebisu Tokyu Building	Ebisu, Shibuya Ward	7.4	5.4	Activia Properties (REIT)	Tokyu Land	Yes

Source: J-REITs, Savills Research & Consultancy

buildings in Tokyo that commanded a combined price tag of JPY41.5 billion. The largest individual office transferred was A-PLACE Ebisu Minami, a 12,168 sq m rental property in Shibuya Ward that was acquired for JPY9.64 billion.

Also indicative of sponsor-sourced J-REIT property transactions was Mori Hills REIT's acquisition of 45% sectional ownership in the Atago Green Hills complex in Minato Ward from its sponsor, Mori Building. The deal took the form of a JPY25.6 billion property swap, with the REIT transferring ownership in the Roppongi First Building and Ark Forest Terrace in exhange. Based on estimated NOI, the transfer price equated to an acquisition yield of 4.7%.

Separately, a large deal involving Japan Real Estate Investment Corporation demonstrates the competitiveness of J-REITs in at-arms-length transactions. In June, the Mitsubishi Estate-sponsored REIT purchased the office and retail portion of TIX Tower Ueno, an 18-storey mixed-use complex in Taito Ward, for JPY22 billion. The seller was SPC of Tokyo Tatemono, Itochu and its subsidiary Itochu Property Development, while the yield in the transaction based upon expected NOI was 4.6%.

Private equity real estate investor MGPA's purchase of eight office properties – seven in Tokyo and one in Yokkaichi City, Mie Prefecture – for a reported JPY12 billion provides an example of an alternative source of investment opportunities: defaulted CMBS structures. Moody's report that up to 700 billion yen of defaulted CMBS is due for redemption by 2014, potentially offering an entry point to investors seeking distressed or opportunistic returns.

Indeed, one such opportunity relating to the former Shinsei Bank Head Office Building in Chiyoda Ward could provide the market with a landmark transaction in the near term. Real estate asset management company Kenedix is reported to have obtained preferential negotiating rights to acquire the 62,423 sq m vacant property, offering a successful bid price of approximately JPY51 billion.

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
Associate, Japan
+81 3 5562 1736
wjohnson@savills.co.jp

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