Tokyo - Q4/2021

MARKET IN MINUTES

Savills Research

Office Leasing

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Rates of rental decline slow

Traditional offices still have an important role to play, although the hybrid working model continues to proliferate across multiple industries.

- While the pandemic has calmed down significantly, the prolonged lukewarm market sentiment has continued to impact office rents and vacancy in the central five wards (C5W).
- Average Grade A office market rents in the C5W fell 2.0% quarter-on-quarter (QoQ) and 7.6% year-on-year (YoY), and now stand at JPY33,681 per tsubo[1] per month.
- The average Grade A office vacancy rate in the C5W increased by 0.3 percentage points (ppts) QoQ and 1.8ppts YoY to 2.8% in Q4/2021.
- Average large-scale Grade B office rents declined to JPY25,532 per tsubo per month – a contraction of 2.2% QoQ and 8.4% YoY.
- The average vacancy rate in the Grade B market loosened 0.3ppts QoQ and 1.9ppts YoY to 3.6%.
- With the pandemic in a manageable state and high vaccination rates, companies are considering gradually increasing office attendance while maintaining some level of remote work.
- Tenant preferences for easily accessible, larger, and newer offices persist, and some companies are changing their office layouts to support a hybrid working model.

"The office remains an important part of the work environment, and newer offices in good locations are still highly sought after. While the hybrid working model has proliferated across multiple industries, most companies intend to gradually increase their in-office attendance as long as the state of the pandemic stays manageable."

SAVILLS RESEARCH & CONSULTANCY

1 1 tsubo = 3.306 sq m or 35.583 sq ft.

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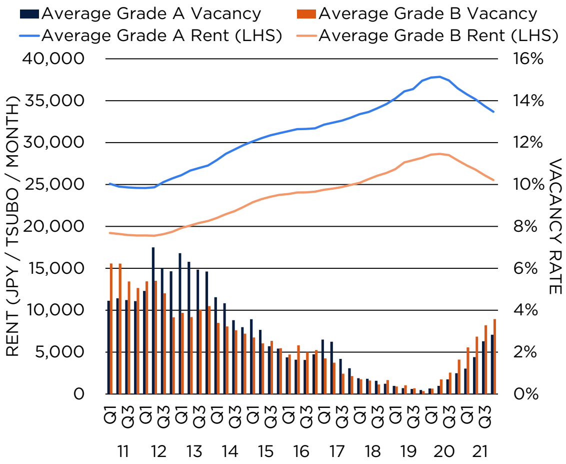
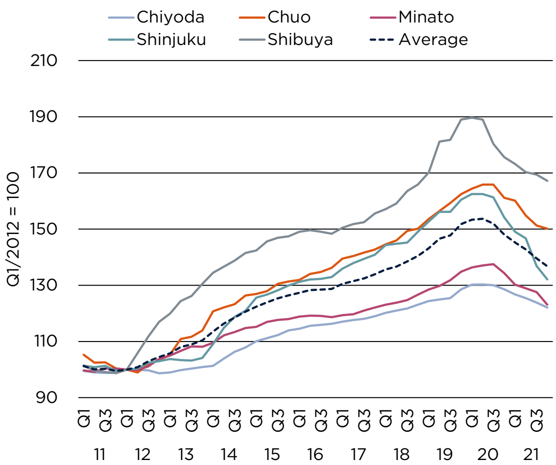
GRAPH 1: Office Rents and Vacancy in Tokyo's C5W*, 2011 to Q4/2021



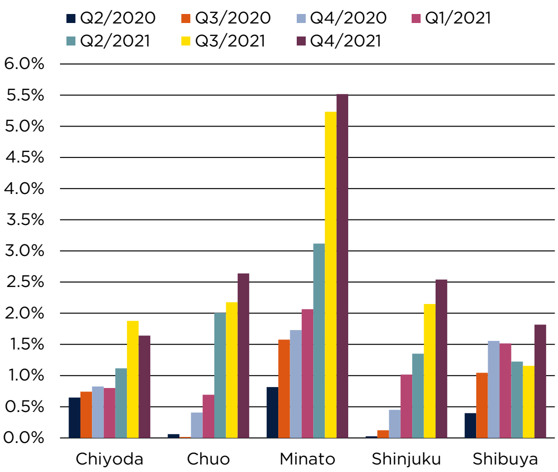
Source Savills Research & Consultancy
*Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index by Ward, 2011 to Q4/2021



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy by Ward, Q2/2020 to Q4/2021



Source Savills Research & Consultancy

GRADE A OFFICES

Burdened by a bearish market sentiment and the uncertainty surrounding new variants, Tokyo's Grade A market continued to soften in Q4/2021. Specifically, rents contracted by 2.0% QoQ and 7.6% YoY to JPY33,681 per tsubo, and vacancy increased 0.3ppts QoQ and 1.8ppts YoY to 2.8%. However, it should be noted that rents contracted 2.2%, and vacancy increased 0.8ppts in the previous quarter, showing that the rate of decline has slowed.

At the submarket level, rental contractions were the highest in Minato and Shinjuku at 3.5% QoQ, while the other wards saw some minor decreases. Looking at vacancy, Shibuya saw the steepest increment of 0.7ppts QoQ, and Chuo's vacancy also loosened 0.5ppts QoQ. However, the increments seen in other wards were much smaller than those of Q3/2021. In fact, Chiyoda even saw vacancy decline 0.2ppts QoQ.

In Q4/2021, the impact from the pandemic appeared manageable, and there were only a limited number of large-scale lease cancellations. A common trend in recent movement announcements was moving to newer offices with good access and larger floorplates. These offices are better suited for supporting flexible work arrangements, like having amenities such as video conferencing booths on the same floor and making free-address seating more convenient. Larger Grade A tenants are more inclined to implement flexible working schemes (Graph 4), and are usually the subjects of such movements.

Overall, the demand for new buildings appears sound. For instance, the latest buildings to open in the C5W, Tokiwabashi Tower and Hibiya Fort Tower, are almost 90% occupied. Pre-leasing of the next Grade A building to open in the C5W in July 2022, Tokyu Fudosan's Kudanminami-1-chome project with over 11,000 tsubo of NRA, is also nearly completed. The project has been well received due to its proximity to Kudanshita station, its quick access to the Otemachi and Marunouchi area, and its nationally famous spots for cherry blossoms. Importantly, it also provides an effective marketing and sales strategy. In August 2022, Tokyo Midtown Yaesu will also open with over 38,000 tsubo of NRA.

Looking ahead, 2023's supply will dwarf that of 2022 with multiple large-scale developments coming to the market, particularly in Minato. The supply opening near large stations should perform well, such as the Sakuragaoka Redevelopment next to Shibuya station, the TTM Project that is sandwiched between Tamachi station and Mita station, and the Toranomon Azabudai Project that has its own infrastructure and amenities. However, the quick succession of high-specification supply coming online in somewhat inconvenient locations may be a challenge. Nonetheless, the office market's recovery is still expected to be K-shaped, especially as secondary vacancy from last year's large supply continues to materialise in the Grade A market. Indeed, while well-located and newer offices remain stable, older offices with poor accessibility are likely to continue suffering and weigh down on the market overall.

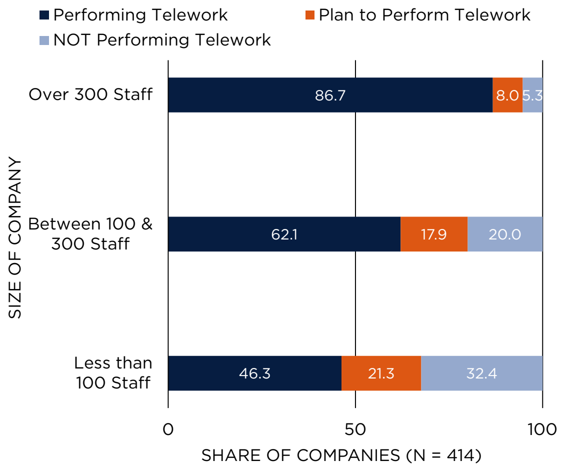
LARGE-SCALE GRADE B OFFICES

The Grade B market continued to loosely mimic the performance of the Grade A market in Q4/2021. Specifically, the market experienced a rental decrease of 2.2% QoQ and 8.4% YoY to JPY25,532 per tsubo. Furthermore, vacancy increments were similar to what the Grade A market saw, with a loosening of 0.3ppts QoQ and 1.9ppts YoY to 3.6%.

Shinjuku saw the largest rental decline in the Grade B market, shrinking 3.1% QoQ, while Minato and Chuo had the steepest vacancy increments of 0.8ppts QoQ. Most of this deterioration was from buildings that are located comparatively further from stations and those built prior to 2000. On the other hand, newer buildings with more convenient access are holding well. Indeed, Shinjuku and Chiyoda have seen decreases in vacancy this quarter. Elsewhere, Shibuya saw the mildest contraction in rents, decreasing 1.0% QoQ.

Looking ahead, most new Grade B buildings in 2022 look set to perform well given their proximity to stations, such as Yanmar Tokyo which is located just outside Tokyo station, and T-Lite which is located next to Toranomon Hills station. Additionally, the Grade B market should stabilise before the Grade A market. Unlike Grade A tenants, Grade B tenants do not typically have the resources and capital to implement firm-wide remote work and are therefore more likely to keep their office space. As seen in Graph 4, medium-sized and small-sized companies have a lower implementation rate of telework compared to their larger counterparts. In addition, Grade B offices generally have an easier time filling office space given the much larger potential tenant pool of the Grade B market and the greater flexibility of dividing up floor plates in Grade B buildings. For additional details, please see our [Tokyo Grade B Office] report.

GRAPH 4: Telework Implementation Status per Size of Company, November 2021



Source Tokyo Metropolitan Government, Savills Research & Consultancy

TABLE 1: Comparison of Submarkets' Grade A Rents as of Q4/2021 - QoQ, YoY, and Since the Pandemic Began in Q1/2020

SUBMARKET	RENT (IN JPY)	QOQ	YOY	SINCE THE PANDEMIC
Chiyoda	41,000	-1.4%	-5.1%	-6.2%
Chuo	32,500	-0.8%	-6.8%	-8.7%
Minato	31,200	-3.5%	-8.4%	-9.7%
Shinjuku	27,900	-3.5%	-14.3%	-18.7%
Shibuya	35,700	-1.3%	-4.8%	-11.9%
Overall	33,700	-2.0%	-7.6%	-10.8%

Source Savills Research & Consultancy

TABLE 2: Comparison of Submarkets' Grade A Vacancy as of Q4/2021 - QoQ, YoY, and Since the Pandemic Began in Q1/2020

SUBMARKET	VACANCY	QOQ (PPTS)	YOY (PPTS)	SINCE THE PANDEMIC (PPTS)
Chiyoda	1.6%	-0.2	0.8	0.8
Chuo	2.6%	0.5	2.2	2.6
Minato	5.5%	0.3	3.8	5.3
Shinjuku	2.5%	0.4	2.1	2.5
Shibuya	1.8%	0.7	0.3	1.6
Overall	2.8%	0.3	1.8	2.6

Source Savills Research & Consultancy

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

Chiyoda's vacancy levels have declined 0.2ppts QoQ to 1.6% and are currently the lowest in the C5W. Meanwhile, rents saw a contraction of 1.4% QoQ and 5.6% YoY to JPY41,000 per tsubo. The rental contraction this quarter in Chiyoda was slightly milder than the overall decrease seen in the C5W. As such, Chiyoda's premium in rent over the Grade A market's average has grown to 22%, up from 19% at the start of 2021.

On the ground level, Chiyoda has only seen a limited number of lease cancellations and movements out of the ward. In fact, Tokiwabashi Tower, which opened in June, will become fully occupied after seeing multiple new leases totalling 3,000 tsubo, led by the trading firm Nagase which will lease 2,300 tsubo. In combination with other smaller moves into other various Grade A buildings, Chiyoda's vacancy looks to remain stable.

Looking forward, JSOL, a system integrator, pre-leased over 2,200 tsubo in the next Grade A office to open in Chiyoda, Tokyu Fudosan's Kudan-Minami Itchome Project, in July 2022. This should also help to carry the pre-leasing momentum of the building. The limited supply after this building in 2022 should give the rest of Chiyoda breathing room to continue reducing vacancy across the ward. As such, Chiyoda's position as the premier ward in the C5W should stay firm.

Chuo

Chuo saw a gentler rental contraction this quarter of 0.8% QoQ and 6.8% YoY to JPY32,500 per tsubo, down from the contraction of 2.3% QoQ and 8.8% YoY in Q3/2021. However, Chuo's vacancy rate is currently the second highest in the C5W and continued to loosen 0.5ppts QoQ and 2.2ppts YoY to 2.6% in Q4/2021. A closer analysis reveals that most of this vacancy is situated around the Harumi and Kyobashi areas. If vacancy continues to inch up, rental declines may continue.

While the outer fringes of the ward have generally been struggling during the pandemic, some movements into this area have been recently announced. For instance, M3, a medical information provider, will be taking a 1,300 tsubo lease in the Tokyo Sumitomo Twin Building that is currently undergoing renovations. In addition, KLL, a freight forwarder, will be leasing 500 tsubo in Harumi Triton, a building that has recently faced difficulties in finding tenants because its location is far away from the main area of Chuo.

In 2022, Chuo will see one of the largest additions to the Tokyo market, Tokyo Midtown Yaesu. If priced reasonably, pre-leasing activity for this development should be uneventful, given its prime location right next to Tokyo station and the recent positive performance of newer buildings in the ward. In 2023, some large redevelopment projects will commence, and the demolishing of old office buildings will create some demand from tenants displaced in the process. When completed, these projects will also feature new amenities, and improve accessibility by introducing a new bus terminal. Overall, while outer submarkets have been weakened to some extent, the limited supply over the next couple of years should give landlords time to deal with the situation.

Minato

Minato's rental contraction was one of the highest in the C5W this quarter, decreasing 3.5% QoQ and 8.4% YoY to JPY31,200 per tsubo. Furthermore, after loosening 0.3ppts QoQ and 3.8ppts YoY to 5.5%, the vacancy in the ward is the highest in the C5W. A major source of this decline came from older buildings as well as buildings located in the bay area, as discussed in our previous office briefing [Office Leasing Tokyo - Q3/2021]. In addition, the new supply in Minato and nearby wards has also created some secondary vacancy.

Fortunately for Minato, some buildings that saw major lease cancellations during the pandemic appear to have acquired new tenants. One such example is the Shiodome Building where Ginsen, an insurance and real estate company, will take a 1,500 tsubo lease. Furthermore, BrainPad, a data analysis company, will also take a lease in Roppongi T-Cube, which Fuji Xerox vacated in late 2020. Elsewhere, TechMatrix, an IT solutions company, will take a 1,500 tsubo lease in Shinagawa Season Terrace as it consolidates its offices around Tokyo into a central location to support teleworking.

Many other buildings have also seen large leasing activity. For instance, Akasaka K-Tower has Mitsui Bussan I-Fashion, the fashion and textile business arm of Mitsui & Co., taking a 2,000 tsubo lease. In addition, Pasona Group decided to lease the Avex Building in its entirety after Avex sold the building to BentallGreenOak earlier in 2021. Indeed, given the large supply expected in 2023, the high level of leasing activity from various industries is good news for the ward, which hopes to carry the momentum into the following year. In the meantime, 2022 will be a quiet year for supply, and should give the market some time to recover and address the worsening situation in some of the older and poorly accessible buildings.

Shibuya

Shibuya's vacancy loosened by 0.7ppts QoQ and 0.3ppts YoY. Meanwhile, rents contracted by 1.3% QoQ and 4.8% YoY to JPY35,700 per tsubo. The main areas of Shibuya have performed well, while most of the rental contractions and vacancy increments this quarter were from outer areas such as Ebisu, which will be discussed further in detail in the next section.

On the other hand, there were some smaller movements into the ward that should help maintain its stability. Furthermore, supply in Shibuya will be limited until 2023, which will provide the market with some breathing room. The Sakuragaoka Redevelopment, which will open in 2023, should perform well given its excellent accessibility and its mixed-use nature, both of which are becoming increasingly preferable attributes for tenants.

Shinjuku

Shinjuku's rents contracted 3.5% QoQ and 14.3% YoY to JPY27,900 per tsubo – a smaller decline compared to the large 6.7% QoQ contraction seen in the last quarter, although the drop was still the largest in the C5W. Vacancy loosened 0.4ppts QoQ and 2.1ppts YoY to 2.5%. The increasing vacancy in Shinjuku mainly came from less accessible offices located further away from major stations. Indeed, the situation of these buildings has worsened as more attractive buildings with affordable rents open up in other wards.

Nonetheless, there have been some movements into Shinjuku. For example, Japan Beverage, a beverage vending machine business, will take a 600 tsubo lease in Sumitomo Fudosan Shinjuku Grand Tower. There are also rumours of other large tenant movements that could alleviate the situation in the ward. For now, rents are expected to continue adjusting, particularly in Western Shinjuku. In the short term, the limited supply should help the market find an equilibrium pricing point. In the long term, some large station-front redevelopments in the pipeline should help revitalise Shinjuku, especially as foot traffic will also be expected to improve in tandem.

DIVERGING PERFORMANCES IN SHIBUYA

In 2013, Shibuya became the second most expensive ward after Chiyoda. Since then, the ward has established a premium of 14.5% over Chuo, which has traditionally been in third place. In fact, until Q1/2020, Shibuya was on pace to dethrone Chiyoda as the most expensive ward, driven by airtight vacancy, a thriving tenant profile, and vibrant neighbourhoods. Indeed, this led to a copious amount of investment geared towards making the area around Shibuya station more attractive.

However, the pandemic has since deflated this optimism. Shibuya's previously flourishing tenant profile of IT companies were the first to implement teleworking measures. Additionally, the heightened rental levels deterred tenants that were previously priced out of the ward from re-entering even as space started to open up. As such, Shibuya experienced the sharpest rental decline at the start of the pandemic and was the most underperforming ward until Shinjuku started seeing more severe corrections recently.

However, while Shinjuku has continued to weaken, Shibuya bucked the trend in 2021 and had three quarters when vacancy decreased. In contrast, all other wards have generally seen increments. Indeed, Shibuya is overall an attractive area, and corrections since the pandemic may have lowered rents closer to a price point that more

TABLE 3: Tenant Relocations, Q4/2021

ORIGIN						DESTINATION	
Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other		
9	13	18	5	3	15		
4	3	1	1			9	Chiyoda
1	5				2	8	Chuo
3		14	1	1	4	23	Minato
1		1	3		3	8	Shibuya
				2		2	Shinjuku
	5	2			6	13	Other

Source Nikkei RE, Savills Research & Consultancy

TABLE 4: Notable Office Leasing Transactions, Q4/2021

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION	NEW LOCATION	APPROXIMATE SPACE	
					TSUBO	SQ M
Pasona Group	Staffing	Relocation	Nippon Building Chiyoda	Avex Building Minato	8,600	28,300
Rakuten Group	E-Commerce	Expansion	Various Various	NBF Shinagawa Tower Minato	4,000	13,200
Nagase	Chemicals Trading	Relocation	Company Owned Building Chuo	Tokiwabashi Tower Chiyoda	2,300	7,600
JSOL	Systems Integration	Relocation	Harumi Center Building Chuo	Kudan-Minami Itchome Project Chiyoda	2,200	7,400
Ginsen	Insurance and Real Estate	Unknown	Various Various	Shidome Building Minato	1,500	5,000

Source Nikkei RE, Savills Research & Consultancy potential tenants are willing to pay. Additionally, the ward has the smallest overall stock in the C5W, which has helped it maintain the lowest vacancy in the C5W amidst the pandemic.

That said, performances in Shibuya vary depending on location, and a closer analysis reveals that Shibuya's overall resiliency is greatly supported by the area around Shibuya station. In this area, rental corrections to suitable price points have helped decrease vacancy. Furthermore, although its vacancy is higher than pre-pandemic levels, the Yoyogi & Sendagaya submarket has also managed to maintain low levels of vacancy. As the most affordable rental level in the ward with proximity to major stations, the submarket has a stable tenant base.

Elsewhere, the Ebisu & Hiroo submarket took the hardest hit from the pandemic and continues to be the primary cause for the rental corrections in the ward overall. Accessibility in the submarket is unideal, and its stock is older compared to the rest of Shibuya. Indeed, the trend seen in the overall Tokyo market also holds true for Shibuya – buildings that are newer and closer to stations look to remain stable, while those further away and older have continued to deteriorate, thus bringing down the market.

Rents for Grade A buildings in Ebisu & Hiroo have declined 16.0% since the pandemic began in Q1/2020. In comparison, the area around Shibuya station contracted 11.7%, and the Yoyogi & Sendagaya submarket saw the smallest contraction of 6.0%. Yoyogi & Sendagaya should remain stable in the short-term and hopefully recover in the mid-term when developments come to the market and help revitalise the area.

Looking forward, the supply situation around the vicinity of Shibuya station appears stable. After a quiet supply year in 2022, 2023 and 2024 will introduce supply that will play to the area's strengths. Specifically, the next largest supply, Sakuragaoka Redevelopment, will introduce over 55,000 tsubo GFA directly next to Shibuya station. Other buildings such as the Dogenzaka 2-chome project and Shibuya 2-chome 17 district projects opening up close to Shibuya station should also make the area more attractive. Indeed, although the hybrid work model has become more popular, high-grade offices with good accessibility should remain popular.

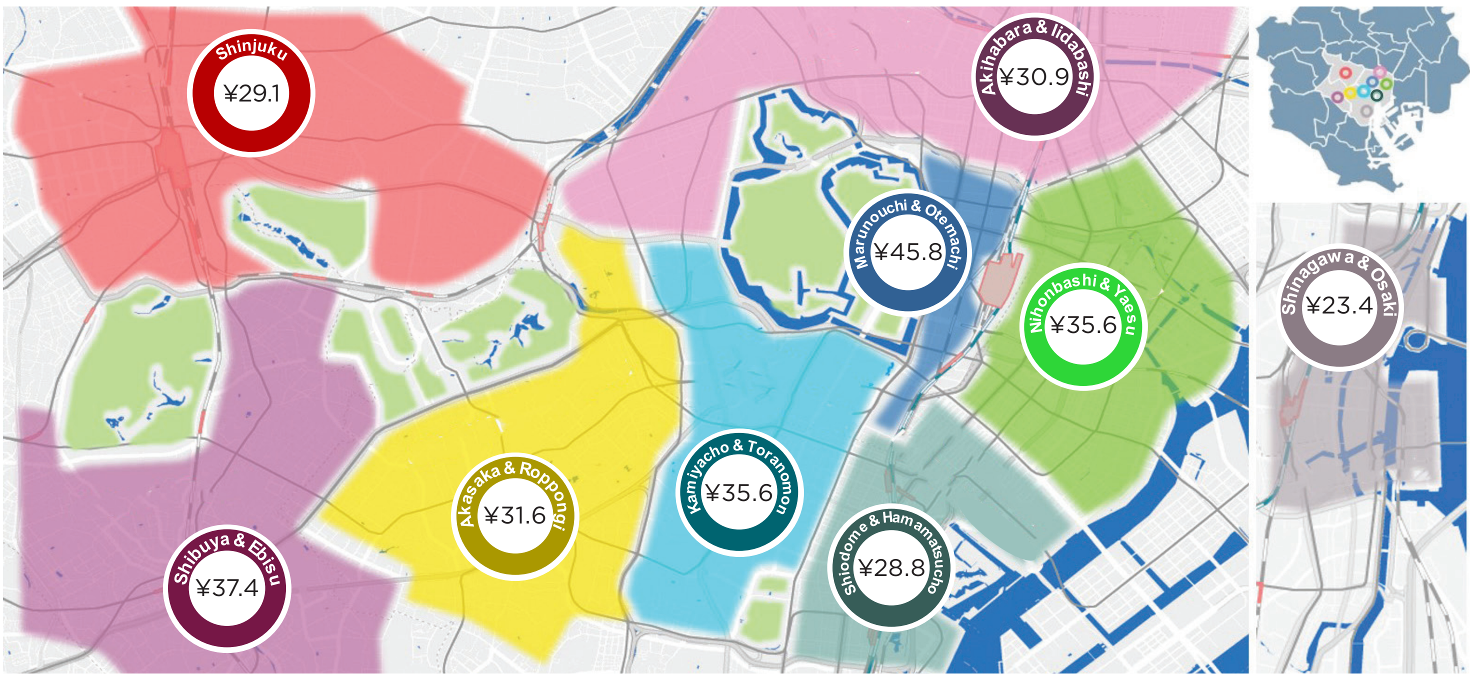
Overall, Shibuya remains an ideal location for prospective tenants to set up a main central office given its high-specifications, large floor plate buildings, and improved accessibility. Although navigating in and around the station was complicated before, various renovations have been improving the walkability and ease of access, particularly for the new buildings surrounding the station that were built in recent years.

TABLE 5: Comparison of Shibuya's Various Submarkets' Grade A Performance During the Pandemic

	RENT JPY/TSUBO			VACANCY			AVERAGE DISTANCE FROM STATION BY WALKING (MINUTES)	AVERAGE FREE RENT PERIOD (MONTHS)	AVERAGE YEAR OF CONSTRUCTION OF GRADE A
	Q1/2020	Q4/2021	CHANGE FROM PRE-PANDEMIC LEVELS	Q1/2020	Q4/2021	CHANGE FROM PRE-PANDEMIC LEVELS			
Ebisu & Hiroo	36,300	30,500	-16.0%	0.0%	4.5%	4.5ppts	4.8	4.5	1997
Shibuya Station Vicinity	45,200	39,900	-11.7%	0.4%	0.0%	-0.4ppts	3.0	0.8	2010
Yoyogi & Sendagaya	34,800	32,700	-6.0%	0.0%	2.7%	2.7ppts	3.6	2.1	2003

Source Savills Research & Consultancy
*In each submarket within the table, only buildings located in Shibuya are included.

MAP 1: Average Rents Per Tsubo In Selected Submarkets, Q4/2021



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

OUTLOOK

With business and consumer confidence gradually increasing through 2021, there were hopes that the economy would recover in earnest, and that the office sector would improve and bottom out in early 2022. Indeed, the pandemic appeared manageable with the high vaccination rates and plummeting cases of COVID-19 in the country. Unfortunately, the Omicron variant has clouded this optimism and delayed the recovery by at least a few months.

Despite the ebbs and flows of the pandemic, the office remains an important part of the workplace, and large-scale cancellations have been limited thus far. For instance, as demonstrated by a series of Xymax surveys in December, more than half of workers go to the office at least twice a week as of September, highlighting the improbability of full teleworking arrangements. Furthermore, as long as the pandemic remains manageable, most companies of all sizes intend to increase their in-office attendance, and over three quarters of workers reportedly would like to go to the office at least one day per week. In fact, in other cities beyond Tokyo, many workers have already begun to fully return to the workplace, even in the second largest city, Osaka.

One trend observed in recent office movements is that companies are shifting their office layouts to support a hybrid model rather than returning office space. This hybrid model should be applicable to most industries, albeit at different scales. Industries such as IT are more likely to implement remote work arrangements, while industries such as construction and finance prefer greater office attendance and have stronger intentions to return to the office. The size of companies should also affect remote working practices – large companies are more likely to continue this practice than smaller companies, especially from a company-benefit point of view.

Overall, even though concerns over new variants are prevalent, more people are expected to return to the office as long as the pandemic situation remains manageable. Therefore, the recovery of office markets is still expected in 2022. With corporate profits nearing pre-pandemic levels, business sentiments have improved in 2021. Specifically, year-to-date corporate profits in Q3/2021 are 50% higher than what was seen over the same period in 2020 and are only 3% lower than the same period in 2019. However, even in a post-pandemic world, there will be many people who will not commute to the office daily, and office demand will thus remain subdued. Furthermore, the Omicron variant may delay economic recovery or instill greater caution about returning to the office. That said, the high vaccination rates and conservative attitudes should help to maintain stability in the office sector going forward.

Savills monitors rents and vacancy levels at more than 500 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.