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Savills World Research
Japan

Spotlight

Tokyo office supply through 2020

June 2018

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"Central Tokyo is expected to witness elevated levels of high-quality supply between now and 2020. Fortunately for landlords, strong corporate profits, a tight labour market and an increased focus on consolidating office space to improve collaboration and productivity are driving tenants to demand larger, higher quality assets in core locations. We therefore believe that robust pre-leasing activity and extremely tight vacancy levels should keep the high quality sector in balance, while secondary vacancy could soften rents for existing stock that does not meet emerging demand in certain submarkets. The strength of tenant demand will play a vital part in market dynamics over the next few years, as will landlords' management of their portfolios."

High supply levels ahead

A series of rapid, large-scale completions from 2018 through to 2020 are expected to add significant supply to central Tokyo's office market. Given long lead times for developments it is unsurprising to see little change in the overall supply picture, though our forecast for 2020 supply has increased while that for 2019 has shrunk slightly due to greater clarity on completion times and delays in certain projects. While many projects are also planned for beyond 2020, risks to the supply-demand balance lie more in the short term so we will focus our analysis there.

Approximately 210,000 tsubo[1] Net Rentable Area (NRA) is expected on average per year between 2018 and 2020, greater than the annual average since 2000 of 190,000 tsubo, though demolitions in preparation for redevelopments during this period will moderate the net increase.

1 1 tsubo = 3.305785 sq m

Supply is concentrated in certain areas - three submarkets account for 70% of the total increase - Otemachi & Marunouchi in Chiyoda, Shinagawa & Shibaura in Minato, and Toranomon, Roppongi & Akasaka in Minato, and is mostly large floor plate, high NRA buildings: across all of the C5W, projects over 10,000 tsubo NRA account for 70% of supply.

It is worth noting that the projected annual increase in C5W supply as a percentage of existing stock is within the long term average for three of the five central wards, as shown in Graph 1, while Chiyoda and Shibuya will see extraordinary supply by this measure. There is strong demand for space in Chiyoda which should limit the impact on average vacancy. Shibuya has been undersupplied in the past and is likely to absorb supply more easily than this metric suggests. In fact, a large proportion of oncoming supply in Shibuya has been pre-leased.

SUMMARY

- By 2020, Tokyo's central five wards (C5W) are expected to add over 630,000 tsubo GFA of rentable office space, increasing total stock by approximately 9% excluding demolitions.
- 70% of the new supply is located in three submarkets: Marunouchi & Otemachi (37%), Shinagawa & Shibaura (19%), and Toranomon, Roppongi & Akasaka (14%).
- While landlords remain somewhat cautious of such a large volume of new supply, completions so far in 2018 are enjoying robust occupancy levels and an encouraging share of upcoming completions has already been pre-leased. The strength of the economy and landlords' management of secondary vacancy is expected to determine support levels for overall market rents over the next few years.
- New completions are expected to achieve rents at the upper end of current market levels and rents are expected to rise in 2018 before softening moderately.
- We forecast average vacancy will remain tight in 2018 then rise slowly afterwards.
- Infrastructure and transport improvements and mixed-use developments will increase Tokyo's regional/global competitiveness, as mentioned in our "Beyond Tokyo 2020" report.
- Developments are expected to improve long term growth and have the potential to move Tokyo's centre of gravity to new areas, as discussed in our "A Gravitational Shift to Shibuya" report.

Submarket dynamics

Marunouchi & Otemachi will see four large completions in 2018 and three in 2020, though this is nothing new. Mitsubishi Estate is a prominent developer in the area and has been adding fresh stock over the last two decades: they are now on what they refer to as their "third wave" of construction since 1998. Early take-up of new supply has been strong and secondary vacancy should be mitigated by the submarket's convenient location and prestige: relatively affordable rents at around the mid 30,000 yen per tsubo per month level should attract sufficient tenants.

Shinagawa & Shibaura will see the completion of the South msb Tamachi Tower in 2018, then a pause for breath in 2019 before the North msb Tamachi Tower and Takeshiba A Towers complete in 2020. The area is well connected with multiple stations on the Yamanote loop line, rents are relatively affordable, and it is one of the few areas with availability of large floor plates. This year we have already seen Shiseido agree to move their headquarters from the Shiodome Tower to the Hamamatsucho Crea Tower, due to complete in August 2018.

Toranomon, Roppongi & Akasaka has two large projects due in 2019: Toranomon 2-10 (on the site of the iconic Okura Hotel) and Toranomon Hills Business Tower. Aside from these, Toranomon expects the completion of the multi-building Azabudai redevelopment project redevelopment project, which includes transport infrastructure such as a brand new metro station connected to a major commuter line and plans for new bus transit routes, which will fuel growth for years to come. The area is well connected and its proximity to the CBD and to Haneda Airport has helped office rents start to approach levels seen in Otemachi through strong demand.

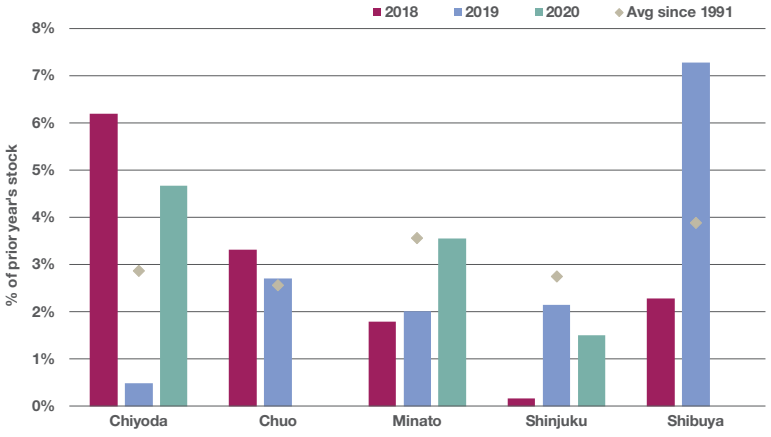
Nihonbashi & Yaesu will see the Takashimaya Mitsui Building complete in 2018 and the Muromachi 3 A project in 2019. Two large development projects in Yaesu 2 chome are due in 2022 and 2023 and the 70,000 tsubo NRA multi-building Nihonbashi 1 chome central district redevelopment project is expected to complete in 2025. All of these developments are led by Mitsui Fudosan which should reduce the risk of specific vacancy as Mitsui has a large tenant base.

Shibuya & Ebisu will see over 60,000 tsubo NRA in 2019. Compared to other submarkets this is relatively little but is much more than the annual average supply to the area since 1990. However, as a result of this reduced supply in the past, there is significant unmet demand for Shibuya office space that has shifted to nearby areas. New oncoming supply is highly likely to meet this pent-up demand and vacancy should remain close to current levels. Google's relocation from Roppongi to Shibuya Stream shows the area is very much in demand.

Shinjuku has very little expected supply. Just two buildings over 10,000 tsubo are being constructed, with the grand total supply expected by 2021 reaching just over 30,000 tsubo NRA. Stock in this submarket continues to age and rents lower than the C5W average reflect this. Occupancy is extremely tight in Shinjuku, so any tenant migration is unlikely to affect rents.

GRAPH 1

Annual GFA supply* as % of prior year's stock, excluding demolitions, 2018 – 2020

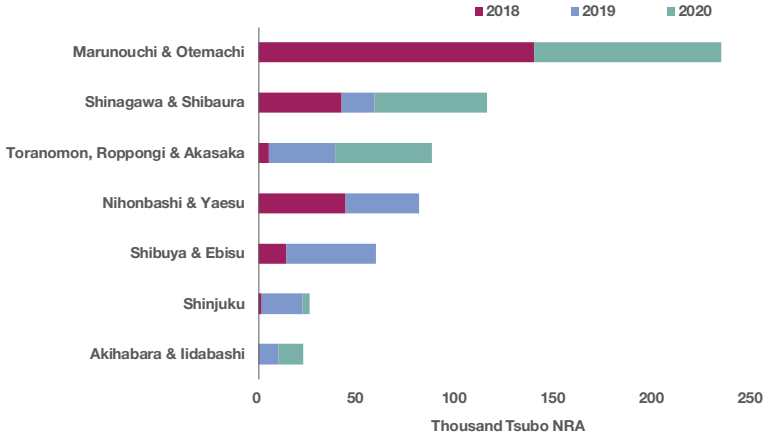


Source: Savills Research & Consultancy

* For the purposes of this report except where specified, "supply" refers to upcoming office NRA in the central five wards with a floor plate of 100+ tsubo. Actual office use NRA is used when possible; for projects that have only published GFA, NRA is estimated at 60% of GFA. For projects that have not specified the proportion of office use, the whole building is assumed to be for office use. Most large mixed-use developments have disclosed the breakdown. Actual NRA may differ from this estimate.

GRAPH 2

Supply by submarket (thousand tsubo NRA), 2018 – 2020



Source: Savills Research & Consultancy

TABLE 1

Large scale office completions between 2018 and 2020

Submarket / Year	Building name	GFA (Tsubo)
Marunouchi & Otemachi		
2018	Otemachi Place West Tower	61,100
2020	Marunouchi 1-3 project	49,100
2020	OH 1 B Tower	43,400
2018	Midtown Hibiya	42,500
2018	Marunouchi Nijubashi	38,600
2018	Otemachi Place East Tower	37,400
2020	OH 1 A Tower	36,900
Shinagawa & Shibaura		
2020	Takeshiba A Tower	44,500
2020	msb Tamachi Station N Tower	36,600
2018	msb Tamachi Station S Tower	34,900
Toranomon, Akasaka & Roppongi		
2020	Tokyo World Gate	32,600
2019	Toranomon Hills Business Tower	28,700
2020	Yotsuya Station Front	17,800
Nihonbashi & Yaesu		
2019	Muromachi 3 A	39,100
2018	Takashimaya Mitsui	30,800
Shibuya & Ebisu		
2019	Shibuya Scramble East Tower	37,300
2018	Shibuya Stream	22,200

Source: Savills Research & Consultancy, press releases

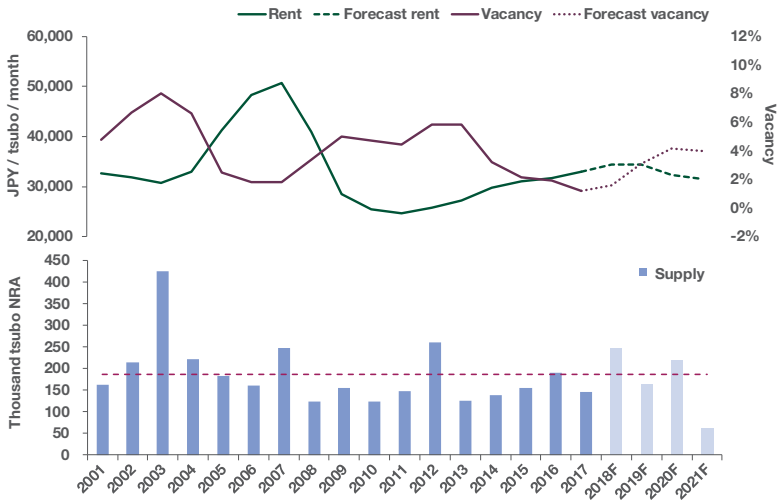
Rent and vacancy forecast

Savills Research & Consultancy forecasts office rents in Graph 3 as primarily a function of GDP growth and expected vacancy rates as well as other variables such as demand for workers and risk appetite represented by capital market movements. All variables have demonstrated strong statistical relationships with office rental movements over the past 15 years. Using these inputs, we expect average office rents to increase slightly until 2019 but then soften.

We have considered the government's plan to increase the national consumption tax rate from 8% to 10% in 2019 and conclude it is likely to have a smaller impact than the previous hike. While the tax raise in 2014 significantly slowed down economic conditions, the upcoming increase is only a 25% proportional increase as opposed to a 60% proportional increase in 2014 and only 2% in absolute terms as opposed to 3%. Furthermore, the government has proposed counter policies to combat the initial effects of the increase. Our view appears to be shared by other market participants as, according to a recent Japan Real Estate Institute (JREI) survey for instance, rents for Grade A office buildings throughout the C5W are expected to rise steadily over the next ten years.

GRAPH 3

Tokyo C5W rent, vacancy and supply relationship, 2001–2021F



Source: Savills Research & Consultancy

Although it is more difficult to predict than supply, a forecast of rents and vacancies would be incomplete without considering demand. A stronger yen may dampen exporter's profits somewhat but we have seen

corporate profits steadily rise and the labour market continue to tighten since 2012 which should support occupancy. Previously unheard of price hikes and signs of meagre but symbolic wage increases also hint at increased demand from increasingly profitable corporations.

There is significant demand from tenants for larger floor plates to foster collaboration among employees and for high-specification buildings to attract and retain talent. With market vacancy at extremely low levels there has been little opportunity for firms to meet these demands through existing stock, which has spurred strong pre-leasing activity for new completions. This suggests primary vacancy will remain low but may raise the risk of secondary vacancy in older, smaller buildings. Older buildings with larger floor plates or those in convenient locations that undergo renovation will still be able to cater for changing tenant demands so are less at risk.

A 2017 survey by Xymax Real Estate Institute ("Xymax") revealed that a large proportion of landlords of small offices have just one or two buildings in their portfolios. With limited budgets they are likely to be unable to renovate their properties which could expose this segment of the market to reduced demand and the prospect of lower attainable rents. Another feature of these older, smaller buildings may balance out large supply. Xymax estimated in 2017 that 26% of small-scale stock in the 23 wards was more than 35 years old in Graph 4. Reduced stock as a result of demolitions could balance out weaker demand.

Graph 5 shows historical vacancy in Grade A office buildings by submarket. A large number of completions can affect vacancy levels in individual submarkets, negatively impacting market sentiment through advertising effects as happened with Eastside Square in 2012. If this were to happen with a few large buildings in the current supply cycle it could wrongly create a perception that vacancy levels are rising across the whole submarket.

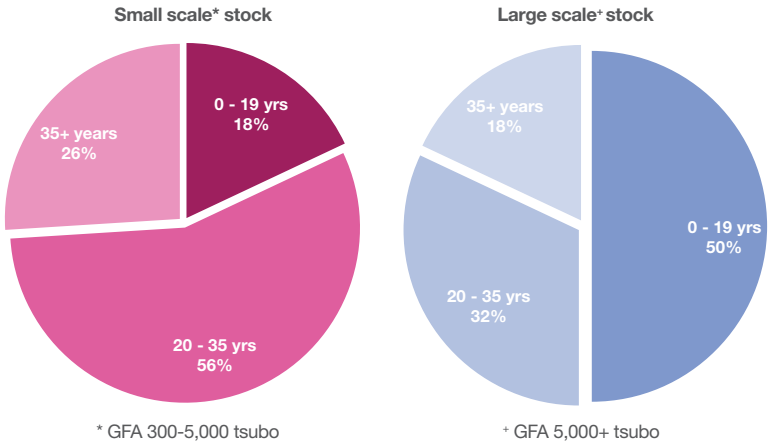
The long view

Though high supply levels may disrupt an office market in the short term, the long term fundamental impact of redevelopment projects is generally positive. For instance, the completion of Toranomon Hills in 2014 has created a new market and had an impact on nearby house prices, office rents, and land prices as people have begun to take advantage of the new facilities. Similarly, Shinagawa has grown in popularity since the Shinkansen was connected in 2003. Many large office buildings sprang up around the station area at the same time and it has emerged as a new office district in its own right.

Where can we expect good news over the next few years? Shibuya is set for a refresh as covered in our spotlight report of November 2017 – "A Gravitational Shift to Shibuya". Toranomon can also arguably expect more growth as planned supply in this area continues out to 2022 along with an entirely new metro station on Tokyo's Hibiya Line. In addition, a rapid transit bus system is expected to be fully operational by March 2021 that will further improve transport infrastructure. The area is within easy reach of Haneda Airport and is central enough to facilitate easy onward travel to other major districts, making it ideal for office workers, residents and business travellers alike. The addition of brand new Shinkansen maglev technology as well as a new JR rail station in Shinagawa will serve to increase that district's popularity even further. For a more in-depth analysis of infrastructure development in Tokyo, we refer you to our recent report "Beyond Tokyo 2020: Prospects for the Japanese Real Estate Market". ■

GRAPH 4

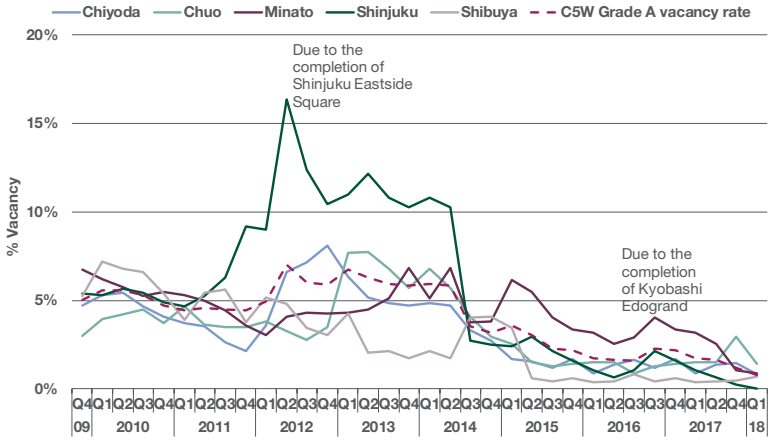
Office stock in the 23W by size and age, Dec 2017



Source: Xymax Real Estate Institute

GRAPH 5

Grade A vacancy rates in the C5W, 2009 – Q1/2018



Source: Savills Research & Consultancy

OUTLOOK

The prospects for the market

"Tokyo's CBD is in the middle of a multi-year period period of raised supply amid record low vacancy levels and we believe that the volume of new builds coming online through 2020 will soften rents and occupancy rates at least temporarily. The global business cycle, including Japan's, looks extended and we cannot discount the possibility of a correction. Uncertainty surrounding the possibility of trade wars, political upheaval in Europe, or a crisis in the Middle East or Asia may disrupt the economic cycle, leading to a change in the outlook for the real estate market.

It might be also the case that continued strong demand from robust corporate profits may lead to steady absorption without the need for large corrections in rents. Japanese corporations' profitability has improved significantly since the Crisis and firms have diversified revenues through international expansion. This strong corporate activity has meant that office market prospects are much brighter, for instance, than they were in late 2016 and early 2017. We expect that new builds in the C5W are likely to be steadily taken up, possibly at the expense of older buildings that are unlikely to be renovated to current standards.

Rental growth has been slow since the Crisis which should provide some downside protection and the concentration of new developments implies that their impact should differ across submarkets. Over the longer term, the high quality and mixed-use nature of upcoming supply alongside the completion of new transport infrastructure should bring new energy to surrounding areas, proving positive for a variety of real estate sectors, not just the office market.

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