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Savills World Research
Japan

Spotlight
Regional Japanese office markets

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Regional Japanese office markets

"Almost fully leased markets and good fundamentals are driving hopes for rental increases. Regional cap rates will likely compress further considering yield premiums over Tokyo, where there is currently a lack of investment opportunities."

Preface: Continuous investor appetite for regional cities

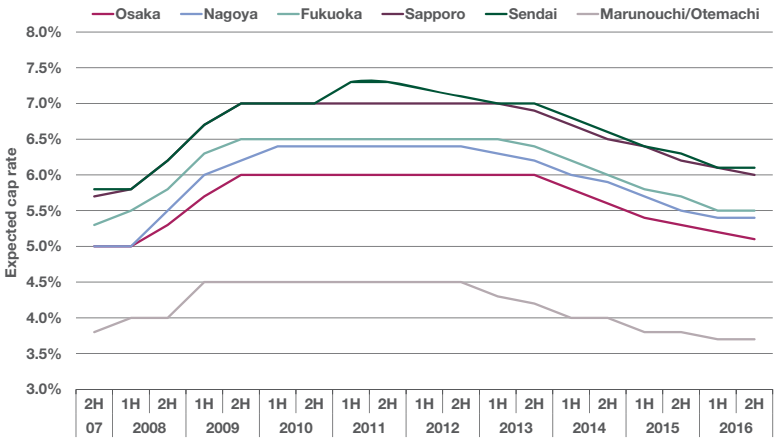
Regional cities are growing more and more popular among investors, both due to their favourable underlying fundamentals and a lack of investment opportunities in Tokyo. Both Tokyo and Japan's regional markets are currently tight, but upcoming supply pipelines show a stark contrast between the two. While many investors are concerned about an upcoming supply glut in Tokyo, leasing agents in regions such as Osaka, Nagoya, and Fukuoka are much more worried about a shortage of future supply and limited existing space. Current rental levels are encouraging developers to supply new hotels instead of offices. Improved office leasing activities and almost fully leased markets, however, are driving hope for rental increases. Steady migration to urban centres should also support this trend.

On the other hand, seasoned and cautious investors know that regional cities may suffer first when the economic cycle starts to flip. In that case, large corporations may shrink their regional operations and cover those cities from Tokyo. This might also be one of the main reasons why developers are still focusing on Tokyo despite improved fundamentals in outlying regions. Cap rates should reflect this risk, making regional investment an interesting opportunistic play.

While cap rates for prime office property in both Tokyo and outlying

GRAPH 1

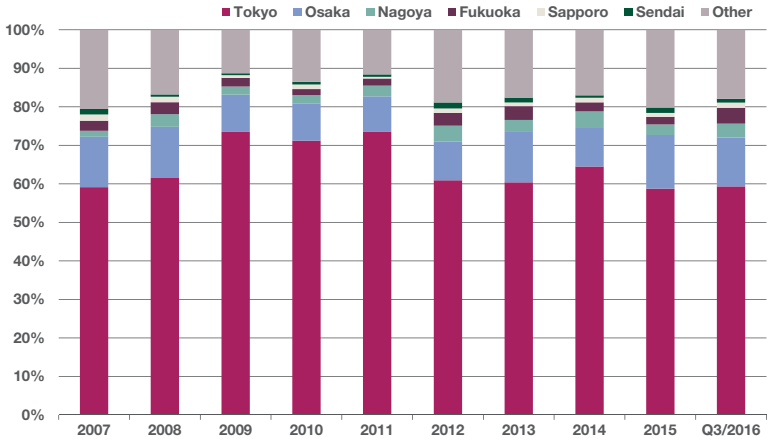
Cap rates for office buildings, 2H/2007–2H/2016



Source: JREI, Savills Research & Consultancy

GRAPH 2

Investment volumes by area for all asset classes, 2007–Q3/2016



Source: Real Capital Analytics (RCA), Savills Research & Consultancy

regions have further compressed, a semi-annual survey by the Japan Real Estate Institute (JREI) indicates that regional cap rates are still an attractive 1.0 to 2.0 percentage points (ppts) higher than in Tokyo. Regional yields could begin to close the gap as investors expand their search for promising assets. Furthermore, strong investor demand often results in actual transaction cap rates that are tighter than JREI's surveyed cap rates.

Investors are increasingly trading property outside of Tokyo. Tokyo assets historically account for about 60% of Japan's annual real estate investment; after rising above 70% in 2009-2011, Tokyo's share has fallen to 59% in 2015 and 2016, the lowest levels since 2007.

Regional markets

Vacancy continues to tighten across the country. As of October 2016, 23 of the 25 office submarkets analysed for this report saw a year-on-year (YoY) improvement in vacancy, three more than in the previous period. Many have pushed below 5% in the past twelve months, and conditions are so tight that tenant brokers are having difficulty finding space for large occupiers.

If occupancy remains firm and supply limited, rents may start to increase in a more sustainable fashion in regional prime districts.

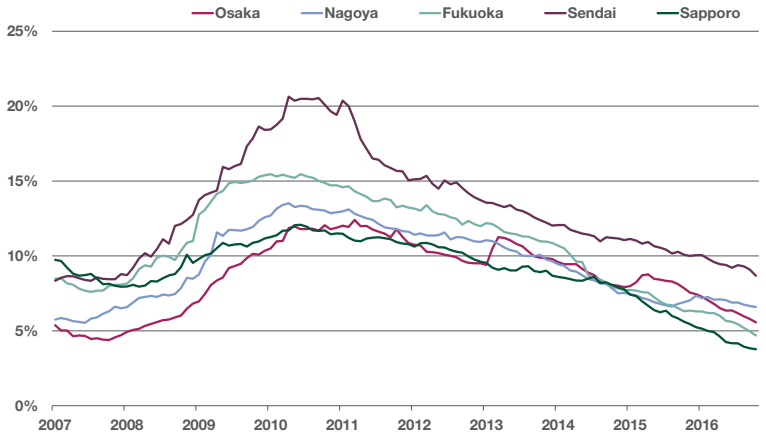
Regional labour markets are also doing well. The job-to-application ratio of all prefectures nationwide exceeded 1.0x as of October, resulting in the highest national figure in about 25 years. Tokyo leads the pack at 2.1x, and other prefectures are not far behind. A high job-to-application ratio is a sign of high demand for labour, which contributes to the office market by increasing the number of office workers and space required.

Outlook

Economic uncertainty has slowed rental growth throughout 2016.

GRAPH 3

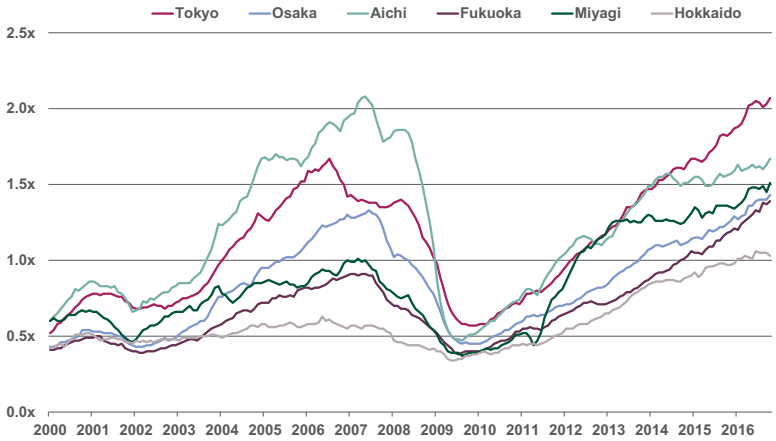
Average office vacancy rate by city, Jan 2007–Oct 2016



Source: Miki Shoji, Savills Research & Consultancy

GRAPH 4

Job-to-application ratio, selected prefectures, Jan 2000–Oct 2016



Source: Ministry of Health, Labour, and Welfare; Savills Research & Consultancy

However, current conditions in regional cities are favourable, especially in Osaka, Nagoya, and Fukuoka. Strong leasing conditions and constrained future supply should accelerate rental growth. Investors must nevertheless monitor any sign of a sudden change in trend to avoid disappointment when the market cycle flips.

Stable fundamentals, a glut of liquidity, and a lack of investment opportunities in Tokyo could direct higher volumes toward Japan's regional cities.

For concision, we have intentionally excluded unchanged background information such as key macro indicators and total office stock in each region. Please refer to the previous issue if interested.

Osaka

Osaka office market

Net Rentable Area (NRA)

Osaka's total NRA stood at 2.2 million tsubo as of October 2016. Major new supply is scheduled to slow to a crawl over the next few years. 2016 was the first no-supply year since the 1980s.

Data from Sanko Estate, a tenant broker, indicates that new supply will average just 6,600 tsubo NRA per year through 2020, less than 25% of the approximately 30,000 tsubo per year over the past decade. This supply shortage stands in stark contrast to the glut facing Tokyo and may put upward pressure on Osaka rents, or at least limit possible softness.

Shortages of large blocks of available space have created a difficult environment for large tenants to relocate, and tenant brokers are also starting to feel the squeeze. Nakanoshima Festival Tower West, scheduled for completion in 2017, will inject over 20,000 tsubo NRA into the market but conditions are expected to remain tight at least through 2020. The only other major new projects on the horizon are Shin Namba Kaikan in late 2018 and the Hankyu Hanshin Building in 2022.

Vacancy

The average vacancy rate for all districts surveyed stood at 5.6% in October 2016, down 2.3ppts from a year earlier, and the tightest figure observed since October 2008. Vacancy is tightest in Umeda at just 4.2%. It appears that occupiers are flowing northwards toward high-quality buildings near Umeda and Yodoyabashi, which could result in secondary vacancies farther south.

Vacancy is expected to remain very low, mainly due to a sharp drop in new supply. A weakening of the JPY in June, if sticky, may further improve vacancy by strengthening the profitability of FX sensitive industries and possibly fuelling expansion. Osaka's economy is now primarily driven by services, many of which cater to its burgeoning tourist population, and manufacturing still makes up 15% of local GDP.

Rent

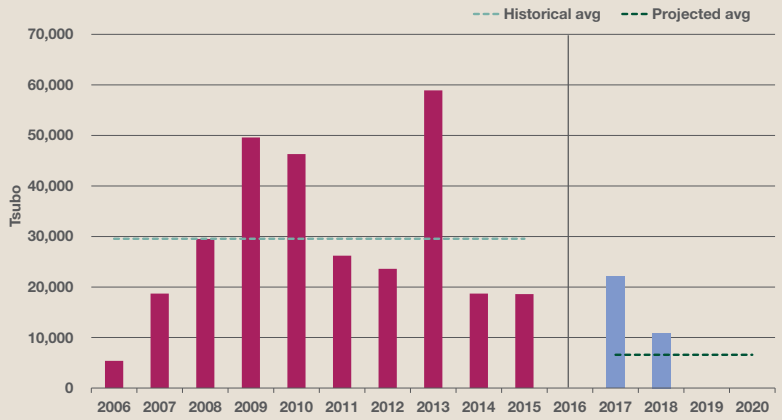
Rental growth in Osaka is mixed. Average rents across the city stood at JPY11,061 per tsubo as of October, a 0.5% decline YoY. Umeda has shown resilience, posting small but positive YoY growth in most months of 2016. Shin-Osaka has also grown, especially since August, and is up 0.5% YoY as of October. All other areas have declined marginally since October 2015. Nevertheless, tight occupancy and a fairly empty supply pipeline offer Osaka rents upside potential.

Umeda

Contract rents in Umeda and Nakanoshima are averaging from

GRAPH 5

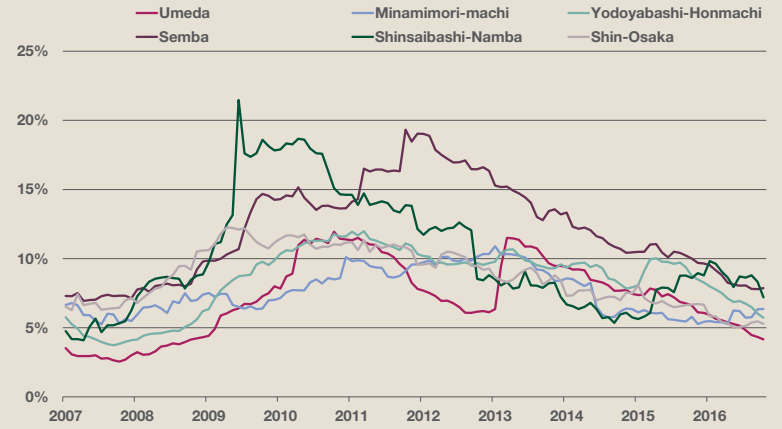
New NRA office supply in Osaka, 2006–2020E



Source: Sanko Estate, Savills Research & Consultancy

GRAPH 6

Vacancy rate in Osaka by area, 2007–Oct 2016

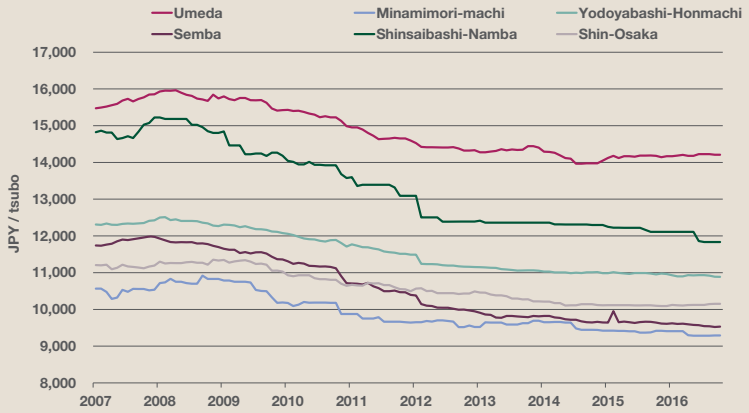


Source: Miki Shoji, Savills Research & Consultancy

Osaka (con't)

GRAPH 7

Average rent in Osaka by area, 2007–Oct 2016



Source: Miki Shoji, Savills Research & Consultancy

JPY17,000 to 28,000 per tsubo per month.

Nakanoshima Festival Tower West will have a GFA of over 45,000 tsubo. It has already been 70% pre-leased, with rents averaging in the low JPY20,000s per tsubo. Notable tenants include Teijin, Dentsu, and Asahi Beer.

Grand Front Osaka, which opened in 2013, is now essentially at max capacity 3.5 years after completion.

Yodoyabashi-Honmachi
Contract rents in Yodoyabashi and Honmachi are averaging from JPY10,000 to 21,000 per tsubo per month.

Obic, a large IT solutions provider, has announced construction of a 25-storey project partially for its own use, scheduled for completion in January 2020. The mixed-use facility will contain both office and hotel space.

Shin-Osaka
Contract rents in Shin-Osaka are averaging from JPY14,000 to 22,000 per tsubo per month.

Vacancy in Shin-Osaka is especially tight. Space is all but unavailable in large, high-quality buildings that cater to companies with national operations. Buildings such as the Nissei Shin-Osaka Building and Hankyu Shin-Osaka Building are effectively not seeking tenants. Occupiers wishing to relocate within the area are having difficulty, and some observed asking rents in high-quality buildings have increased.

Outlook
Osaka's ever-improving vacancy, now combined with a fairly empty supply pipeline, could give rents the jolt they need to resume growth. High asset prices in Tokyo have led investors to consider regional property more seriously in 2016, and Osaka is often first in line to benefit from such attention.

Nagoya

Nagoya office market

NRA

Total NRA in Nagoya stood at 1.0 million tsubo as of October 2016. As in Osaka, demand for space in prime areas such as Meieki is causing some secondary vacancies elsewhere.

The only major upcoming supply is scheduled for 2017, when JR Gate Tower and Global Gate will both commence operation. JR Gate Tower is almost fully pre-leased; however, Global Gate is suffering from construction delays in a public underground access route that Nagoya was supposed to finish simultaneously. The route, which now looks to be delayed several years, is important to Global Gate's accessibility.

Vacancy rate

Vacancy in Nagoya has been trending steadily down since 2010, and stood at 6.6% as of October 2016. This is 0.3ppts tighter than in October 2015. The vacancy rate in Meieki jumped almost two full percentage points from 4.4% to 6.3% from August to November 2015 as JP Tower Nagoya came on the market, but has since tightened slightly to 6.0% as demand for prime space continues.

It is likely that industrial titans in Nagoya such as Toyota have kept a close eye on exchange rates, but predictions of a stronger yen after the Trump election have not borne fruit. Indeed, the sudden weakening of the yen may be a boon to export oriented companies, and many appear to be ready for a stronger yen regardless.

Rent

The average office rent in Nagoya as of October 2016 was JPY10,801 per tsubo, flat YoY. Strength in Meieki and relative weakness in Nagoya's other three submarkets have on balance left Nagoya's average office rent largely stable over the past twelve months. Top observed rents in Nagoya were around JPY30,000, 7% higher than Osaka's highs of around JPY27,000 to 29,000.

Meieki's average rent increased 1.5% YoY as of October 2016 to stand at JPY12,506 per tsubo per month. Redevelopment projects such as the Chubu Nihon Building (Sakae, 2019) and the Nishiki Nichome Project (Fushimi, 2018) are also increasing the overall competitiveness of available assets.

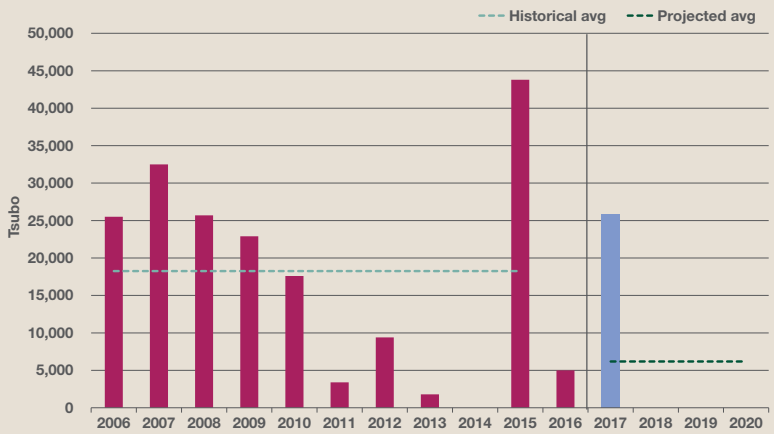
Meieki

Contract rents in Meieki are averaging from JPY13,000 to 30,000 per tsubo per month.

The completion of JR Gate Tower on November 7 added approximately 10,000 tsubo of premium NRA to the

GRAPH 8

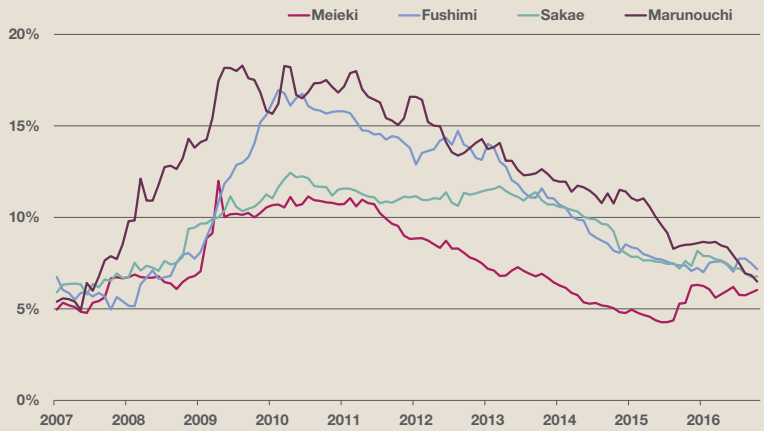
New NRA office supply in Nagoya, 2006–2020E



Source: Sanko Estate, Savills Research & Consultancy

GRAPH 9

Vacancy rate in Nagoya by area, 2007–Oct 2016



Source: Miki Shoji, Savills Research & Consultancy

Nagoya (con't)

market. Japan Rail companies have already signed leases, and the building is expected to open at full capacity with rents near the area high of around JPY30,000 per tsubo.

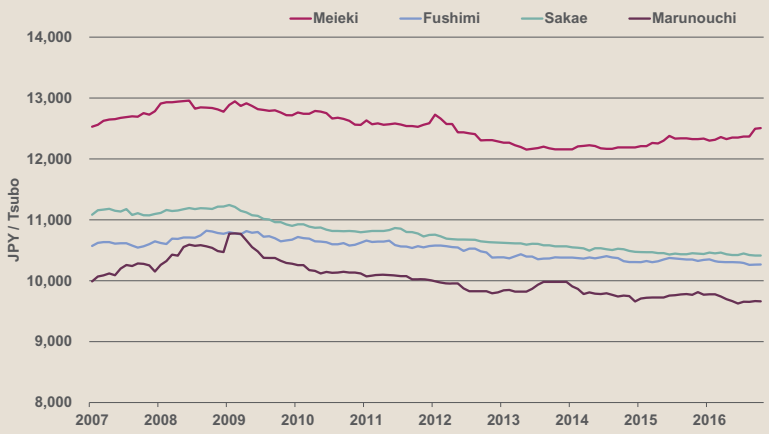
Global Gate's B2/36F west building, located south of Nagoya Station, is scheduled to open in Spring 2017. The building is only about 50% pre-leased due to the aforementioned construction delays in its surrounding infrastructure. The property may continue to struggle, but Nagoya overall currently has no major supply expected after 2017, which, like in Osaka, may further tighten vacancy and possibly give rents a boost as well.

Fushimi and Marunouchi
Contract rents in Fushimi and Marunouchi are averaging from JPY9,000 to as high as JPY20,000 per tsubo per month, though most are still currently on the lower end of that range.

Multiple companies have relocated from Fushimi and Marunouchi to high-quality space in Meieki – especially the new JR Gate Tower – causing some secondary vacancies. Leasing activity is proceeding, however, and the area is seeing take up.

GRAPH 10

Average rent in Nagoya by area, 2007–Oct 2016



Source: Miki Shoji, Savills Research & Consultancy

Sakae
Contract rents in Sakae are averaging from JPY10,000 to 18,000 per tsubo per month.

Demand for medium- and small-sized space in Sakae is driving redevelopment projects such as the aforementioned Chubu Nihon Building. Vacancy is subsequently expected to tighten further as buildings are temporarily taken off the market for construction and improvement.

Outlook
Continuously compressing vacancy and a lack of upcoming supply could result in rental increases, especially in prime areas. JR Gate Tower's rapid absorption at rents in line with area highs is a good sign of high demand. Global Gate's completion may temporarily increase vacancy, but Nagoya's strong overall market could absorb it as well.

Fukuoka

Fukuoka office market

NRA

The total size of Fukuoka's office market stands at 700 thousand tsubo. The city is seeing multiple redevelopment projects, partially driven by the government's Tenjin Big Bang initiative, which relaxed FAR requirements in the central business district. Several major redevelopment projects are planned through 2024. Vacancy is so tight, however, that some redevelopment projects are being delayed because large tenants cannot find suitable relocation space. Fukuoka is currently seeing the tightest leasing market of all surveyed major cities.

Spring 2016 saw the completion of the B3/12F JRJP Hakata Building in front of Hakata Station, adding 13,000 tsubo to the market. The building is one of the largest office buildings in Kyushu. It is operating at full capacity with rents close to the area's approximate highs of around JPY20,000 per tsubo.

Vacancy rate

Fukuoka's vacancy rate has trended sharply tighter, especially since 2014, and now stands at 4.7%. The city's strong occupancy appears set to continue. Limited upcoming supply and a positive economic outlook should drive occupiers to take up what little remaining office space there is.

Open floor space in prime areas is typically now limited to blocks of fewer than 100 tsubo. It is said that many companies have had to cancel relocation plans due to lack of adequate space, and tenant brokers are struggling to meet demand.

Average rent

The average rent in Fukuoka stands at JPY9,260 per tsubo per month, up 0.4% from a year earlier. This is mainly driven by increases in the Station Front and Gion areas. Increases are likely due in part to especially tight supply conditions in Fukuoka, which have prevented large intracity moves and therefore limited secondary vacancy. Given the large drop in supply facing both Osaka and Nagoya, it is possible that future rental movements in those cities may resemble current trends in Fukuoka.

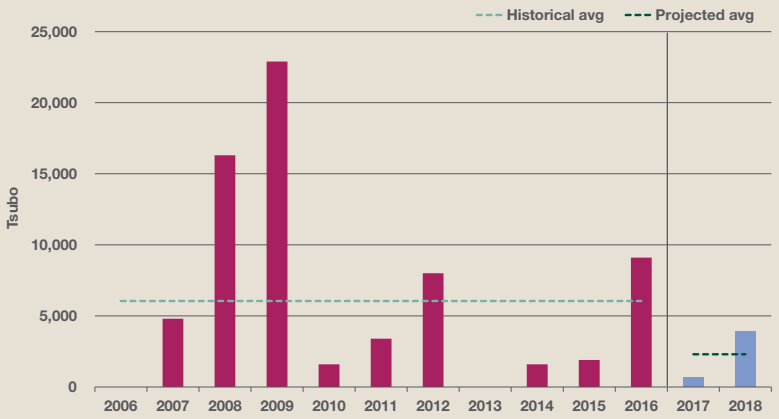
Station Front

Contract rents in the Hakata Station Front area are averaging from JPY15,000 to 20,000 per tsubo per month.

In addition to the completion of the JRJP Hakata Building earlier in 2016, renovation of the Kamiyo Hakata Building is scheduled to complete in April 2018. Additionally, JR recently purchased a large site in the area from social app company LINE and intends to construct a multipurpose facility on the plot. Completion is scheduled for 2019.

GRAPH 11

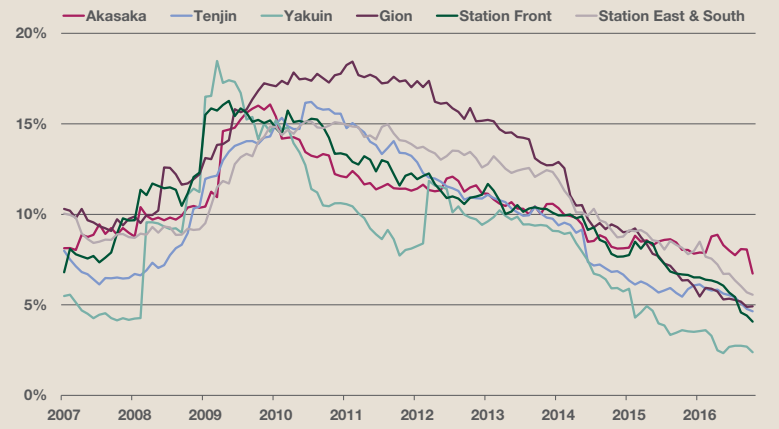
New NRA office supply in Fukuoka, 2006–2018E



Source: Sanko Estate, Savills Research & Consultancy

GRAPH 12

Vacancy rate in Fukuoka by area, 2007–Oct 2016



Source: Miki Shoji, Savills Research & Consultancy

Fukuoka (con't)

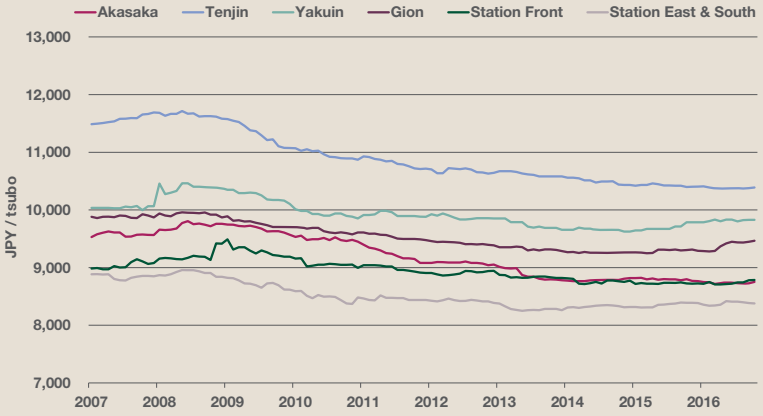
Tenjin
Contract rents in Tenjin are averaging from JPY10,000 to 20,000 per tsubo per month.

Tenjin is expected to undergo significant redevelopment through the local government's Tenjin Big Bang initiative. One landmark project is the construction of the new Tenjin Business Center, which is scheduled to complete in 2020 with a standard floorplate of 700 tsubo. It will occupy the site previously harbouring the Nishi-Nippon City Bank. Railway company Nishitetsu has also revealed plans to combine the Fukuoka Building and the adjacent retail complex Tenjin Core into one large development. Plans may be delayed, however, because current tenants are having difficulty finding suitable space to relocate to.

Bidding is also scheduled to begin in early 2017 for the site of the former Daimyo Elementary School, located in a strategic downtown district.

Outlook
Fukuoka's office market appears to have a promising future. The city has a strong demographic story, boasting the fastest growing population of all ordinance-designated cities in Japan – it recently supplanted Kobe as the country's fifth largest – and Fukuoka's local government is working hard to attract interest through initiatives like its Tenjin Big Bang project. The number of registered businesses operating in Fukuoka expanded by 7% in FY2015, more than in any other designated city. Recent events such as the Kumamoto earthquake and the Hakata sinkhole have not noticeably softened rents or occupancy, illustrating the market's resilience.

GRAPH 13
Average rent in Fukuoka by area, 2007–Oct 2016



Source: Miki Shoji, Savills Research & Consultancy

Sendai

Sendai office market

NRA

As of October 2016, Sendai's office market totalled 460 thousand tsubo, about half the size of that of Nagoya and one quarter of Osaka's market. Sendai has seen little change in NRA since the Great East Japan Earthquake in March 2011. The city as a whole has recovered admirably since the quake; however, there is still a shortage of demand in some areas and it is unlikely that developers will prioritize large-scale projects in Sendai until occupancy climbs solidly toward 95%. It is currently at 91.3%.

Vacancy rate

Sendai's citywide vacancy rate sits at 8.7% as of October 2016. Vacancy improved significantly immediately following the earthquake in 2011, especially in the Station East area. This was due to a sudden demand for call centres and conference space by relief organisations and businesses displaced from the surrounding areas. This demand was largely temporary, however, and vacancy increased again in late 2012 as some immediate relief efforts subsided.

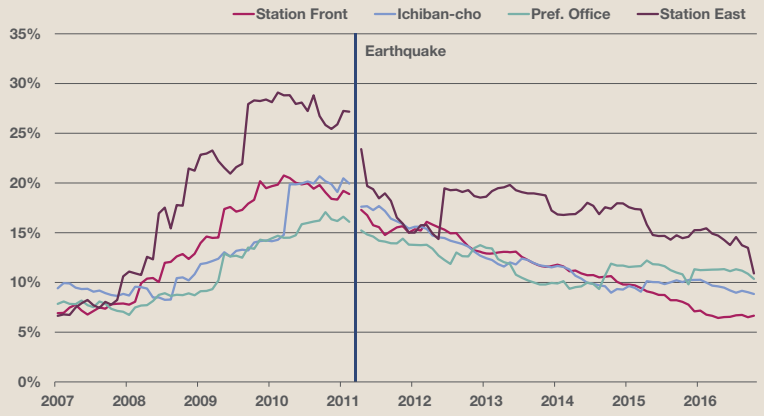
The Station East area noticeably outperformed the other three areas over the past 12 months, strengthening an additional 3.6ppts to 10.9%, though it still shows the highest vacancy rate of all districts surveyed across all five cities.

Average rent

Average rent in Sendai stood at JPY8,974 per tsubo per month in October 2016, representing a YoY decrease of 0.8%. Relatively ample vacancy compared to Japan's other cities indicates that landlords have limited pricing power. If Sendai follows the same pattern as Japan's other major cities, we should expect to see vacancy rates improve another few percentage points before rental rates can see meaningful gain.

GRAPH 14

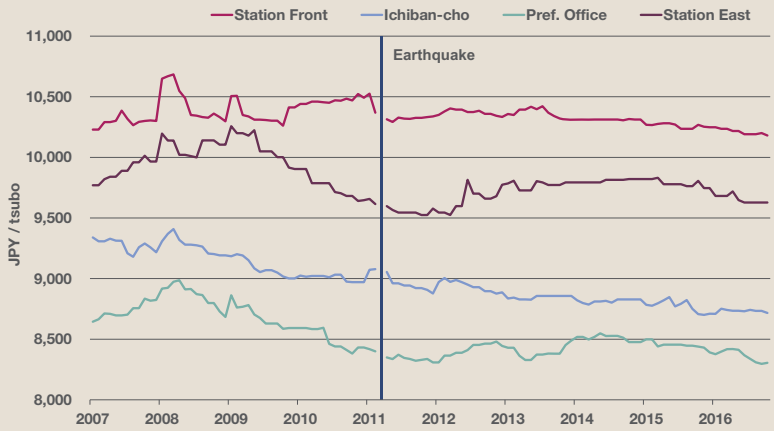
Vacancy rate in Sendai by area, 2007–Oct 2016



Source: Miki Shoji, Savills Research & Consultancy

GRAPH 15

Average rent in Sendai by area, 2007–Oct 2016



Source: Miki Shoji, Savills Research & Consultancy
*No data available for March 2011

Outlook

The Great East Japan Earthquake hit Sendai the hardest in 2011, and as such the city's office market has faced a doubly difficult uphill climb following the 2008 financial crisis. Sendai's long-term prospects are nevertheless positive as the Tohoku region's largest hub. The Japan Real Estate Institute reports that land prices, asset prices, and investment by local real estate companies have all slightly risen in recent years, indicating that Sendai may now be on a gradual road to growth.

Sapporo

Sapporo office market

NRA

The total NRA available in Sapporo's five major office districts totals 510 thousand tsubo as of October 2016. Small annual increases have continued since 2011, growing the market 2.6% since the financial crisis. Such additions appear to be tapering off, however, and Sapporo is now facing the same supply shortage as in other regional cities. The area is enjoying attention from hotel developers hoping to capitalise on Japan's burgeoning inbound tourism, but office supply is tight.

Vacancy rates

Sapporo's average vacancy rate stands at 2.7% in October 2016, tightening an impressive 2.5ppts since the beginning of 2015, when it first compressed below 5%.

Vacancy in the Odori-koen, Station Front, and Minami 1-jo areas are now all below 4.0% at 3.8%, 2.8%, and 2.0% respectively. Sapporo's downtown areas are nearing max capacity and there is very little room for further improvement in vacancy. Tenants that wish to move are having difficulty finding available space.

Average rent

The average rental rate in Sapporo was JPY8,242 per tsubo per month as of October.

Sapporo's rental growth has expanded to include all districts. The city's growth is driven by the Odori-koen, Minami 1-jo, and Kitaguchi areas, all of which have posted gains in excess of 1.0% in 2016. Rents remain lowest in the Sosei River and Kitaguchi areas, which reflect their higher vacancy rates.

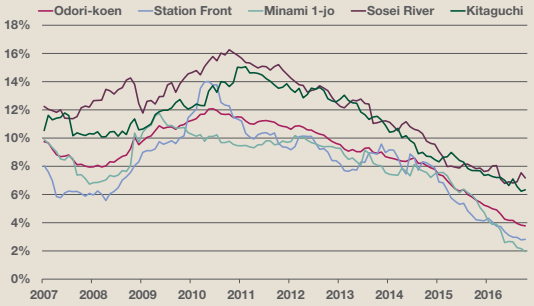
Outlook

Sapporo's occupancy conditions are the tightest among all cities surveyed, with three areas below 4.0% vacancy. These conditions are pushing rents up.

Commercial land prices in Sapporo also increased 3-6% in Q3/2016, more than in Greater Tokyo and Greater Osaka, according to a quarterly government survey. The opening of the new Hakodate Shinkansen station in early 2016 is also expected to stimulate travel to the region and ultimately supply 200,000 new jobs to major cities in Hokkaido. It is expected to reach Sapporo in 2030.

GRAPH 16

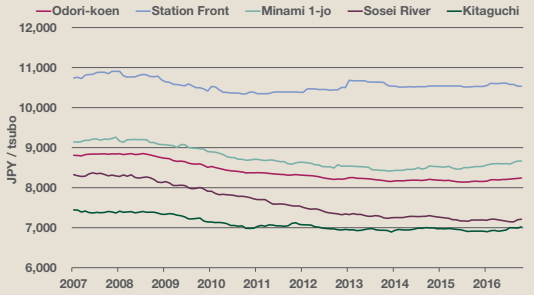
Vacancy rate in Sapporo by area, 2007–Oct 2016



Source: Miki Shoji, Savills Research & Consultancy

GRAPH 17

Average rent in Sapporo by area, 2007–Oct 2016



Source: Miki Shoji, Savills Research & Consultancy

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