savills

Briefing
Office sector

Q2 2017

SUMMARY

Average rents in the C5W extended gains through Q2/2017 as occupancy held steady. Pre-leasing activity is better than originally anticipated.

- Occupiers are so far showing strong demand for new projects. The five biggest leasing deals announced in Q2 were all for space in brand-new buildings.

- Average passing rents for Grade A office space in the central five wards (C5W) strengthened to JPY32,374 per tsubo[1] per month, representing a 0.7% rise quarter-on-quarter (QoQ) and a 2.5% increase year-on-year (YoY).

- The average Grade A office vacancy rate in the C5W held steady at 2.5%, representing a loosening of 0.9 percentage points (ppts) YoY.

- Average passing rents for large-scale Grade B office space rose to JPY24,506 per tsubo, climbing by 0.5% QoQ and 1.9% YoY.

- The average vacancy rate for large-scale Grade B office properties tightened by 0.2ppts QoQ and 0.8ppts YoY to 1.5%.

1 1 tsubo = 3.306 sq m or 35.583 sq ft

"Rental growth has exceeded expectations for the first half of 2017 as strong demand has led to voracious absorption of new supply. There is still much more supply ahead, and tertiary vacancy is a concern, but takeup has thus far held strong." Savills Research

Grade A offices

Grade A office fundamentals are holding strong in spite of Tokyo's imminent influx of new supply. Occupiers are competing for new, high-grade space, and landlords are gradually filling new projects. Occupancy in the city's established stock remains very tight. Other than a few temporary availabilities around Minato and Chiyoda, Tokyo's 2.5% vacancy is almost entirely contained in new projects that have come online in late 2016 and early 2017. Landlords have seen little reason to decrease rents.

As a result, rents continue to climb, albeit more slowly than in the first quarter. Grade A office rents strengthened to JPY32,374 per tsubo per month, representing a 2.5% increase YoY and a 0.7% increase QoQ. Chuo and Shinjuku led the pack with respective YoY increases of 4.8% and 4.4% primarily due to increases in the first quarter of 2017. All five wards posted additional QoQ growth in Q2.

Large-scale Grade B offices

The average vacancy rate for large-scale Grade B office[1] properties remains extremely tight at 1.5%. This is another new record for the tightest Grade B vacancy rate since we started our survey in 2008. Both Shinjuku and Shibuya are seeing vacancy rates of just 0.7%, reflecting their extremely tight supply situations and popularity.

Grade B rental growth continues at a slow and steady pace. The average monthly rent for large-scale Grade B properties was JPY24,506 per tsubo in Q2. This represents a QoQ gain of 0.5% and a YoY gain of 1.9%. Grade B rents appear to be growing at roughly the same pace as Grade A rents.

Grade A rents and vacancy rates by ward

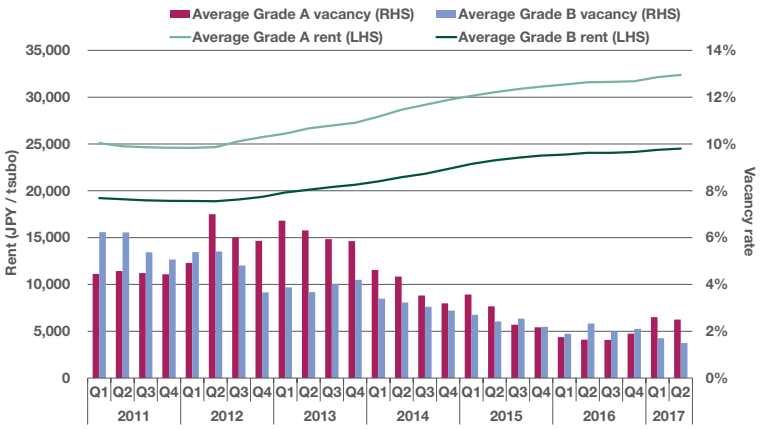
Chiyoda

The Grade A vacancy rate in Chiyoda was 2.6% in Q2, a softening of 0.5ppts QoQ and 1.2ppts YoY. This softening is due to the opening of Otemachi Park Building and Hibiya Park Front, which are both about 50% leased and filling gradually. The average Grade A passing rent in Chiyoda stood at

1 "Large-scale Grade B office" refers to buildings with a GFA of 4,500 tsubo (15,000 sq m) and a building age of less than 25 years. Some buildings are included that do not fit this definition.

GRAPH 1

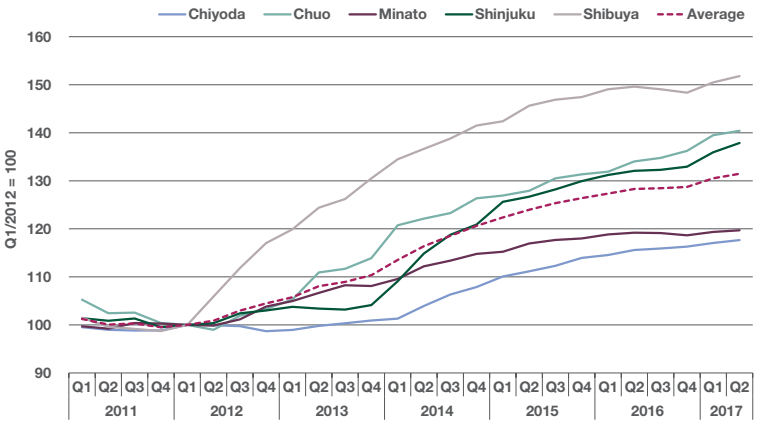
Office rents and vacancy in Tokyo's C5W*, 2011–Q2/2017



Source: Savills Research & Consultancy
* Chiyoda, Chuo, Minato, Shibuya, and Shinjuku.

GRAPH 2

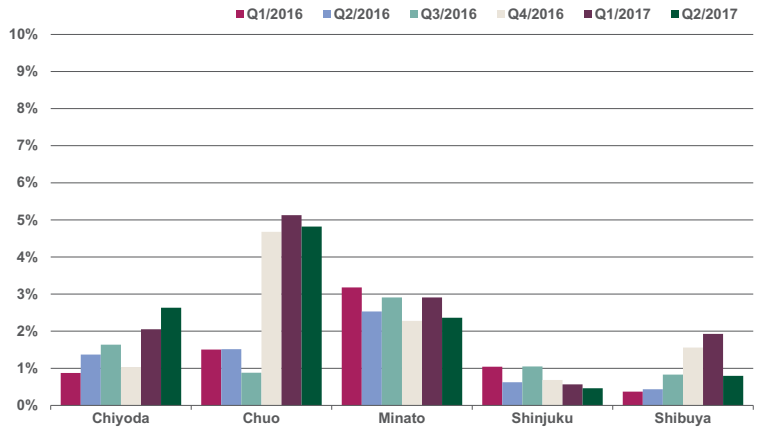
Grade A office rental index by ward, 2011–Q2/2017



Source: Savills Research & Consultancy

GRAPH 3

Grade A office vacancy by ward, 2016–Q2/2017



Source: Savills Research & Consultancy

JPY39,555 per tsubo, increasing by 0.5% QoQ and 1.8% YoY.

Relocation activity in and out of Chiyoda was subdued in Q2. The Nikkei reported only six significant leasing transactions, five of which were below 500 tsubo. Occupiers nevertheless displayed an interest in new buildings, with IT developer Lockon leasing a floor or the newly completed X-Press Yurakucho, and Granvista Hotels also taking a floor of the new S-Gate Otemachi Kita.

Chuo
Chuo's average Grade A vacancy rate tightened 0.3ppts from its Q1 peak to sit at 4.8% in Q2. This is still 3.3ppts looser YoY, as Kyobashi Edogrand and Ginza Six gradually fill their remaining space. Rents in Chuo strengthened 0.7% QoQ and 4.8% YoY due to the opening of those buildings. The average Grade A passing rent in Chuo currently stands at JPY30,426 per tsubo.

Dai-ichi Life Insurance leased almost 2,000 tsubo in Ginza Six, while Alibaba.com Japan, Erex, and Yamato Material leased a few hundred tsubo each in Kyobashi Edogrand.

Minato
Average Grade A vacancy in Minato tightened 0.5ppts QoQ and was virtually flat YoY at 2.4%. Grade A rents strengthened 0.3% QoQ and 0.4% YoY to JPY30,327 per tsubo. Persistent vacancy in a few large buildings has kept rental increases slow, though these vacancies are gradually filling.

Minato's looser vacancy and nearly-complete Grade A developments have made it a hotbed of leasing activity. GlaxoSmithKline and Saison Information Systems are reportedly leasing a combined 5,000 tsubo in Akasaka Intercity Air. Creative staffing company Creek & River is meanwhile taking all eleven rental office floors of Mori Building and Obayashi's new Shinbashi 4-chome Project for a total of 2,800 tsubo.

Shibuya
At just 0.8% vacancy, Shibuya lags only Shinjuku for the title of tightest Grade A office market in Tokyo. Vacancy is an impressive 1.1ppts tighter QoQ but 0.4ppts looser YoY. Grade A rents increased 0.9% QoQ and 1.5% YoY to JPY32,429 per tsubo.

Shibuya currently makes up less than 10% of Tokyo's leasable office stock, and as a result tenant activity is relatively limited. KDDI's e-commerce subsidiary announced plans to lease 400 tsubo in the brand-new Shibuya Cast, however, which is now leased to capacity. Tenants have been decided for essentially all of Shibuya's major supply until 2020.

Shinjuku
Shinjuku's Grade A vacancy rate tightened by 0.1ppts both QoQ and

TABLE 1

Major tenant relocations, announced Q2/2017

Origin						Destination	
Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other		
5	12	10	4	3	15		
1	2	1		1	1	6	Chiyoda
2	6			1	1	10	Chuo
2	4	8	2	1	2	19	Minato
			2			2	Shibuya
					2	2	Shinjuku
		1			9	10	Other

Source: Nikkei RE, Savills Research & Consultancy

TABLE 2

Notable office leasing transactions, Q2/2017

Company	Business sector	Type	Previous building and ward	New building and ward	Approximate space	
					tsubo	sq m
Sega Sammy	Gaming	Relocation	Various Various	Nishi-Shinagawa 1-chome Project Shinagawa	13,300	44,000
Amazon Japan	E-commerce	Expansion	Various Various	Meguro Station Front Project Shinagawa	6,000	20,000
GlaxoSmithKline	Pharma	Unknown	GSK Building Shibuya	Akasaka Intercity Air Minato	3,500	11,600
Creek & River	Talent support	Relocation	Sumitomo Kojimachi Bldg #4 Chiyoda	Shinbashi 4-chome Project Minato	2,800	9,300
Warabeya Nichiyo	Foodstuffs	Relocation	Unnamed building Kodaira City	Humax Shinjuku Tomihisa Building Shinjuku	2,100	6,900

Source: Nikkei RE, Savills Research & Consultancy

YoY to 0.6%, once again making it the tightest market in the C5W. Grade A rents in Shinjuku climbed by 1.4% QoQ and 4.4% YoY to reach JPY29,136 per tsubo.

Shinjuku's extremely tight vacancy conditions are limiting leasing activity. The Nikkei has only reported two significant leasing deals in 2017. The larger of the two occurred in April, when foodstuffs company Warabeya Nichiyo leased the brand-new, 2,100 tsubo Humax Shinjuku Tomihisa project in its entirety. Limited upcoming supply should keep the Shinjuku market tight. Mitsubishi Jisho's 44,100 sq m Sendagaya 5-chome Project is due for completion in 2019 but is rumoured to be already 80% full.

Absorption exceeding expectations

Investors entered 2017 with some trepidation, worrying that Tokyo's upcoming supply glut would depress market fundamentals. In January over half of the 15 analysts participating in the Nikkei's semi-annual survey predicted rents flattening by mid-2017. However, performance has thus far exceeded expectations at annualized growth of 4.3%.

We commented in our Q1 report that pre-leasing activity had been strong; this remained true in Q2. Tenants are eagerly relocating and in some cases expanding into new development projects. All five of Q2's largest leasing deals involve contracts in new development projects (Table 1). Furthermore, Amazon's lease of 11 floors in the Meguro Station Front project is rumoured to be an expansion, and the company could retain its current offices for some time.

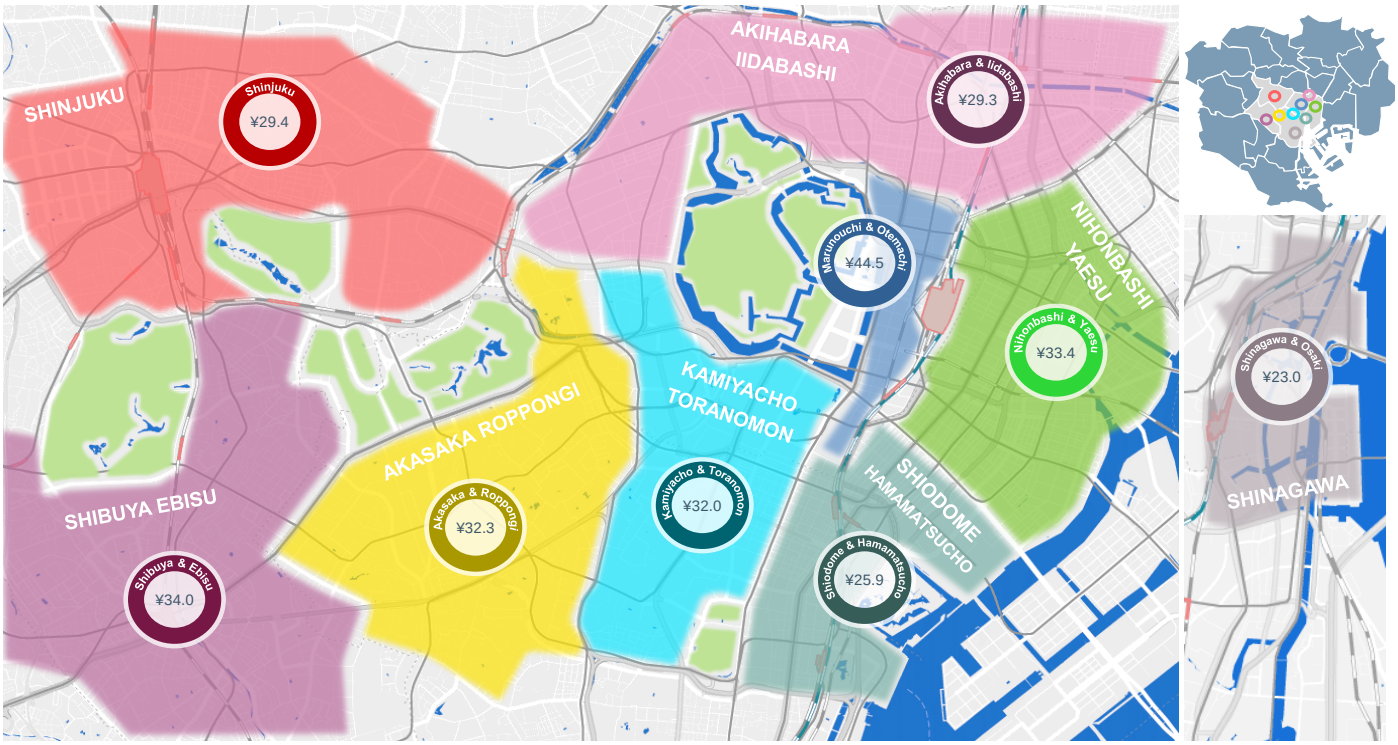
Other major deals appear to be consolidations, which means that tertiary vacancy could become a concern for older buildings. Lured by large floorplates and brand-new amenities, some of Japan's largest corporations are using new Grade A supply as an opportunity to bring their myriad subsidiaries under a single roof. Sega Sammy Holdings, for example, is consolidating several offices into 44,000 sq m of Sumitomo's new Nishi-Shinagawa project.

The Grade B buildings that typically house such subsidiaries will likely fill any resulting vacancies quickly, given the enduring positive performance of the sector. Investors may want to take care with smaller and older buildings, however, which could experience tertiary vacancy as an end result of consolidations. Owners of such buildings may prioritise attracting and maintaining quality tenants over pushing through rental increases.

On the whole, leasing remains strong and absorption of 2017-18 supply is underway. Akasaka Intercity Air is expected to open close to fully leased in August. Hibiya Park Front is approximately 50% leased and gradually filling. Ginza Six is now approaching 80% occupancy. Shibuya Cast opened in April and is already full. Upcoming supply remains large, but demand is holding stronger than expected.

MAP 1

Average rents per tsubo in selected submarkets, Q2/2017



Grade A Buildings, average passing rent + CAM per tsubo in thousand JPY. Coloured areas for illustrative purposes only.
Source: Savills Research & Consultancy

OUTLOOK

The prospects for the market

Tokyo Grade A offices have extended their climb for another quarter. Rental increases in Shinjuku were particularly strong. Large supply in 2018-2020 remains a hot topic of conversation, but market fundamentals have thus far held firmer than anticipated. At the current pace it is now possible that gradual rental growth could continue through the end of 2017 or even longer. Successive new, high-grade openings will likely pull up area averages, though rents in existing stock could stay relatively flat.

Companies are eagerly taking up space in new developments. The appeal of large open floorplates and state-of-the-art amenities appears to be driving leasing deals in brand-new, high-grade projects, inching up average market rents. However, this means that older and smaller offices may see some elevated tertiary vacancy over the coming years.

Owners are likely to focus more on attracting and maintaining quality tenants than on rental increases. This could keep occupancy high, but may also temporarily limit rental growth to new, high-quality buildings.

Savills monitors rents and vacancy levels at more than 450 buildings located in Tokyo's central five wards with a GFA of 3,000 tsubo (10,000 sq m) or above. Unlike similar market information issued by other research institutions, the rental data provided relates to estimated passing rents, inclusive of common area management fees, as opposed to asking rents. Meanwhile, vacancy figures reflect current vacant space without the inclusion of 'expected' vacancy, or that reported prior to tenants vacating their premises. As a result, benchmark figures, particularly vacancy rates, tend to be lower than other market indices.

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