Office

Q3/2011

"With rents at historic lows, the Tokyo leasing market remained active in the third quarter as requirements for office consolidations continued to drive demand. The earthquake-related lull in investment transactions in Q2/2011, meanwhile, proved short lived, supported by a general view that market pricing is close to its nadir."

Image: Sanno Park Tower, Chiyoda-ku, Tokyo

- Office consolidations translated into healthy take-up in the small- to medium-size bracket in Q3/2011, while new large-scale relocations remained limited.
- Quarterly rental declines continued to moderate, with average Tokyo Grade A and Grade B rents dipping by a nominal 0.4% and 0.6% respectively.
- Prime rents in Minato performed the strongest out of the central five wards, rising 70 basis points (bps) over the preceding quarter to approximately JPY25,320 per tsubo.
- The average Tokyo Grade A vacancy rate continued to see improvement, dipping 10 bps from the previous quarter to 4.5%. The average Grade B vacancy rate fell 90 bps to 5.4%.
- At the ward level, the average vacancy rate in Chiyoda fell approximately 100 bps to 2.6%. This compares to a 20-bp rise in Shibuya and a 100-bp increase in Shinjuku.
- Investment activity demonstrated a healthy increase in Q3/2011 as uncertainty relating to the natural disasters of March subsided.

Office

Tokyo leasing market update

"Japanese firms sought to actively consolidate existing offices, taking advantage of the historically low rents available"

The third quarter of 2011 continued to see strong leasing demand for office units in the small- to medium-size bands. As in Q2/2011, leasing activity was driven by requirements for consolidation space from private domestic companies and TSE-listed corporates. Such firms have sought to achieve cost efficiencies through the amalgamation of multiple existing back offices, while simultaneously taking advantage of the historically low rents and attractive incentive packages currently available to upgrade in terms of building specification or location. Although a handful of head-office relocations were announced between July and September, large-scale leasing deals for headquarters buildings remained notable by their absence. This is believed to reflect a general disinclination among domestic conglomerates and foreign institutions to commit to new landmark tenancy agreements at a time when future business outlooks are clouded by global economic uncertainty and, particularly for exporters, an unfavourably strong yen.

Seven deals were reported in Q3/2011 involving units of 4,000 sq m (1,200 tsubo[1]) or over. The largest was the Japan Nuclear Energy Safety Organization's agreement to take just over 9,000 sq m of space at Kajima Corporation's Toranomon Towers Office in Minato Ward. The incorporated administrative agency intends to consolidate two nearby offices within the 60,000 sq m, five-year-old building towards the end of the year. In neighbouring Shinagawa Ward, Canon MJ IT Holdings has taken a similar amount of space at the NRE Tennozu Building. The 25,260 sq m office building is owned by Nomura Real Estate Office Fund, a J-REIT, and was formerly leased in its entirety to Japan Airlines International until it was partially vacated in March 2011. Eight Canon Group subsidiaries consisting of around 2,500 employees will relocate to the property from six buildings spread across Tokyo, starting in late November.

New or soon-to-complete buildings accounted for several of the largest deals recorded in the quarter. Sumitomo Realty & Development's tentatively named Nishi-shinjuku 8-chome Project, a 40-storey tower totalling approximately 180,000 sq m in Shinjuku Ward, has secured a deal for around 8,000 sq m of space from Benesse Corporation. The education and publishing-related company will relocate some of its operations from its 19-year-old Sasazuka Call Center in Shibuya Ward and other locations to the building, which is due to complete in December 2011. In Minato Ward, Mitsui-Soko will occupy around 6,225 sq m at Mitsui Fudosan's residential-led Onarimon M-Square Project, which reached completion in August, while telecoms equipment manufacturer Ericsson Japan took approximately 3,300 sq m at Momento Shiodome, a 23-storey office and residential tower in Higashi-Shinbashi which was completed in March.

Notable office leasing transactions, Q3/2011

Company	Former location(s)/ ward	New location/ ward	Area		Type
			tsubo	sq m	
Japan Nuclear Energy Safety Organization	Tokyu REIT Toranomon Building, Kamiyacho MT Building/Minato	Toranomon Towers Office/ Minato	2,750	9,090	Consolidation
Canon MJ IT Holdings	Canon S Tower, etc/Minato	NRE Tennozu Building/ Shinagawa	2,740	9,050	Consolidation
Panasonic Consumer Marketing	Tennozu First Tower/ Shinagawa	Canalside Building/ Shinagawa	2,690	8,890	Space reduction/ group consolidation
Benesse	KDC Sasazuka/ Shibuya	Sumitomo Nishi-shinjuku 8-chome Project/ Shinjuku	2,400	7,934	Consolidation
Mitsui-Soko	MSC Centre Building/Minato	Onarimon M-Square/ Minato	1,883	6,225	Consolidation
Sanrio Co, Ltd	TOC Osaki/ Shinagawa	Osaki Gate City/ Shinagawa	1,200	4,000	Consolidation/ space reduction
Showa-densen	Tokyu Toranomon Building/Minato	Shiroyama Trust Tower/ Minato	1,200	4,000	HQ relocation
Ericsson Japan (Nippon Ericsson)	Koraku Mori Building/Bunkyo	Momento Shiodome/ Minato	900	1,300	HQ relocation

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

1 1 tsubo = approximately 3.3 sq m

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One older building which has been the target of leasing activity is the Canalside Building in Higashi-Shinagawa, Shinagawa Ward. Panasonic Consumer Marketing will relocate from nearby Tennozu First Tower to around 8,900 sq m of space at the property, which was completed in 1993 and has a net rentable area (NRA) of approximately 24,160 sq m. The company will be joined by another division of electronics manufacturer Panasonic Corporation, Panasonic Technical Services, which is set to move from the Shiba district of Minato Ward to a 2,300-sq m unit there in Q1/2012. The leasing announcements follow General Electric (GE) Japan's acquisition of the property from a special-purpose company of Davinci Advisors in July. At the time of transfer, all of the building's 11 stories were reported to be vacant (see 'Tokyo investment market update' below).

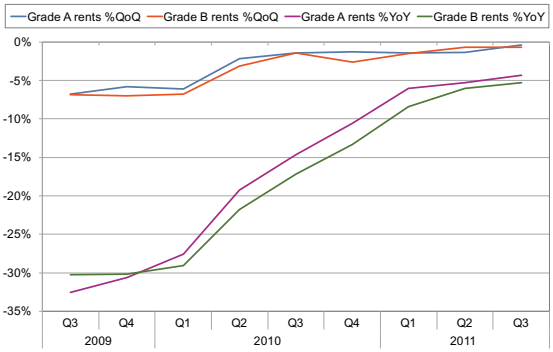
Rents and vacancy in Tokyo's central five wards

"Quarterly rental decline is now close to 0% while average vacancy rates have continued to show improvement"

According to Savills survey data, the average Grade A rent[2] for Tokyo's central five wards[3] stood at approximately JPY24,660 per tsubo per month in Q3/2011, reflecting a decline of just 40 bps over the previous quarter. This compares favourably to the 1.3% dip in rents recorded in Q2/2011 and supports the assumption that prime rental rates will level out in the short term. On average, rents in Tokyo's Grade B market[4] stood at approximately JPY19,000 per tsubo per month. This figure reflects a rental decline of 60 bps quarter-on-quarter – the same rate of decline witnessed during the preceding three-month period. On a year-on-year basis, downward pressure on achievable rental levels moderated for the eighth consecutive quarter, with Grade A rents declining by 4.3% and Grade B rents decreasing by 5.3%. This compares to declines of 14.7% and 17.2% respectively during the same quarter of 2010 and falls exceeding 30% in Q3/2009.

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) with a building age of less than 25 years. Some buildings are included that do not fit this definition.

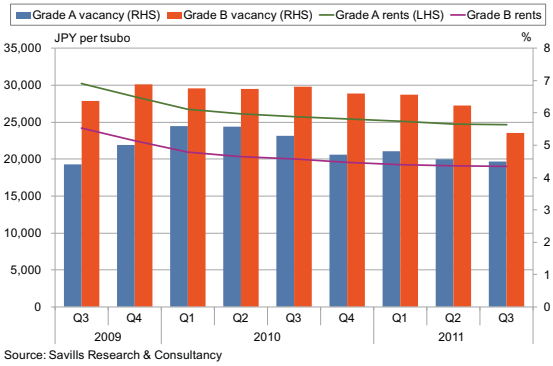
Percentage change in Grade A and B office rents in Tokyo's central five wards, Q3/2009–Q3/2011



Source: Savills Research & Consultancy

The average Grade A office vacancy rate continued to show improvement in Q3/2011, contracting by approximately 10 bps quarter-on-quarter to stand at 4.5%. Average vacancy in Grade B properties was slightly higher at 5.4%, which reflects a fall of 90 bps from the Q2/2011 figure. Year-on-year, vacancy in these markets shifted inwards by 80 bps and 144 bps respectively.

Average Grade A and B office rents and vacancy in Tokyo's central five wards, Q3/2009–Q3/2011



Source: Savills Research & Consultancy

When looking at Grade A rents at the ward level, Minato Ward performed the strongest of the central five wards in Q3/2011, with its average achievable rental figure rising 70 bps over the preceding quarter to approximately JPY25,320 per tsubo.

Rents in Chiyoda and Shinjuku wards – Tokyo's most expensive and least expensive prime office submarkets respectively – remained relatively stable during the three-month period. In the former, robust demand for premium-quality stock in this highly desirable office location largely mitigated latent downward pressure on rents. The average rental figure dipped by a marginal 30 bps to stand at JPY33,220 per tsubo.

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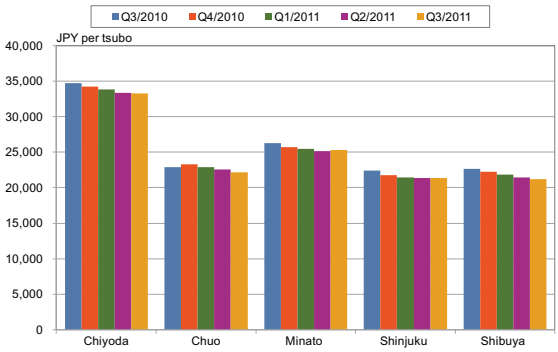
Shinjuku's average achievable rent held steady at JPY21,330 per tsubo, supported by the inclusion of newly completed Grade A space in the rental pool. By comparison, Grade A rents in Shibuya and Chuo wards fared less well, witnessing quarterly rental declines of 1.1% and 1.5% respectively. However, while depreciatory pressures are still evident in these submarkets, the rate of decline has shown signs of moderation in recent quarters.

Average Grade A rents by ward, Q3/2010–Q3/2011

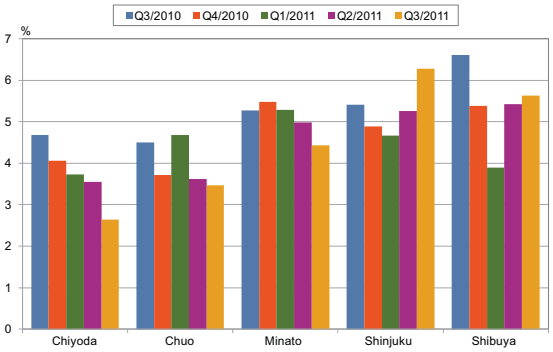


Source: Savills Research & Consultancy

Grade A vacancy rates in three of the central five wards demonstrated healthy improvement through the third quarter. In Chiyoda Ward, average vacancy fell by approximately 1 percentage point to 2.6%. This compares to a 60-bp contraction in Minato Ward, where the volume of vacant space averaged approximately 4.4%, and a 10-bp decrease in Chuo Ward, which recorded an average vacancy rate of 3.5%.

The vacancy rate trend for the more peripheral office submarkets of Shibuya and Shinjuku demonstrated an upwards trajectory in Q3/2011. In Shibuya, average vacancy rose by 20 bps to 5.6%, whereas Shinjuku's average rate rose by approximately 1 percentage point to 6.3%. This notable increase in vacant space in the latter ward can largely be attributed to the inclusion of the recently completed Shinjuku Front Tower in the property survey group. At the end of September, approximately 28,000 sq m or 49% of the total NRA in the 35-storey building was available for lease.

Average Grade A vacancy rates by ward, Q3/2010–Q3/2011



Source: Savills Research & Consultancy

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 achievable 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 update

'Investment activity demonstrated a healthy increase in Q3/2011 as uncertainty relating to the natural disasters of March subsided"

Investor appetite for Tokyo office assets demonstrated signs of a revival in the third quarter, as uncertainty relating to the natural disasters of March and the resultant power supply constraints subsided. As in recent quarters, domestic players, in particular the REITs, were the active buy-side parties in most open-market transactions. Investments conducted by J-REITs in Q3/2011 totalled over JPY176 billion; this represents an increase of around 134% over the preceding quarter and approximately 116% over the same quarter of 2010.

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The largest reported office transactions comprised a portfolio reshuffle between Mori Hills REIT and its sponsor company, Mori Building. The J-REIT purchased 6,744 sq m of space at Roppongi Hills Mori Tower (approximately 2.8% of the building's total NRA) for JPY18.68 billion. It also acquired 7,680 sq m of floor space in the ARK Mori Building (approximately 5.8% of the building's total NRA) for JPY17.2 billion. Simultaneous to the above, Mori Building took over the REIT's ownership rights in Roppongi Hills Gate Tower, a 29,112-sq m property which was completed in 2001, for approximately JPY35.86 billion. Estimated NOI cap rates for the two REIT acquisitions both equate to 4.5%, while the cap rate for Roppongi Hills Gate Tower was 4.2%, based on actual NOI as of January 2011.

While a number of overseas investment groups are reported to be gearing up to re-enter the Japanese market, office transactions involving foreign entities were limited in their number in the third quarter. Two indirect distressed property acquisitions are, however, worthy of note.

An investment vehicle of Fortress Investment Group is reported to have acquired the former head-office building of confectioner Fujiya in Ginza, Chuo Ward. The 7,560 sq m vacant property is reported to have been under the control of the lender, Citibank, and the purchase was made via recapitalisation of the existing debt structure. While the new equity investment has not been disclosed, the special-purpose company of Citigroup which originally purchased the building in 2007 is reported to have paid approximately JPY13.55 billion for the asset. Fortress is expected to reposition or redevelop the 36-year-old property in the future.

The second transaction is the aforementioned transfer of ownership rights in the Canalside Building in Higashi-Shinagawa to GE Japan (see 'Tokyo leasing market update' above). As the mezzanine lender, the Japanese arm of the US-based GE Company is rumoured to have taken over the asset after the equity holder, an entity of Davinci Advisors, failed to service its debt obligations. Leading up to the default, the 18-year-old building is reported to have been fully vacant for around one year after the former sole-tenant, NEC Networks & System Integration, relocated to Sumitomo Realty & Development's Iidabashi First Tower in Koraku, Bunkyo Ward. The new leasing deals announced in Q3/2011 to Panasonic Group companies will take the occupancy rate closer towards the 50% threshold.

Looking forward, investment activity involving both Japanese and overseas investors is expected to increase as government investment in post-quake reconstruction provides a fillip to the real economy and stimulates office demand in the short to mid term. Given the recent dearth of landmark leasing transactions, the expectation of possible pent-up demand for large-scale headquarters relocations may form part of some investors' acquisition strategies. Moreover, the wider view that the rental market is now at or near the bottom of the current cycle, and that pricing is now competitive in comparison with other regional centres, is likely to add a measure of impetus to investments going into 2012. The extent of this recovery will, however, depend greatly on the sustainable growth of both the domestic and global economies, which remain clouded by unbalanced foreign exchange markets, stock market volatility and sovereign debt worries.

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 - Macao
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, 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, Zhuhai

ASIA

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.
30 Cecil Street, #20-03 Prudential Tower, Singapore 049712
Tel: (65) 6836 6888 Fax: (65) 6836 2668
Contact: Chris Marriott E-mail: cjmarriott@savills.asia

Savills - Taiwan
Savills (Taiwan) Limited
17F-1, Exchange Square, 89 Sung Ren Road
Xin-Yi District, Taipei, Taiwan
Tel: (886) 2 8789 5828 Fax: (886) 2 8789 5929
Contact: Cynthia Chu E-mail: 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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