REPORT

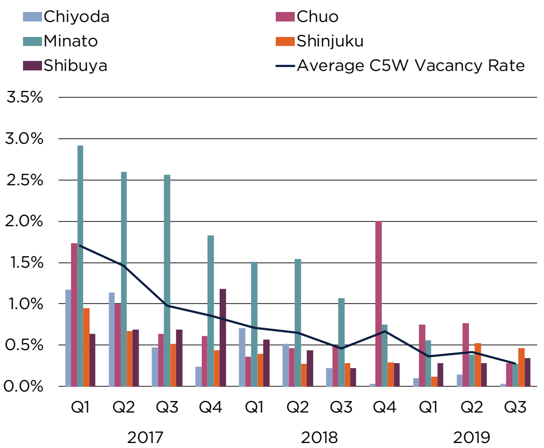
Savills Research

Asian Cities Report – 2H 2019

Tokyo Grade B Office

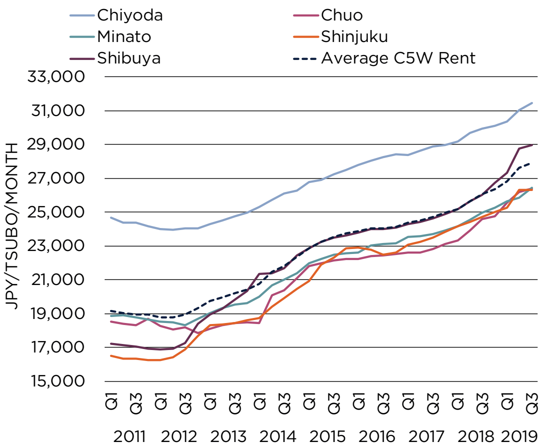
Grade B rents continue to rise amid limited vacancy

GRAPH 1: Grade B Office Vacancy By Ward, Q1/2017 to Q3/2019



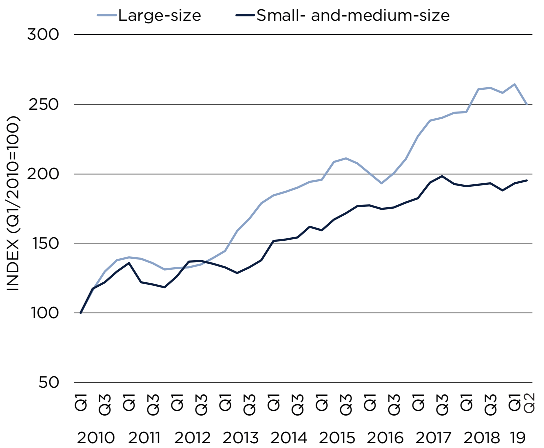
Source Savills Research & Consultancy

GRAPH 2: Grade B Office Rents By Ward, Q1/2011 to Q3/2019



Source Savills Research & Consultancy

GRAPH 3: Four-period Moving Average Of Profits For Small & Medium-size And Large-size Companies, Q1/2010 to Q2/2019



Source Ministry of Finance, Savills Research & Consultancy

INTRODUCTION

In the central five wards (C5W)[1], where Grade A supply has been at historically high levels, large-scale Grade B[2] office supply continues to be limited, and the situation is being exacerbated by tenants squeezed out of the somewhat pricey Grade A market. As a result, average rental growth in the Grade B market has outpaced Grade A.

Amid a challenging global economic environment, the performance of large-size companies[3] have stuttered, whilst small- and medium-size companies[4] have seen some recovery in profits. As a result, vacancy rates for Grade B offices could face continued tightness, underpinning rental growth going forward.

LARGE-SCALE GRADE B OFFICES

Against a backdrop of feverish demand, vacancy rates lie below 1.0% across all submarkets, both in the Grade A and B markets. As of Q3/2019, the spread between average vacancy of Grade A and Grade B offices is indistinguishable, with the former at 0.2% and the latter around the 0.3% mark. The lofty rents demanded in the Grade A market could, in part, explain this phenomenon as those less financially able are pushed towards Grade B assets. This trend is expected to continue with the majority of future supply designated as Grade A, where the differing rent ranges, compared to Grade B, means that these markets do not directly compete.

The average Grade B office rent in the C5W was JPY27,904 per tsubo as of Q3/2019, representing an annualised growth of around 4.3% since 2011. Offices in Shibuya and Chuo experienced the greatest growth this quarter, with the former particularly impressing. Rents in these two submarkets grew 11.2% and 7.2% year-on-year (YoY), respectively, increasing to JPY28,950 and JPY26,379 per tsubo. This positive momentum is likely to continue in these submarkets given the extremely low vacancy – both around 0.3%.

Chiyoda has historically been the submarket that commands the highest rent, and this remains true as of Q3/2019. Following growth of 5.1% YoY – the greatest growth for nearly five years – the average rent in this submarket rose to JPY31,463 per tsubo, with top rents as high as JPY40,000. The premium over its peers, however, has been falling as the other submarkets have experienced even greater growth rates over the same period. It currently lies around 9%, having been as high as 18% at the end of 2016. Vacancy rates in Chiyoda have reached rock-bottom.

Rents in Minato and Shinjuku increased 5.9% and 6.5% YoY, respectively, and now stand at JPY26,430 and JPY26,300 per tsubo. Despite the encouraging rental growth, it was not enough to close the gap between average C5W Grade B rents, with both submarkets at around a 6% discount to the broader market. Regardless, areas such as Roppongi in Minato continue to post high rents, with the highest rent at JPY37,000 per tsubo.

ECONOMIC TRENDS

From Q2/2016 to Q1/2019, the divergence among average profits for large and small- and medium -sized companies widened to its largest spread. This trend seems to have reversed in Q2/2019, as global economic uncertainty and trade disputes weighed on the bottom line for larger businesses with greater international exposure. Given that over a third of Japan's large-scale companies are located in the capital, any continued decline in profits could have an impact on the office market. To wit, larger companies that are starting to feel the pressure may find Grade A rents unaffordable, especially in the manufacturing space, and therefore may transition towards the large-size Grade B market. In an already crowded market, the added competition should, therefore, support further rent growth.

1 Chiyoda, Chuo, Minato, Shinjuku, and Shibuya.
2 "Large-scale Grade B office" typically 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 that do not fit this definition are included.
3 Large-sized companies are defined as those with capital stock of more than JPY100 million.
4 Small- and medium-sized companies are defined as those with capital stock of less than JPY100 million.

INVESTMENT TRENDS

Investment in the office sector continues to dominate, with flows representing over 50% since 2013 (Graph 4). Having seen a pick-up in office investment volumes from 2017 to 2018, it appears that flows have declined in 1H/2019 YoY, perhaps as a sign of the limited opportunities and high price tags manifesting caution in the market. It could, on the other hand, be a sign that investors are happy to retain assets given the prospect of stability, especially considering the attraction of Japan's capital. Either way, the lack of supply, for now, is helping prop up office valuations.

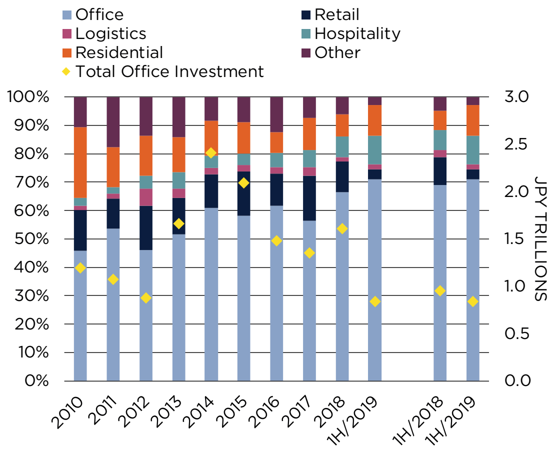
OUTLOOK

The Grade B market is at its tightest level in recent history as vacancy rates continue to fall. This is expected to continue with new supply focusing on the Grade A market.

Profits of small- and medium-size companies experienced some recovery from the dip witnessed in mid-2017. If this continues, Grade B rents should see some further upside, especially as these companies make up most of the tenant pool. However, economic uncertainties abound. The sensitivity of these smaller companies to the domestic economy is higher than that of larger companies, and the risk from the recent consumption tax hike in October 2019 is yet to be fully understood. Furthermore, despite the domestic bias, these businesses are by no means immune to the effects of international disputes, and any deterioration of market conditions could trickle down to the Grade B office market.

Nonetheless, Japan's relative political and economic stability, along with the fact that these smaller sized firms appear more sound than before 2008, suggests that rental growth in the Grade B market should be able to continue growing for the time being.

GRAPH 4: Investment Volumes In Tokyo By Sector, 2010 to 1H/2019



Source RCA, Savills Research & Consultancy

> Whilst supply remains tight, Grade B rents should be able to continue their upward trajectory. Nonetheless, persistent economic uncertainty cannot be ignored.

TABLE 1: Large-scale Grade B Office Transactions By J-REITs In The C5W, Year-to-date 2019*

<table>
<tr><th>PROPERTY</th><th>WARD</th><th>PRICE (JPY/US$)</th><th>CAP RATE</th><th>BUYER</th><th>ANNOUNCED</th></tr>
<tr><td>G-Base Tamachi</td><td>Minato</td><td>28.2 bil/255 mil</td><td>3.2%</td><td>Nippon Building Fund</td><td>April</td></tr>
<tr><td>Glass City Harumi</td><td>Chuo</td><td>11.2 bil/98 mil</td><td>3.8%</td><td>Daiwa Office REIT</td><td>February</td></tr>
<tr><td>Hulic Ginza 7-Chome (25%)</td><td rowspan="2">Chuo</td><td>5.6 bil/50 mil</td><td>3.3%</td><td rowspan="2">Hulic REIT</td><td>June</td></tr>
<tr><td>Hulic Ginza 7-Chome (20%)</td><td>4.5 bil/41 mil</td><td>3.3%</td><td>September</td></tr>
</table>

Source J-REIT disclosures, Nikkei Real Estate, Savills Research & Consultancy
* As of Q3/2019.

Savills Japan
Yurakucho ITOCiA 15F
2-7-1 Yurakucho, Chiyoda-ku
Tokyo 100-0006, Japan
+81 3 6777 5100