MARKET IN MINUTES
Savills Research

Office Leasing

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A market searching for a landing point

Gradual recovery is underway, although uncertainty has grown in the global economy.

- Rents have been largely flat, while vacancy rates remain elevated in some wards.
- Average Grade A office[1] rents in the C5W inched down 0.2% quarter-on-quarter (QoQ) to JPY32,765 per tsubo[2] per month, falling 2.7% year-on-year (YoY).
- The average Grade A office vacancy rate in the C5W tightened slightly by 0.2ppts QoQ, but rose 1.1ppt YoY to 3.9%.
- Average large-scale Grade B office[3] rents inched down 0.7% over the quarter to JPY24,469 per tsubo per month and declined 4.2% YoY.
- Vacancy rates in the Grade B market tightened 1.1ppts over the quarter to 3.7%, but still rose 0.1ppts YoY.
- With Japan having entered an endemic state, office demand is likely to keep growing on a gradual pace and help market recovery, although the slowdown of the global economy is weighing down on the outlook.

1 Grade A offices refer to buildings with a GFA of 9,000 tsubo (30,000 sq m) and a building age of less than 15 years. Some buildings that do not fit this definition are included.
2 1 tsubo = 3.306 sq m or 35.583 sq ft.
3 Large-scale Grade B offices refer 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.

"Overall, 2022 has continued to see small rental corrections with vacancy rates remaining elevated in some wards. Although there was some positive economic news and the pre-leasing of 2023 supply is sound, gloomy prospects for the global economy are shrouding the market outlook. With a large wave of supply in 2023, bifurcation in the market is likely to continue."

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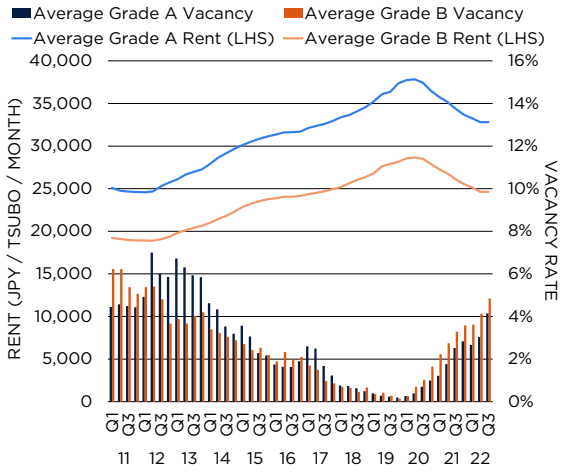
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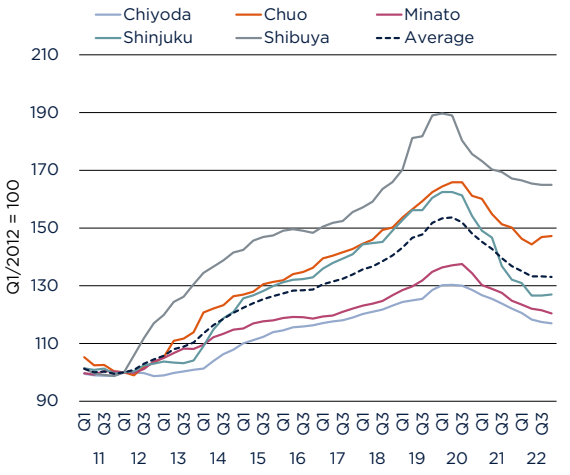
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GRAPH 1: Office Rents and Vacancy in Tokyo's C5W*, 2011 to Q4/2022



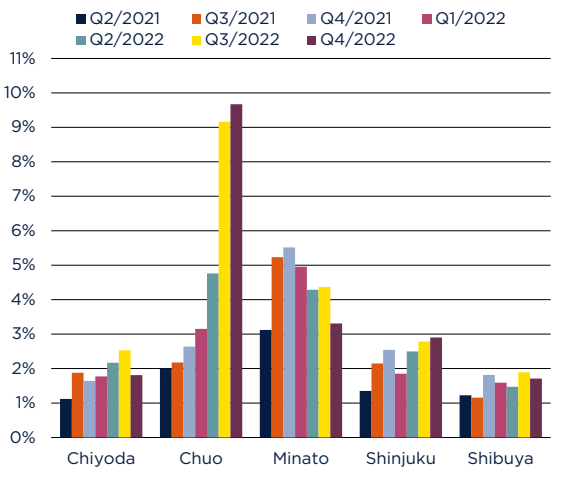
Source Savills Research & Consultancy
* Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index by Ward, 2011 to Q4/2022



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy by Ward, Q2/2021 to Q4/2022



Source Savills Research & Consultancy

GRADE A OFFICE

The Grade A office market has remained largely steady, with rents inching down by a slight 0.2% over the quarter Q4/2022 to JPY32,765 per tsubo, resulting in an annual decline of 2.7%. Consequently, the total rental correction from the peak seen in Q2/2020 reached 13.4% for the Tokyo Grade A office market in the central five wards (C5W), although the pace of rental corrections has noticeably slowed down in recent quarters. Although the last quarter saw a pause in rental corrections, that was a temporal situation triggered by the addition of a few new offices that have above average rents.

At the ward level, Minato saw a rental correction of 0.9% QoQ in Q4/2022, the largest among the C5W. On the other hand, the average rents in Shinjuku and Chuo edged up 0.3% and 0.2% QoQ as some offices raised rents. Additionally, Shibuya's rents remained unchanged this quarter, demonstrating its continued strength.

The average vacancy rate held up at 3.9%, a slight tightening of 0.2ppts QoQ, although it loosened 1.1ppt YoY. Chiyoda, Minato, and Shibuya recorded decreases in vacancy rates, while Chuo and Shinjuku saw a further loosening this quarter. That said, with the exception of Chuo, vacancy rates remain low across the submarkets, ranging from 1.7% to 3.3%. Although Chuo has a high vacancy rate of 9.7%, this is rooted primarily in the opening of Yaesu Central Tower in the last quarter, and it should be noted that this new tower seems to be gaining traction toward its full opening in spring 2023. Indeed, discounting the impact from Yaesu Central Tower, Chuo's vacancy would be a much more moderate 5.8%.

Overall, the market is attaining a state of stability, continuing its ongoing trend. Although the market keeps seeing corrections, they are gradually becoming more moderate. In fact, a majority of buildings have not seen any rental declines, with some even raising rents in recent quarters. As discussed later in this report, the further transition to normalisation is expected to prop up the market going forward.

LARGE-SCALE GRADE B OFFICES

In general, the large-scale Grade B market has continued to move in tandem with the Grade A market. Rents in the large-scale Grade B market inched down 0.7% QoQ and 4.2% YoY to JPY24,469 per tsubo. Similar to the Grade A market, the total rental decline from the peak seen in Q2/2020 accumulated to 14.6%. At the ward level, Shibuya demonstrated its strength with its average rents growing 0.1% QoQ while Shinjuku saw this quarter's largest decline of 2.3% QoQ.

As for vacancy rates, the large-scale Grade B market saw a moderate tightening of 1.1ppts QoQ to 3.7%. The average vacancy rate in Minato remained high at 9.2% as several Grade B office buildings in the ward continue to have large amounts of vacant space. Meanwhile, Shibuya still maintains the lowest vacancy rate among the C5W at 1.0% after a tightening of 0.8% QoQ.

Overall, the large-scale Grade B office market has also continued a trend of corrections becoming more gentle that has been ongoing for the past year. While the affordability of large-scale Grade B offices is attractive for some tenants, older buildings in inconvenient locations are expected to continue to struggle. The bifurcation of the market is likely to deepen as tenants favour buildings that have suitable features for hybrid work.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

Chiyoda's rents have seen a moderate decline of 0.4% QoQ and 4.2% YoY to JPY39,339 per tsubo. Meanwhile, vacancy rates tightened 0.7ppts QoQ, but edged up 0.2ppts YoY to 1.8%. While several office buildings in the ward still have large vacancy rates, many saw some improvements. The total rental correction of the ward since its peak in Q2/2020 is 10.2%, which is better than the C5W of 13.4%.

This quarter, it was reported that KDDI will be consolidating several office locations into Garden Air Tower and the Iidabashi i-Mark Building in Chiyoda in March and April of 2023, while returning about 2,300 tsubo of office space currently spread across Sumitomo Fudosan Iidabashi First Tower and the Nichirei Suidobashi Building. Elsewhere, Meiji Yasuda Life Insurance is reportedly considering moving into Marunouchi Trust Tower. Although it is unclear as to which office buildings it is moving from, Meiji Yasuda Life Insurance has multiple offices in Chuo which might be consolidated in this relocation.

Overall, Chiyoda continues to demonstrate its stability, supported by a high concentration of large, blue-chip companies in the ward. Going forward, there will be some dislocated demand from the planned demolition of the Kokusai Building and the Teigeki Building in the area, which should help to fill vacant spaces in nearby buildings. Distance from major stations will likely be a primary factor that influences building performances in the ward.

Chuo

Chuo saw average rents increase over the quarter, growing 0.2% QoQ to JPY31,897 per tsubo, although it still posted an annual decline of 1.9%. This quarterly growth followed another rental increase seen in the previous quarter, which was mainly caused by an addition of newly built buildings. Its vacancy rate remains the highest among the C5W at 9.7% primarily due to Midtown Yaesu Central Tower, which still has uncommitted space. That said, the tower is gradually filling the remaining space toward its full opening in spring. The next large additions to the area will be the Yaesu 1-Chome project and the Nihonbashi 1-Chome project in 2025, meaning that the market still has a few years to prepare.

In Chuo, it is reported that Bridgestone will return 2,000 tsubo in Tokyo Square Garden, although it is expected to keep about 3,000 tsubo in the building. Meanwhile, Miki Shoji is moving its headquarters to Tokyo Square Garden. Elsewhere, Honda Foundation is expected to lease about 300 tsubo in the newly completed Yanmar Tokyo Building, and Hokkan Holdings is reportedly to move its headquarters from the Marunouchi Mitsui Building to the newer Nihonbashi Mitsui Tower.

Minato

Minato saw a rental decline of 0.9% QoQ to JPY30,516 per tsubo. On an annual basis, it was a decline of 3.5% YoY, which was slightly higher than the C5W average. Meanwhile, vacancy rates in Minato tightened moderately by 1.1ppts QoQ and 2.2ppts YoY to 3.3%.

In Minato, Adidas will reportedly return 1,200 tsubo in Sengokuyama Mori Tower, which it had been occupying since 2012. Meanwhile, the Tokyo Shiodome Building, which had large vacancy caused by the departure of SoftBank in 2020, is seeing positive movements. For instance, Showa Denko is expected to relocate to the Tokyo Shiodome Building and lease about 3,000 tsubo, while major valve manufacturer Kitz will reportedly move its headquarters to the building in November 2023, leasing 1,100 tsubo. Additionally, Unicharm will reportedly move its headquarters to tentatively named Tokyo Mita Redevelopment Project Office Tower, which is slated for completion in February 2023, and lease 2,400 tsubo. Earlier this year, it was also reported that Kyocera will move to this new building, expectedly leasing 5,600 tsubo.

As such, Minato saw gradual improvement this quarter with vacancy rates tightening. Going forward, the highly anticipated Toranomon Azabudai project and Toranomon Hills Station Tower are slated to open in 2023. Although pre-leasing activity appears to be progressing, we need to pay close attention to their impact on the market.

TABLE 1: Tenant Relocations, Q4/2022

ORIGIN							DESTINATION	
Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other			
7	5	20	1	3	20			
4	1				4	→	9	Chiyoda
1	4	1			2	→	8	Chuo
2		16		1	5	→	24	Minato
		3			1	→	4	Shibuya
			1	2		→	3	Shinjuku
					8	→	8	Other

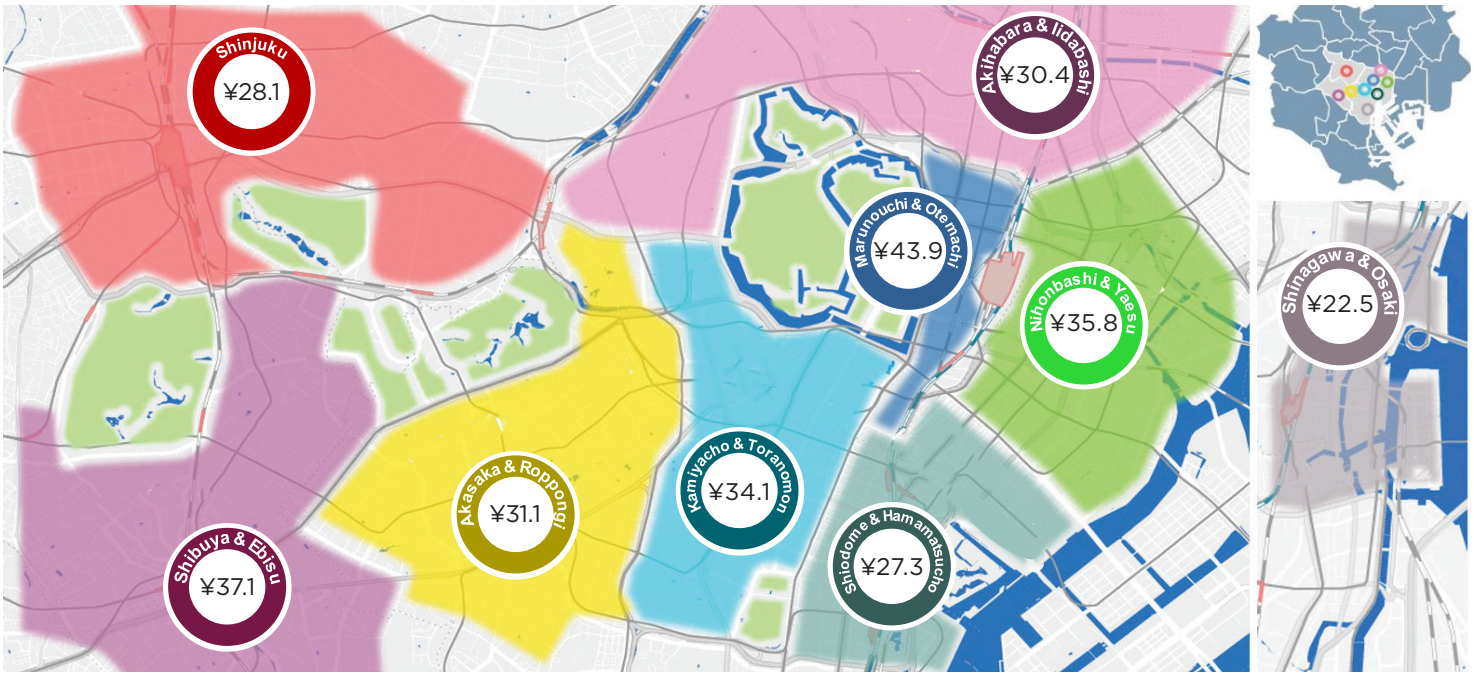
Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Q4/2022

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION		NEW LOCATION	APPROXIMATE SPACE	
						TSUBO	SQ M
Showa Denko	Chemical	Undisclosed	Unknown	→	Tokyo Shiodome Building	3,000	9,900
			Unknown		Minato		
Unicharm	Hygiene product manufacturer	HQ Relocation	Sumitomo Fudosan Mita Twin Building West	→	Tokyo Mita Redevelopment Project Office Tower	2,400	7,900
			Minato		Minato		
Kitz	Valve manufacturer	HQ Relocation	Kitz Building	→	Tokyo Shiodome Building	1,100	3,600
			Chiba		Minato		
Sony PCL	Video content production	HQ Relocation	Meguro Tokyu Building	→	A-Place Shinagawa Higashi	1,000	3,400
			Shinagawa		Minato		
Nikken Leasing	Machine rental	HQ Relocation	Sanno Grand Building	→	Tokyo Shiodome Building	1,000	3,400
			Chiyoda		Minato		

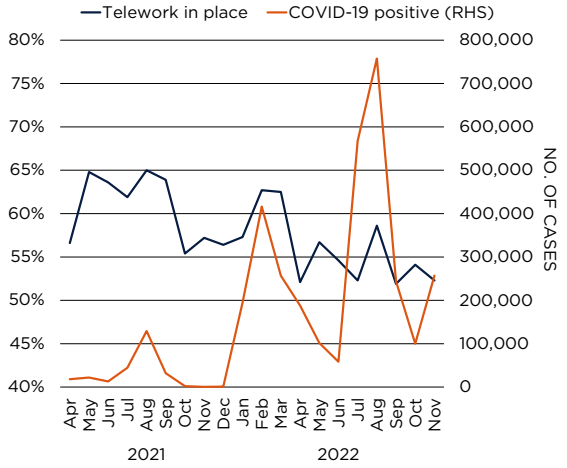
Source Nikkei RE, Savills Research & Consultancy

MAP 1: Average Rents Per Tsubo in Selected Submarkets, Q4/2022



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

GRAPH 4: : Telework Implementation Rates in Tokyo vs COVID-19 Cases, April 2021 to November 2022



Source Tokyo Metropolitan Government, Savills Research & Consultancy

Shibuya

Once again, Shibuya demonstrated its strength as rents in the ward remained flat. Over the quarter, the average rent was unchanged at JPY35,238 per tsubo, although it declined 1.3% YoY. The stable rents appear to be supported by low vacancy rates, which inched down 0.2ppts QoQ to 1.7%, the lowest among the C5W. Serviced offices near Shibuya station appear to have seen sound demand as well.

This quarter, it is reported that J Trust will lease 860 tsubo in Yebisu Garden Place and move its headquarters there. The company will also consolidate its currently scattered offices with an aim to improve collaboration among different functions. Although the Ebisu area was lagging in well-performing Shibuya, it was also announced earlier this year that Traders Holdings will move to Yebisu Garden Place in 2023, leasing 660 tsubo. Elsewhere, system integrator NSW will reportedly lease 980 tsubo in JMF-Building Shibuya 02, which is owned by Japan Metropolitan Fund Investment Corporation, a large J-REIT.

Shinjuku

Shinjuku's rents inched up 0.3% QoQ, but continued to decline 3.9% YoY to JPY26,833 per tsubo, resulting in an accumulated rental correction of 21.8% since the previous peak in Q2/2020. Meanwhile, vacancy rates were relatively stable at 2.9%, only slightly edging up 0.1ppts QoQ and 0.4ppts YoY.

In Shinjuku, Rizap Group is moving its headquarters from Shinjuku Front Tower in Kita-Shinjuku to Sumitomo Fudosan Shinjuku Grand Tower in Nishi-Shinjuku and is expected to lease 800 tsubo. While leasing activity appears to have been quiet this quarter, Shinjuku's stable vacancy rate is reassuring. The office buildings proximate to stations continue to see sound demand. In the long term, station-front redevelopments should help the area's growth.

STEADY RECOVERY IN AN ENDEMIC STATE

As discussed in A Deep Dive into Tokyo Office, the pandemic triggered a prolonged downturn of the office market and reversed the strong growth seen in preceding years. Despite optimistic views in the early days, the pandemic lasted long, and the Tokyo office market experienced contractions meanwhile. As such, economic improvement, and Japanese society's progression to an endemic state that the market saw in 2022 is a long-awaited development that gives a sense of relief.

One trend that portrays the normalcy in the office market is a declining trend of telework implementation rates. In Tokyo, the rate peaked at 65% in 2021 and spiked in early 2022 due to a surge of COVID-19 cases,

but it has been generally trending downward over the past two years (Graph 4). Especially, it is noticeable that the implementation rate did not significantly surge in recent months even with the large number of new cases, indicating that many companies have accepted the new life with COVID-19. Although another wave is approaching, the overall trend toward a post-pandemic world is unlikely to be reversed considering all the normalising measures that took place.

To be sure, telework arrangements will continue in a post-pandemic world. However, telework policies differ from company to company. Overall, not unexpectedly, major IT-related companies such as Yahoo!Japan and DeNA tend to have more accommodative policies regarding telework. Competition for talent is fierce in the industry, and the promise of flexible work styles is a perk that could help make the company a more attractive place to work. However, with tech giants' global push for returning to the office, the future is ambivalent. Furthermore, the recent outperformance of Shibuya where IT companies are concentrated appears to suggest that tenants are willing to keep their office space.

Additionally, reviewing recent announcements of tenant relocations, a majority appear to be companies that aim to improve operation by consolidating functions typically in newer and more convenient offices. Although companies generally do not expect office attendance to go back to 100%, many appear to have kept their leased space unchanged or only moderately reduced. As such, overall office demand is expected to remain relatively stable, although performances might diverge at the property level.

Overall, the transition to an endemic state is a welcome change for the recovery of the office market. However, as some companies decide to make telework permanent and reduce office space, office buildings that will not be considered suitable for hybrid work styles will likely continue to see soft demand. While improvements in economic conditions should buoy the overall office market, the bifurcation of performances is likely to continue in the near term.

OUTLOOK

The Tokyo office market has continued to see gradual corrections through 2022, although there have been signs of improvements as rental declines have significantly slowed down. While vacancy rates remain elevated in some wards, they have been relatively stable across the C5W in recent quarters. Sound pre-leasing levels at around 50% for the 2023 supply bodes well for the market outlook as well. New office supply is also expected to create new office demand.

2022 marked the first year of a post-pandemic world in Japan. Although Japan lagged other global peers, it has now relaxed its border controls, and office attendance has also increased. Although the office market is not completely out of the woods, this steady recovery is expected to accelerate market recovery going forward.

That said, a global economic slowdown is looming larger as a risk to the market. Factors such as the conflict in Ukraine, elevated energy prices, and inflation as well as interest rate hikes have all weighed on the global economy. Although Japan was fairing relatively well compared to other developed countries, it is not insulated from the impact. A historic weakening of the yen has also adversely affected the consumer sentiment. While Japanese tenants are expanding their floors, overseas tenants stop expanding leased spaces. This trend is likely to go on in 2023 when large supply is coming.

Overall, the Tokyo market has been fairly stable with some signs of bottoming out in 2022. Indeed, some properties have started seeing rents stabilise or even edge up in recent quarters. Nonetheless, the global economic slowdown could introduce hurdles to the market in the near term, and demand might take longer to recover. With uncertain market conditions continuing, the gap between outperforming and underperforming offices may widen even more.

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.