Savills World Research
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Spotlight
Tokyo office supply through 2020

February 2017

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"Tokyo's CBD expects a glut of high-quality supply to come online through 2020. This rapid increase in NRA may soften rental levels over the short to medium term, but it will also breathe new life into some of the city's most up-and-coming districts. Capital values, infrastructure quality, and district image should all increase as Tokyo's already modern office market grows even more state-of-the-art."

SUMMARY

- From 2017 through 2020, Tokyo's Central 5 Wards (C5W) are expected to add approximately 800,000 tsubo of rentable office space, increasing total stock by approximately 11% excluding demolitions.

- 71% of the new supply is located in three submarkets: Marunouchi & Otemachi (27%), Toranomon, Roppongi & Akasaka (22%), and Shinagawa & Shibaura (23%).

- This influx of new supply will likely soften rental levels over the short to medium term. Average vacancy in the C5W will likely weaken to near 5%, but should remain stronger than it was after the financial crisis and the Tohoku earthquake.

- Much of this supply is arriving as part of enormous, premium-grade, mixed-use, integrated redevelopment projects. Over the long term, these projects could drastically revitalise their surrounding districts, much like how Mori's Roppongi Hills development influenced northwest Minato.

Large supply ahead

A series of rapid, large-scale completions from 2017 through 2020 are expected to add significant supply to central Tokyo's office market. On average, approximately 200,000 tsubo[1] should come online each year. The influx totals approximately 11% of the Tokyo CBD's current NRA, though ongoing demolitions will result in a smaller net impact. Note that additional large completions are expected past 2020 when Tokyo holds the Olympics, but because such projects are subject to significant change, this report will focus on 2017-2020 supply.

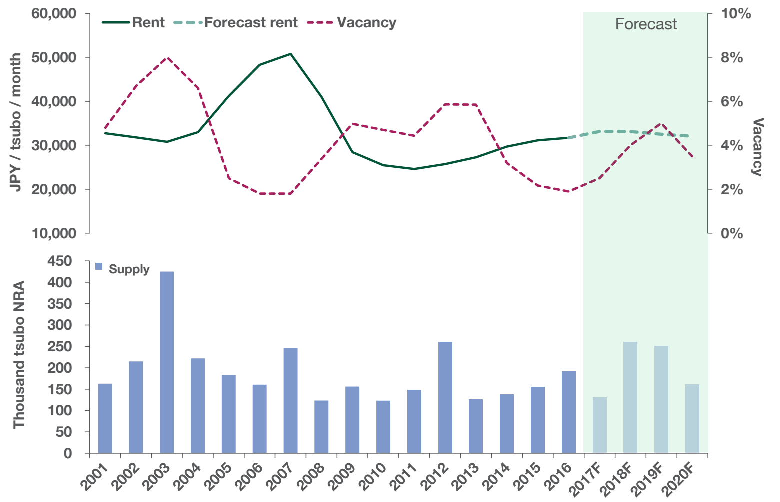
This supply is not spread evenly throughout the C5W. It will be primarily located in three distinct submarkets: Otemachi & Marunouchi, Shinagawa & Shibaura, and Toranomon, Roppongi, & Akasaka. Together, these three submarkets account for over 600,000 tsubo, or about 70% of the total increase. The concentrated nature of the supply increase helps demonstrate how much of the NRA is coming through individual, large-scale projects.

Shinjuku, by contrast, is expecting only minimal new supply. Shibuya is expecting moderate new supply, but because Shibuya's office stock is relatively small compared to those of other wards it is expecting the largest increase in percentage terms. Shibuya's NRA could grow almost 20% over the next four years. Shibuya is uniquely well-positioned to absorb its supply, however, because the district is seeing high demand especially from software and tech companies seeking to relocate or expand.

1 1 tsubo = 3.305785 sq m

GRAPH 1

Tokyo C5W rent, vacancy and supply* relationship, 2001–2020F



* For the purposes of this report, "supply" refers to upcoming office NRA in the central five wards with a floor plate of 100+ tsubo. Actual NRA is used when possible; for projects that have only published GFA, NRA is estimated at 60% of GFA. Actual NRA is likely to differ from this estimate.
Source: Miki Shoji, NLI Research Institute, Savills Research & Consultancy

The difference in % increases between Shinjuku and Shibuya is so great that Shibuya's share of C5W office stock is set to grow from 8% to 9% by 2020, while Shinjuku could fall from 13% to 12%.

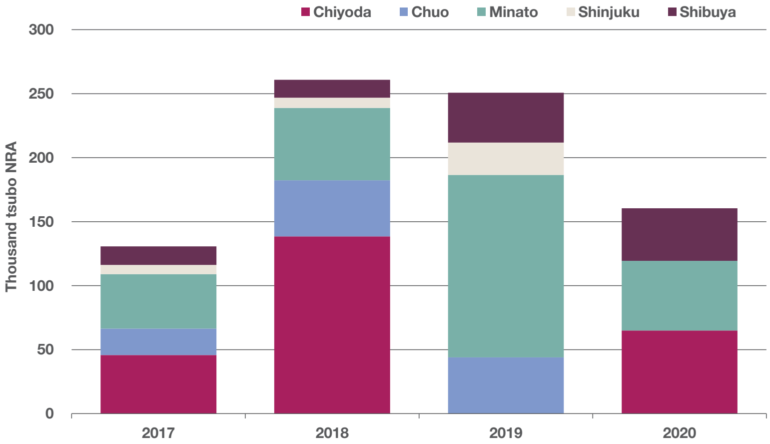
Further breaking down the C5W into submarkets, we can see that a plurality of projects are concentrated in the Marunouchi & Otemachi area. This submarket is traditionally Tokyo's most expensive office district and continues to see intense redevelopment activity. Marunouchi & Otemachi will receive approximately 235,000 tsubo of NRA through 2020, or 27% of the C5W's total new supply. Major developments in the area include Mitsui Fudosan's OH-1 development, a 108,000 tsubo GFA, twin-tower, multipurpose facility housing a hotel and conference hall, and NTT Urban Development's Otemachi Nichome project, another twin-tower facility of similar scope. Major developments are scheduled to extend as far as 2027, when Mitsubishi Estate expects to complete the main tower of its 200,000 tsubo GFA Tokiwabashi project (cover image). Though the supply increase in Marunouchi & Otemachi is large, the area is dominated by ultra-prime assets and well-connected developers, which should help mitigate risk. Owner/developers such as Mitsubishi and Mitsui have some power to reshuffle existing tenants to maintain operational stability.

The Shinagawa & Shibaura submarket and the Toranomon, Roppongi & Akasaka submarket, both primarily located in Minato Ward, are not far behind. Shinagawa & Shibaura will add 196,000 tsubo NRA through 2020, primarily comprised of buildings in the Tamachi and Shibaura areas. Major projects include the 87,000 tsubo GFA twin-tower TGMM Shibaura development, led by Tokyo Gas, Mitsui, and Mitsubishi.

Toranomon, Roppongi & Akasaka will add 188,000 tsubo of NRA through 2020, concentrated mainly in Toranomon. The district has seen extensive redevelopment over the past few years, notably through Toranomon Hills Mori Tower, which now commands rents on par with those in Otemachi. Upcoming developments include Toranomon Trust Tower, a 64,000 tsubo GFA mixed-use skyscraper containing a hotel and

GRAPH 2

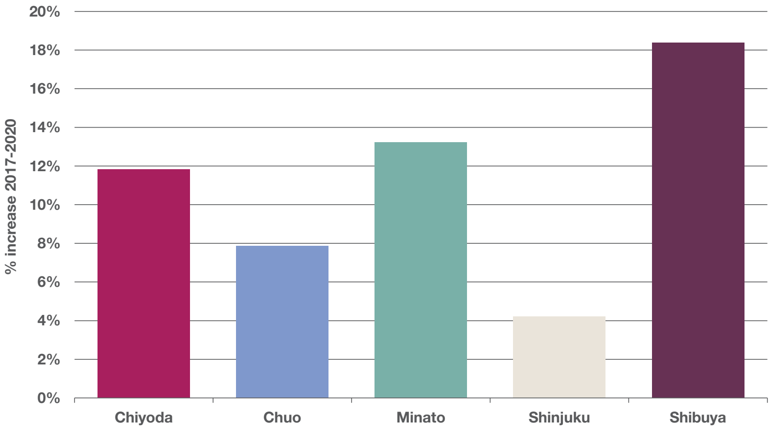
Expected supply in Tokyo's CBD by ward, 2017–2020



Source: Miki Shoji, Savills Research & Consultancy

GRAPH 3

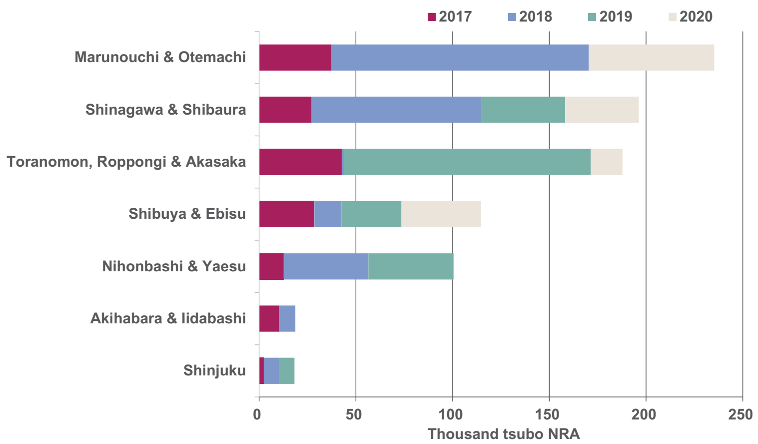
Expected stock increases in Tokyo's CBD by ward (%), 2017–2020



Source: Miki Shoji, Savills Research & Consultancy

GRAPH 4

Expected supply in Tokyo's CBD by submarket, 2017–2020



Source: Savills Research & Consultancy

TABLE 1

Selected redevelopment projects in Tokyo

Name	Location	GFA (Tsubo)	Completion*
Tokiwabashi District Redevelopment	Otemachi	200,000	2027
Toranomon-Azabudai District Redevelopment	Toranomon	196,000	2022
Yaesu Nichome Central Area Redevelopment	Yaesu	115,000	2022
OH-1 Project	Otemachi	108,000	2020
Otemachi Nichome Project	Otemachi	107,000	2018
TGMM Shibaura Project	Shibaura	87,000	2019
Toranomon Trust Tower	Toranomon	64,000	2019
Sakuragaoka District Redevelopment	Shibuya	56,000	2020
Shibuya Station District Redevelopment	Shibuya	55,000	2020
Takeshiba District Redevelopment	Hamamatsucho	55,000	2020
Toranomon 2-10 Project	Toranomon	33,000	2019

*Final expected completion date. Some projects will partially complete earlier.
Source: Public disclosures, Savills Research & Consultancy

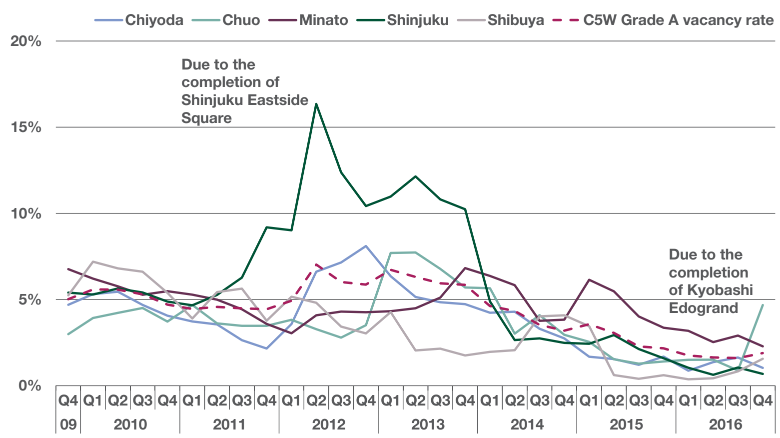
residences, and the Toranomon 2-10 Project, which will transform the site of the Okura Hotel into a 55,000 tsubo GFA mixed-use facility. Farther ahead, Mori Building recently released details for its upcoming 196,000 tsubo GFA Toranomon-Azabudai District project, the centrepiece of which is an enormous 65-storey mixed-use skyscraper. The building will contain an international school, an "expat-oriented" supermarket, and a 1,000 sq m penthouse apartment, rumoured to be the largest of its type in Tokyo. At 330 metres the tower will be Japan's tallest office building when completed in 2022, just two metres shy of Tokyo Tower.

Of the areas covered in this report, the Minato Ward submarkets are perhaps most vulnerable to rental impact from rapid, large completions. New offices in these areas should work to secure large anchor tenants quickly.

The Shibuya & Ebisu submarket is expecting fewer large projects than the top three areas, but its relatively small size means that its redevelopments could have a larger impact on the local district. Major projects include Tokyu Fudosan's Sakuragaoka District Redevelopment project and the Shibuya Station District Redevelopment project, both of which are expected to complete in 2020 and contain about 55,000 tsubo

GRAPH 5

Grade A vacancy rates in the C5W, 2009–2016



Source: Savills Research & Consultancy

GFA each. Shibuya has become a preferred location for Tokyo's fast-growing IT companies. Shibuya's office submarket is currently so tight, however, that companies are scattered as far as Ebisu, Meguro, and Roppongi. New supply may enable relocation closer to central Shibuya.

Rent and vacancy impact

Market observers are understandably concerned about this large volume of upcoming supply. In January, Nikkei Real Estate published the results of its semi-annual survey of office market analysts, the majority of which forecasted rents flattening by year-end 2017. Vacancy is likely to rise off of its current tight levels, and it may take time for the market to absorb these new assets depending on economic conditions.

Savills Research & Consultancy forecasts office rents [Graph 1] as primarily a function of GDP growth and expected vacancy rates, as well as other variables such as demand for workers and market sentiment (as measured for instance 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 in 2017, but then remain flat or possibly even decrease marginally in 2018 and 2019. The Abe administration's plan to increase the national consumption tax rate from 8% to 10% in 2019 may also soften economic conditions and subsequently rental levels. Because the space coming on the market is typically of very high quality, however, this new supply should ultimately raise Tokyo's potential rents and bolster the city's competitiveness.

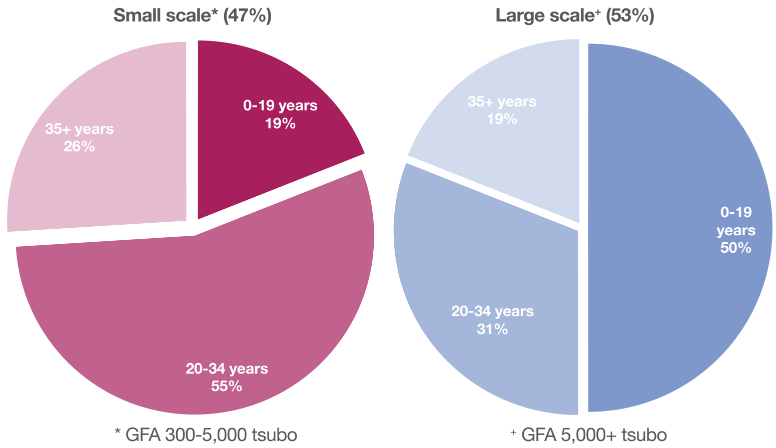
Vacancy should see a similar softening and subsequent recovery. Offices are already close to maximum capacity in the C5W, with Grade A vacancy reaching an inflection point of 1.6% in 2016. This is not a sustainable rate – under such tight conditions, tenants have trouble relocating, and businesses can't expand – so new supply is in many ways a welcome relief for Tokyo. The rapid pace of completions will likely loosen vacancy over the short term. Vacancy in the C5W already rose slightly to 1.9% in the fourth quarter of 2016 on the back of large completions, notably Kyobashi Edogrand, which opened with significant vacancy.

Large tenants have slowed pre-leasing in the latter half of 2016, preferring instead to see completed facilities before committing. It is possible that more buildings will open with vacancies over the coming years. Demand for prime assets in the C5W is still very high, however, as demonstrated by Tokyo's ever-tightening occupancy trends and a steady inflow of population from outlying areas. Furthermore, Tokyo's very gradual rental growth since the crisis now offers it downside protection. Rents are currently still 35-40% below their pre-crisis peaks and unlikely to soften significantly even during this period of heavy supply.

The addition of new supply to the market should also be partially mitigated by increased removal of ageing assets from stock. Xymax Real Estate Institute estimates that 19% of Tokyo's large-scale stock in the 23 wards and 26% of its small-scale stock is now more than 35 years old.

GRAPH 6

Office stock in the 23W by size and age, 2016



Source: Xymax, Savills Research & Consultancy

This less competitive stock is nearing the end of its useful life and should gradually be taken off the market as redevelopment continues.

Neighbourhood revitalisation

Though fundamentals may soften in the short term, the long-term impact of these redevelopment projects should be positive. The projects will do far more than simply provide additional office space. They will build and grow state-of-the-art, integrated communities around Tokyo's CBD. These projects should ultimately raise land values, bolster local infrastructure, and further strengthen Tokyo's competitiveness on the world stage.

We consider Mori Building's Roppongi Hills redevelopment project and its impact on the surrounding area to be a relevant case study. Constructed from 2000 to 2003, Roppongi Hills is a multipurpose facility that now occupies 12 hectares of land in Tokyo's CBD. The area was previously characterised by detached houses and small apartments. In addition to constructing a 230,000 tsubo GFA mixed-use facility containing a high-end movie theatre, a penthouse museum, public exhibition space, and green areas, Mori Building also improved access by opening roads and pedestrian walks both above and below ground and added direct connections to local subway stations.

Now, land values above the Roppongi metro station are 70% higher than they were in the year 2000. The project's success has brought other landmark developments to the area, not least of which is the 170,000 tsubo GFA Tokyo Midtown project, which opened in 2007. Between its affluent "three-A" residential districts of Azabu, Aoyama, and Akasaka, its luxury shopping areas, and its prime office space, northwestern Minato has rapidly become one of Tokyo's most fashionable and diverse submarkets.

We expect many of the projects highlighted in this report to have similar long-term impacts on their surrounding neighborhoods. A transformation is already underway in Toranomon, where Mori opened Toranomon Hills Mori Tower in 2014. Future development plans include an entirely new metro station – the first in 30 years – along Tokyo's Hibiya Line, and additional office and residential towers. Land values in Toranomon jumped approximately 20% from 2014 through 2016. JR East also intends to open a new station in Shinagawa on the Yamanote Line in order to improve accessibility between Shinagawa and Osaki stations. Commencing operations in 2020, the station will be the first new stop added to Tokyo's central loop line in almost 50 years.

Such continuous improvement should spur rental growth and increase capital values over the long term.

OUTLOOK

The prospects for the market

Tokyo's CBD is about to experience an influx of new office supply not often seen since the early 2000s. The volume of NRA coming online through 2020 will likely soften rents and vacancy over the short to medium term, but demand factors and the decommissioning of old stock could lead to steady absorption. Gradual, slow rental growth since the crisis means that overall downside risk is somewhat limited. Furthermore, new projects are concentrated in the Marunouchi & Otemachi, Shinagawa & Shibaura, and Toranomon, Roppongi & Akasaka submarkets, meaning that impact is likely to vary by area. Shinjuku is for example scheduled to see almost no significant expansion.

The high quality and mixed-use nature of upcoming supply should bring new energy to surrounding areas. These new facilities should ultimately drive up district rents and capital values over the long term, as well as increase Tokyo's overall competitiveness as a regional headquarters for multinational corporations.

In the end, economic conditions – specifically, demand from large corporations – will determine office market equilibrium. Ongoing evolution in global economic prospects and the business cycle will impact absorption.

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