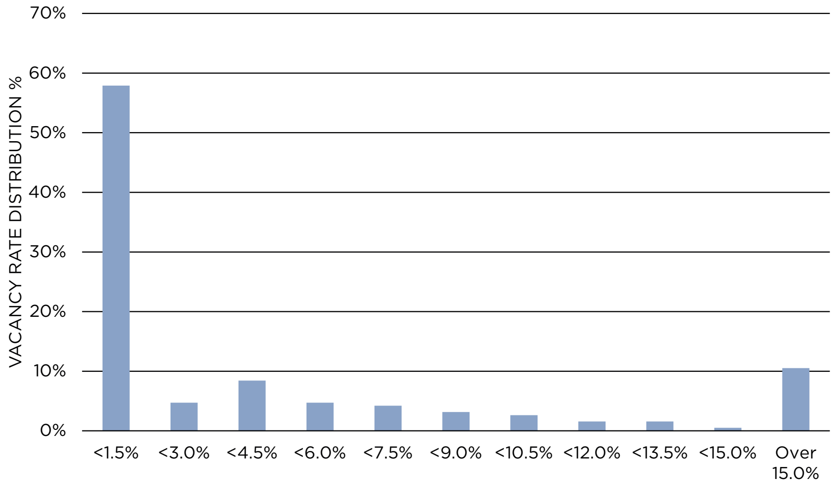
SPOTLIGHT
Savills Research

Tokyo Grade B Offices

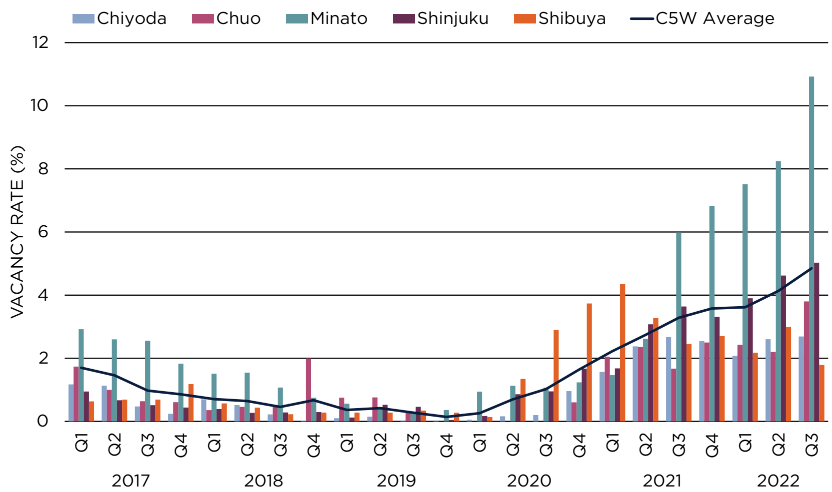
Grade B offices show signs of stabilising

GRAPH 1: Vacancy Rate Distribution of Large-scale Grade B Offices in the C5W, Q3/2022



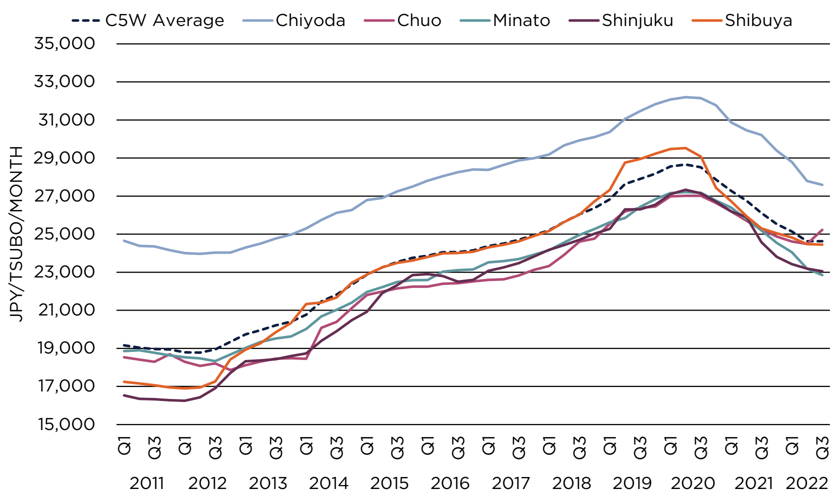
Source Savills Research & Consultancy

GRAPH 2: Large-scale Grade B Office Vacancy by Ward, Q1/2017 to Q3/2022



Source Savills Research & Consultancy

GRAPH 3: Large-scale Grade B Office Rents by Ward, Q1/2011 to Q3/2022



Source Savills Research & Consultancy

INTRODUCTION

Since the onset of the pandemic, the Tokyo office market has experienced successive rental corrections as office demand weakened. The new supply in preceding years contributed to a softening of the market. Although most of the supply in recent years is considered to be Grade A offices[1], the loosening in the market derived from this new supply also seems to have affected the wider market, including large-scale Grade B offices[2].

Indeed, Grade A offices have become more affordable than three years ago, which has resulted in cases of tenants moving to higher grade offices. Consequently, large-scale Grade B offices were forced to lower rents to maintain their relative affordability. In fact, since the beginning of 2020, large-scale Grade B offices have experienced around the same level of rental corrections as Grade A offices.

Nevertheless, the large-scale Grade B market has shown resilience, with vacancy rates at a moderate 4.8% in Q3/2022. Additionally, the current vacancy rate appears to be exaggerated by several properties that have significant vacancies (Graph 1). In fact, the majority of large-scale Grade B offices continue to maintain low vacancy rates.

Overall, the Tokyo Grade B office market is showing signs of recovery. Vacancy rates have started stabilising in wards such as Chiyoda and Shibuya, and the pace of rental corrections has slowed down. Although Minato's vacancy increments in recent quarters stand out, they were primarily a product of several office buildings with large vacancies and the ill-timed completions of new offices. As market conditions are expected to recover, the performance of large-scale Grade B offices is likely to improve going forward.

LARGE-SCALE GRADE B OFFICES

As indicted in the introduction, large-scale Grade B offices in the central five wards (C5W) have experienced prolonged corrections since the onset of the pandemic. Prior to the pandemic, the average vacancy rate was virtually 0% due to robust office demand across Tokyo, but it began to rise in Q1/2020 and recorded 4.8% in Q3/2022.

1 Grade A offices refer to buildings with a GFA of more than 9,000 tsubo (30,000 sq m) and a building age of less than 15 years. Some buildings that do not fit these definitions are included.

2 Large-scale Grade B offices refer to buildings with a GFA of more than 4,500 tsubo (15,000 sq m) and a building age of less than 25 years. Some buildings that do not fit these definitions are included.

Throughout Q3/2022, the Tokyo Grade B office market has continued to experience corrections with vacancy edging up and rents softening. However, some wards have started to show signs of stabilising in recent quarters. Indeed, the current high vacancy rate is largely the product of a few buildings with high levels of vacancy. With office demand expected to gradually recover, the Tokyo Grade B office market should improve going forward.

The ward with the highest vacancy rate as of Q3/2022 was Minato, which added T-LITE and Oak Shinagawa Konan to its stock in 2022. Minato is also home to several office buildings with large vacancies, especially in the bay-side areas. Elsewhere, Shinjuku has the second highest vacancy rate of 5.0%. This is an interesting contrast with the Grade A offices in the same ward, which recorded a lower vacancy rate of 2.8% in Q3/2022.

This higher vacancy rate of Grade B offices in Shinjuku could be explained by the rental premium of Grade A offices against Grade B in Shinjuku, which has shrunk from 27% in Q1/2020 to 16% in Q3/2022 while other wards largely maintained or increased their premiums during the same period. As such, it is likely that the relative affordability of Grade A offices in the ward attracted tenants from large-scale Grade B offices.

On the other hand, Shibuya recorded the lowest vacancy rate of 1.8% in Q3/2022. This may be noteworthy considering that Shibuya saw the most rapid loosening in vacancy at the beginning of the pandemic as IT companies in the ward quickly adopted remote work policies and reduced office space. However, since Q1/2021, Shibuya has seen vacancy gradually tighten, supported by sound demand. Elsewhere, Chiyoda has maintained relatively low vacancy rates throughout the pandemic.

Against the backdrop of loosening vacancy rates, rents for large-scale Grade B offices have been experiencing corrections across the C5W. On average, rents in the Grade B market have seen almost the same level of rental correction as in the Grade A market. However, reviewing each ward separately, Grade B offices have been noticeably worse off than Grade A offices with the exceptions of Chuo and Shinjuku. Considering that some tenants are taking advantage of current affordable rents of Grade A offices and moving to higher specification buildings, rents for large-scale Grade B offices might need more time to recover.

Going forward, the performance of the office market, including large-scale Grade B offices, will likely depend on future economic conditions. Fortunately, Japan's corporate profits have increased by 17.6% year-on-year in Q2/2022, setting new highs according to the Ministry of Finance. Moreover, the reopening of borders should help the economy.

However, the global economy is experiencing a slowdown as persistently high inflation is causing broad disturbances. Central banks are continuing their policies of quantitative tightening, but the operation has been difficult as another global recession is looming. The prolonged war in Ukraine and energy crisis also weigh further on the economy. In this light, as a baseline scenario, we expect rents for large-scale Grade B offices to bottom out towards late 2023 and start gradual recovery afterwards.

INVESTMENT TRENDS

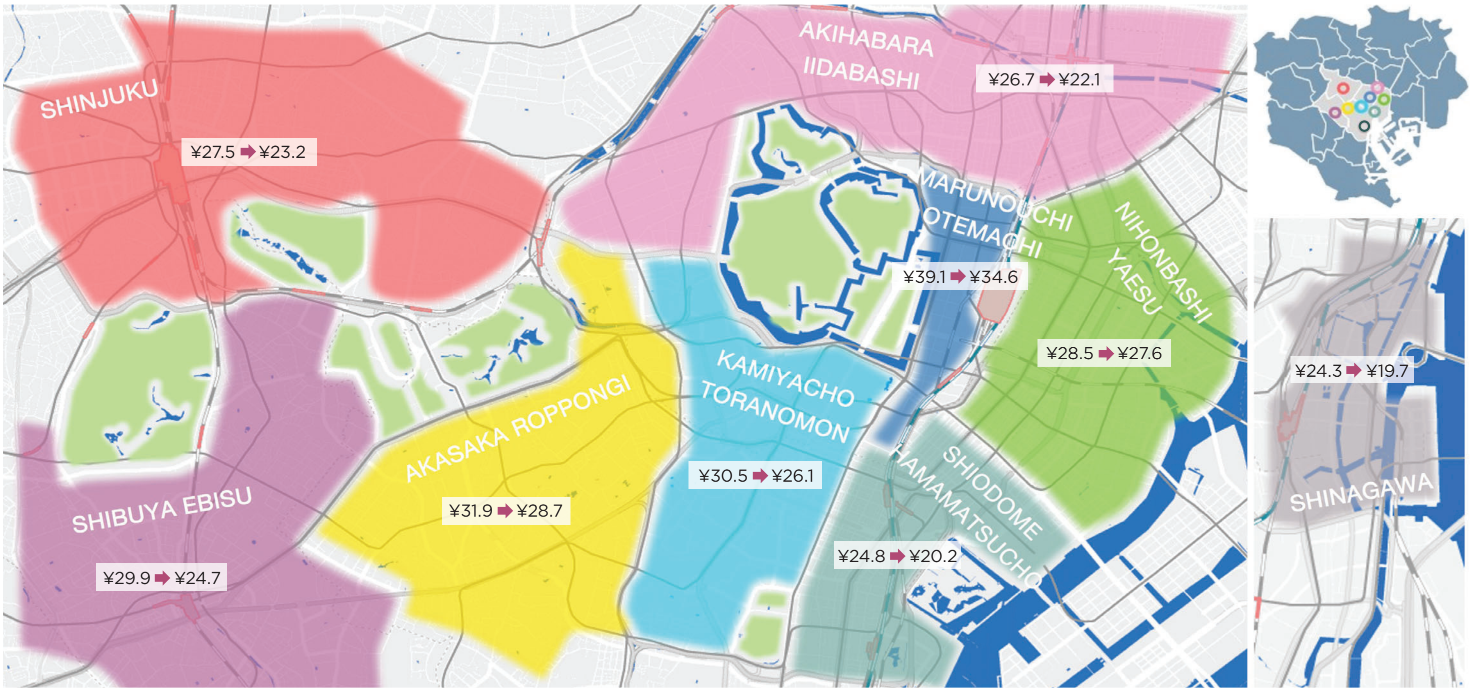
Although there are still uncertainties revolving around the office market, investor interest in the office sector remains sound. According to Savills in-house survey, cap rates for Grade B offices inched up from 3.2% in Q2/2020 to 3.4% in Q4/2020 as the market sentiment softened, but the rates have been stable since then. Competition is still fierce, and properties with value-add opportunities attract particularly strong interest.

TABLE 1: Transactions by J-REITs in the C5W, Q4/2021 to Q3/2022

PROPERTY	WARD	PRICE (JPY/USD)	CAP RATE	BUYER	TRANSACTION DATE
JMF Building Akasaka 02	Minato	42.4 bil / 360 mil	2.7%	Japan Metropolitan Fund	Dec 2021
Harumi Center Building	Chuo	24.3 bil / 180 mil	3.8%	Undisclosed	May 2022
Aoyama Oval Building (47.5%)	Shibuya	18.6 bil / 190 mil	2.9%	Tokyu REIT	Dec 2021
Tokyo Tatemono Higashi Shibuya Building	Shibuya	11.3 bil / 97 mil	3.6%	Japan Prime Realty Investment Corporation	Jan 2022

Source J-REIT disclosures, Savills Research & Consultancy
Note: We have selected office buildings whose GFAs are between approximately 4,500 and 9,000 tsubo to be in line with Savills definition of large-scale Grade B offices.

MAP 1: Large-scale Grade B Office Rent by Submarket, Q2/2020 vs Q3/2022



Source Savills Research & Consultancy

OUTLOOK

Overall, the Tokyo large-scale Grade B office market is following a trend similar to that of the Grade A office market. Although the pandemic has shifted to an endemic state, the weakening of market conditions has continued.

That said, the Grade B market has started seeing signs of improvement. Vacancy rates are stabilising in some wards, and the pace of rental corrections is slowing. Although Grade B offices appear to have been prompted to lower rents due to their diminished relative affordability in the face of declining Grade A rents during the pandemic, the gradually improving Grade A office performance should steadily alleviate the downward pressure placed on the Grade B market.

Going forward, economic conditions surrounding the office market will likely determine the trajectory of its recovery. While Japan is currently faring relatively well compared to its global peers, a slowdown of the global economy would inevitably affect the Japanese economy.

As other central banks continue quantitative tightening, whether the Bank of Japan adjusts its long-held policy is of investors' significant concern as well.

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