MARKET IN MINUTES
Savills Research

Office Leasing

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Market adjustment slows

Although the market continues to correct, we note signs that the rate of adjustment is slowing.

- For the central five wards (C5W), COVID-19 is still taking a toll on the market and casting a shadow over the market's future, although the impact appears to be showing signs of alleviation.
- Average Grade A office market rents in the C5W fell 1.9% quarter-on-quarter (QoQ) and 5.3% year-on-year (YoY), and now stand at JPY35,762 per tsubo[1] per month.
- The average Grade A office vacancy rate in the C5W increased slightly by 0.2 percentage points (ppts) QoQ to 1.2% in Q1/2021.
- Average large-scale Grade B office rents declined to JPY27,275 per tsubo per month – a contraction of 2.1% QoQ and 4.5% YoY.
- The average vacancy rate in the Grade B market lies at 2.2% following a loosening of 0.6ppts QoQ and 2.0ppts YoY.
- With limited supply expected this year and the next, the market should have time to adjust and recover, although secondary vacancy derived from the large supply in 2020 is a concern.
- While prime real estate is expected to hold steady, rents in poorly located and older offices are likely to fall, resulting in an overall market deterioration.

"While average rents continue to correct, the overall adjustment has started to slow. Although rents in poorly located and ageing buildings are expected to deteriorate further dragging down the market overall, certain wards and submarkets are expected to hold up well."

SAVILLS RESEARCH & CONSULTANCY

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

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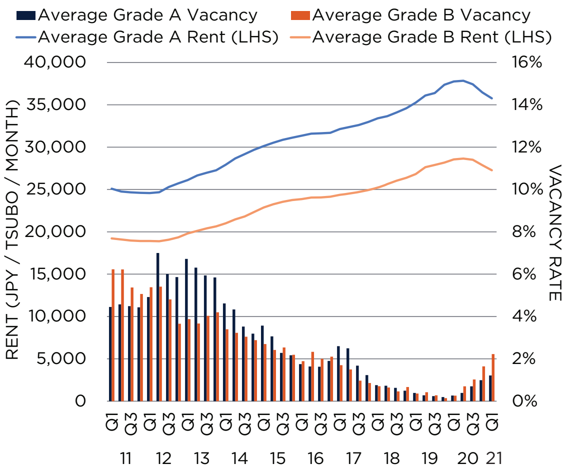
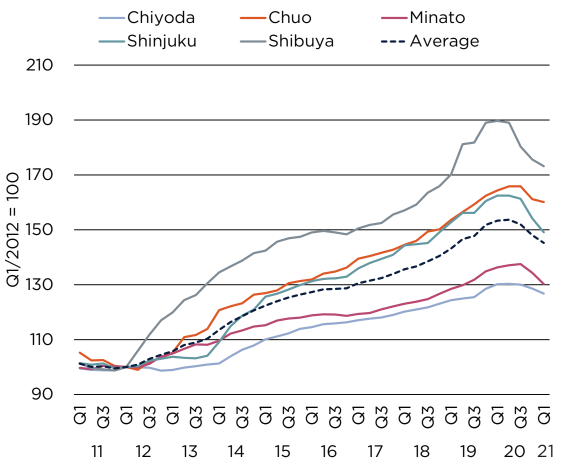
GRAPH 1: Office Rents And Vacancy In Tokyo's C5W*, 2011 to Q1/2021



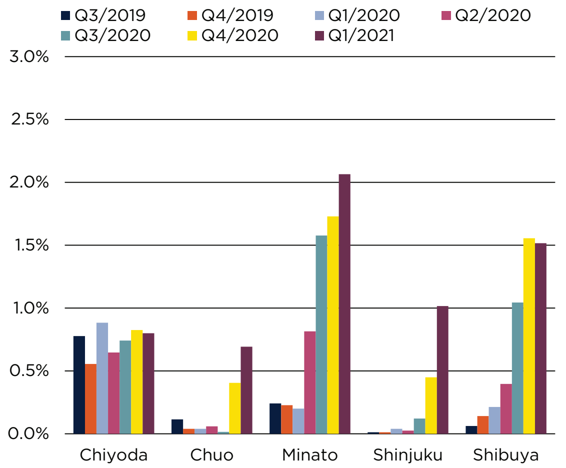
Source Savills Research & Consultancy
*Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index By Ward, 2011 to Q1/2021



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy By Ward, Q3/2019 to Q1/2021



Source Savills Research & Consultancy

GRADE A OFFICES

Tokyo's Grade A[2] office market continues to see a deterioration in rents as the outlook for the Japanese and global economies remains clouded, although there appears to be some optimism particularly in capital markets. While quarterly rents have declined 1.9% QoQ to JPY 35,762 per tsubo[3], the magnitude of decline is smaller than the 2.6% QoQ correction seen in the last quarter. Although the YoY rental decline still portrays a pessimistic image with the average rent in Q1/2021 shrinking 5.3%, it must be considered that this quarter's drop was accentuated as Q1/2020 was the last quarter before the COVID-19 pandemic started affecting the market and was the strongest since 2008. Additionally, vacancy levels remain tight at 1.2%, only a 0.2ppts loosening from Q4/2020. Chiyoda showed particular resilience, experiencing a slight tightening both for QoQ and YoY changes.

At the ward level, Shibuya continued to perform poorly with rents dropping a staggering 8.7% YoY, although QoQ changes over the past two quarters show that the decline is slowing down. When analysing QoQ and YoY changes together, Shinjuku and Minato are the main perpetrators for the rental decrease for the C5W. Shinjuku showed particularly poor performance with a decrease of 3.3% QoQ. However, this drop in rent could be seen as a natural market correction. As the market softened and vacancies began to increase, rent levels in Shinjuku adjusted in line with the submarket's overall building quality and age; in comparison, other wards have seen newer, state-of-the-art buildings enter the market. Minato followed closely behind Shinjuku with a quarterly decrease of 3.1%. The leading cause for the decrease is the high number of small and medium-sized enterprises (SMEs) in Minato. These companies are more vulnerable to market fluctuations and thus are more likely to adjust their leases in response to a poor financial environment.

Taken as a whole, the C5W's decline in rent is starting to curtail after the market began correcting in Q3/2020. Overall, there are signs of resilience, and although some new supply came to the market not fully leased, the overall market fundamentals remain sound. Encouragingly, traffic to workplaces currently stands at 75% of pre-COVID-19 levels, a significant improvement from the 40% levels observed during the initial lockdown in April 2020.

LARGE-SCALE GRADE B OFFICES

Within the large-scale Grade B market, we saw a 2.1% reduction in rent QoQ to JPY27,275 per tsubo. Vacancy, on the other hand, increased 0.6ppts QoQ for the third straight quarter. As a result, for the first time since Q4/2017, vacancy levels have exceeded 2%. Fortunately, the premium Grade A offices have over Grade B offices has held steady about 31%.

At the ward level, Chiyoda and Shibuya's Grade B buildings both showed above-average decreases in rent this quarter. As for vacancy, Chuo had the highest uptick this quarter, increasing 1.4ppts to 2.1%, with submarkets such as Harumi struggling to attract new tenants.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

Chiyoda maintains its premier status in the C5W. Unlike other markets that have seen notable increases in vacancy, Chiyoda's current vacancy levels are on par with pre-COVID levels. Looking forward, recent relocation announcements convey a trend that many companies wish to hold onto their Chiyoda address, although they may decrease their lease size.

In addition, the premium in Chiyoda's rent over the average rent of Grade A buildings in the C5W increased to 19.2% in Q1/2021, up from 15.9% in Q1/2020. Although Chiyoda did see a mild decrease in rents, the decline, when compared to the rest of the C5W, is significantly lower. This could be because Chiyoda's rental growth prior to the pandemic was moderate compared to the other wards, therefore limiting correction in rents. Taken all together, with market fundamentals still sound and limited supply expected over the next two years, Chiyoda is looking like it will hold up well for the foreseeable future.

Chuo

Chuo showed resilience in Q1/2021 with the lowest decrease in YoY rent within the C5W at 2.6%. Chuo also had the slowest QoQ rental decline at 0.7% – just shy of the decrease seen in Q4/2020. In terms of vacancy, Chuo maintained vacancy rates under 1% and experienced the second smallest increase QoQ.

With the comparatively large tenant pool of Japanese corporate headquarters, known for hoarding cash, ongoing availability should remain tight. On the other hand, given the prevailing vacancy situation in the Harumi area, coupled with supply increases via redevelopments in Yaesu, there may be some concerns in the future that rent might decrease as vacancy increases.

Minato

Minato's rents have declined further this quarter, falling 3.1% QoQ to JPY33,000 per tsubo in Q1. Vacancy is a similar story, loosening 0.3ppts QoQ. However, the

2 "Grade A office" refers to buildings with a GFA of 9,000 tsubo (30,000 sq m) and a building age of less than 15 years. Some buildings are included that do not fit this definition.
3 Throughout the report, "per tsubo" is shorthand for "per tsubo per month".

TABLE 1: Tenant Relocations, Q1/2021

ORIGIN							DESTINATION	
Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other			
10	15	19	8	3	6			
5	6	6			2	→	19	Chiyoda
	4	1				→	5	Chuo
2	3	7	2	1	4	→	19	Minato
1		4	4	1		→	10	Shibuya
	1	1		1		→	3	Shinjuku
2	1		2			→	5	Other

Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Q1/2021

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION		NEW LOCATION	APPROXIMATE SPACE	
						TSUBO	SQ M
Itochu Techno-Solutions	Systems Integration	HQ Relocation & Office Consolidation	Multiple Chiyoda, Shinagawa, Toshima, Setagaya	→	Kamiyacho Trust Tower Minato	10,000	33,000
Pasco	Geospatial Informaiton Technology	HQ Relocation & Office Consolidation	Multiple Meguro, Hachioji	→	Meguro Knowledge Plaza Meguro	2,600	8,500
Colopl	Video Game Developer	HQ Relocation	Yebisu Garden Place Tower Shibuya	→	Midtown East Minato	2,240	7,400
Link and Motivation	Human Resources Consulting	HQ Relocation	Ginza Six Chuo	→	Kabukiza Tower Chuo	1,800	5,900
SAP Japan	Software Developer	HQ Relocation & Office Consolidation	Multiple Chiyoda, Chuo	→	Mitsui & Co. Building Chiyoda	1,700	5,600

Source Nikkei RE, Savills Research & Consultancy

worsening environment might be understandable considering recent supply, as two new buildings have been introduced into the market with the larger of the two still without leases for multiple floors.

In the meantime, we will see movement into Minato from other areas of Tokyo. A noteworthy example is Itochu Techno-Solutions Corporation (CTC) who will centralise its offices that lie outside the C5W into Minato with a 10,000 tsubo lease in Kamiyacho Trust Tower. Going forward, however, whether the demand for office space can keep pace with the supply is up for debate. From mid-2021 until the end of 2024, large redevelopments with GFAs of over 30,000 tsubo, such as the Hibiya Fort Tower and the Toranomon Azabudai Project, will introduce a GFA of about 585,000 tsubo into the market. Although Minato is bearing the brunt of the new supply, there is some hope that with the second cheapest rent in Tokyo and upcoming state-of-the-art developments on the horizon, the ward may prove to be a favourable area for many companies.

Shibuya

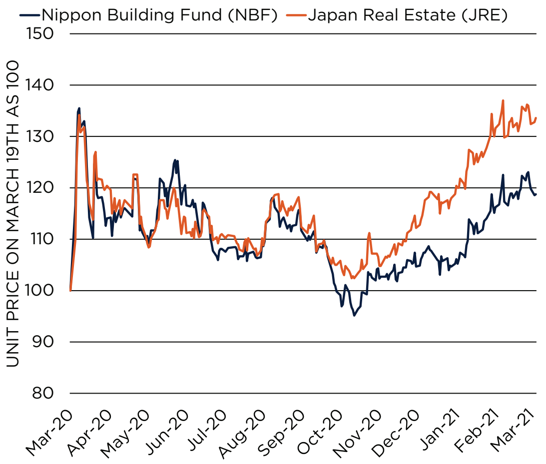
Shibuya sees some much-needed relief from the rapid correction it experienced over the last couple of quarters. In terms of QoQ rental decrease, Shibuya only declined 1.4% – the second lowest drop in the C5W this quarter. To this effect, some companies are relocating to the newer buildings that have opened amongst Shibuya's redevelopment boom in the last couple of years. Moreover, vacancies have improved for the first time since Q3/2019, decreasing 0.1ppts to 1.5%.

Much of the office rental growth that Shibuya has seen over the last decade has remained intact despite the recent decline in rent. In fact, Shibuya is still holding onto its position as the second most expensive ward in Tokyo. To boot, Shibuya is beginning to see its premium over the average rent for the C5W increase again since the premium began decreasing in Q4/2019. There is additional good news as some companies may return to Shibuya as space becomes available and affordable. This, in turn, may help Shibuya recover the ground it lost during the COVID-19 pandemic. In addition, major players in Shibuya such as Tokyu are creating pre-established office space with more flexible arrangements to attract tenants. With many SMEs looking for these conditions, Shibuya is facing a potentially brighter future.

Shinjuku

The rate of rental decline seen in Shinjuku has decreased marginally from the steep 4.4% QoQ decline in Q4/2020, down to a decline of 3.3% QoQ in Q1/2021, landing at JPY31,500 per tsubo. However, the quarterly rental decline in Shinjuku is still the largest in the C5W. Furthermore, Shinjuku also saw the largest increase in vacancy of 0.6ppts QoQ. Overall, Shinjuku seems to be falling further behind the rest of the C5W. For instance, the gap

GRAPH 4: NBF And JRE Performance, March 2020 to March 2021



Source Tokyo Stock Exchange, Savills Research & Consultancy

in rents between its closest competitor Minato has widened from JPY200 per tsubo to JPY1,500 over the past year - the largest gap seen since Q1/2017. A driver behind this increasing gap may be the ageing stock that Shinjuku has, which is driving down rent as demand softens.

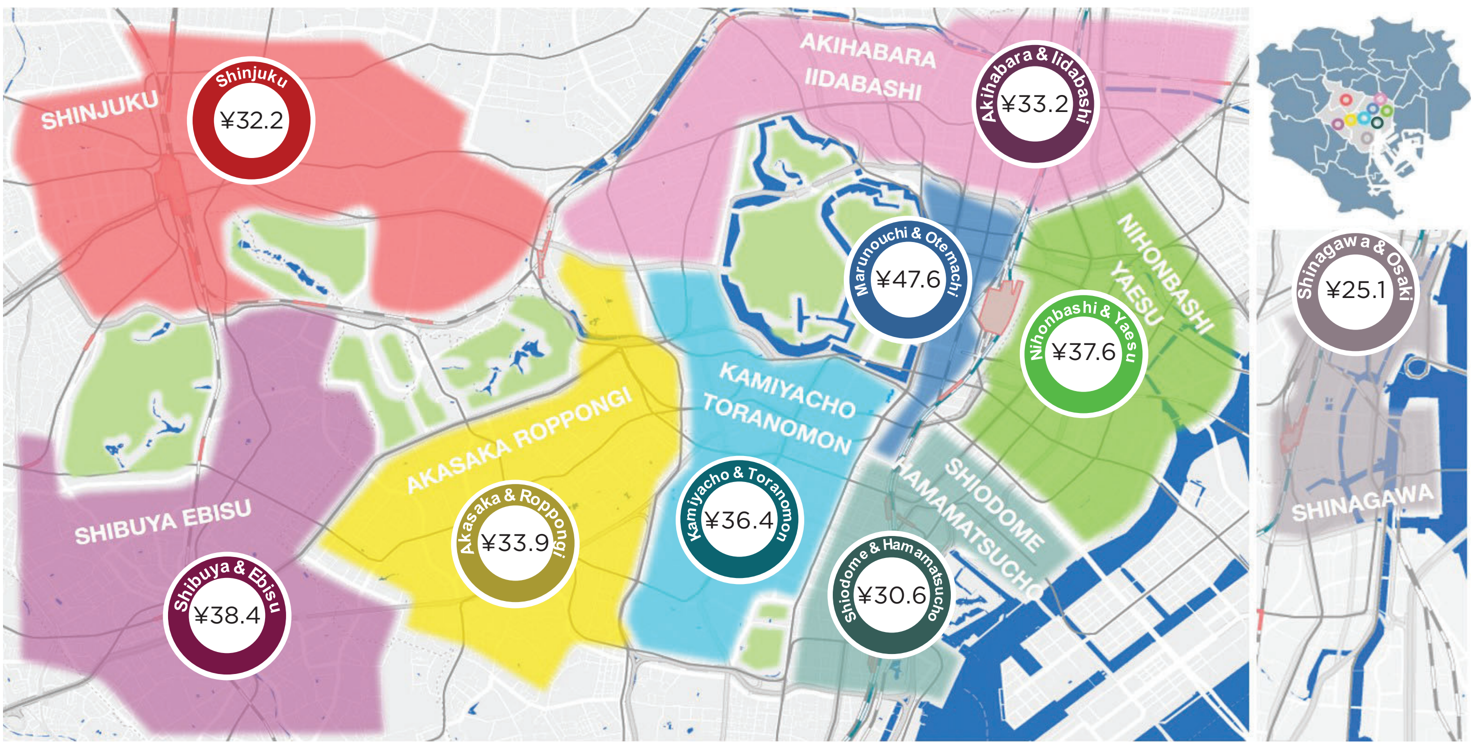
The silver lining for the ward is that the ageing buildings and relatively low rents could present ripe opportunity for redevelopment. Both Odakyu and Keio, major players in Shinjuku, have plans for redevelopments over the next decade. In fact, Odakyu has released its proposal for a new nearly 50-storey skyscraper with the middle floors expected to be primarily office space. Located at the same exit as Odakyu's above-mentioned redevelopment, there are rumours that Keio may redevelop some of their current real estate that has been standing for nearly 50 years, though plans are yet to be officially released. There are also rumours of other smaller redevelopments. All in all, these are all positive signs for Shinjuku going forward and may spark new life into the ward.

PROSPECT OF THE OFFICE MARKET

With the COVID-19 situation looming over the office real estate market in 2020, many companies adopted a wait-and-see approach. The current rental corrections and increased incentives demonstrate that the market is still finding a price point to start recovering. In the meantime, some companies, albeit a limited number, are beginning to execute their lease strategies in response to the changes caused by the pandemic.

However, the somewhat excessive pessimism appears to be easing in 2021. Specifically, despite the uncertainty that COVID-19 has brought to the market, vacancies remain roughly at 1.2% for Grade A buildings and rents are still about 70% of the peak levels seen prior to the financial crisis, implying that the downside is somewhat limited. At the ward level, Shibuya, which significantly weakened in the second half of 2020 as technology companies were the first to implement large-scale work-from-home measures and return office floors, is seeing some movements into the ward. In reaction to offices in Shibuya becoming increasingly available and affordable, we are also hearing more rumours about potential inbound relocations in the near future. Furthermore, Chiyoda and Chuo have shown grit since the COVID-19 pandemic started. As those wards are home to large Japanese firms that have lush cash reserves, they were able to weather the pandemic more effectively. Within each member of the C5W, some areas will hold likewise strong, whereas some areas within the same ward with ill-located or aged buildings will grow weaker, resulting in an image of overall weakened market performance.

MAP 1: Average Rents Per Tsubo In Selected Submarkets, Q1/2021



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

Easing pessimism in the office market can also be seen within the two major office J-REITs, Nippon Building Fund (NBF) and Japan Real Estate (JRE), that have recently showed sound rebounds. On 19 March 2020, these two office J-REITs fell to their 52-week low, then recovering by around 15% in the following weeks but lingering low until October 2020. NBF especially suffered at the time of a large equity offering. Since then, both have recovered considerably, with NBF around 20% to 25% above its lowest point last year and JRE hanging around 30% to 35%, having been supported by solid financial results. Given the high level of uncertainty in the office market throughout the pandemic, the bounce back we have seen shows the resilience of the office J-REITs and the office market at large. In fact, on April 2, Starwood Capital Group announced its intention to conduct a takeover bid of the Invesco Office J-REIT. This demonstrates a wider range of parties appear more optimistic on Japanese office market.

While these positive signs are being observed, the continuing uncertainty in future economic activity has sparked new demand for flexible offices. These settings are becoming increasingly desirable, especially for smaller or rapidly growing firms. By reducing the need for upfront capital expenditure and other costs, these flexible options can be critical for cost-effectiveness. Flexible offices also allow tenants to respond quickly to changing financial prospects with limited restoration costs when returning lease space to landlords. In response to this emerging trend, Hulic has begun expanding its office brand “Bizflex”, which offers tenants both pre-established offices and flexible leasing arrangements with leasing terms as short as three months and possibly without security deposits. It also provides quick move-in and subscription options for internet and other utilities. Some companies are already taking advantage of these flexible services such as Cookpad, a food tech company, who will move its headquarters to a WeWork office.

Looking forward, we may see a review of office size and location as companies look to focus on better located offices with collaborative and flexible layouts. This transformation may be accelerated given the slow vaccine rollout we are seeing in Japan. All in all, the shift means that the traditional three tsubo per person golden rule of office planning might be a thing of the past as companies shift their office layout to a more collaborative space with amenities such as lounge areas and creative areas. Although some companies will reduce in size, this shift in planning may require other companies to either hold onto their current size or maybe even acquire larger lease sizes in total to ensure adequate space for these new diversified and flexible offices.

OUTLOOK

The recent corporate performance and economic recovery are positive signs that should eventually translate to recovery and growth for the office market as the pandemic calms down. The corporate performance increase has a strong foundation moving forward due to the strong return of demand and production of electronics and automobiles in response to COVID-19 and the increased push for digitalisation within Japan. In addition, it has been thanks to the recent increase in profitability of the non-ferrous metal and chemical industries due to a rise in the international commodity market. That said, the slow pace of vaccination in Japan is likely to keep personal consumption low throughout 2021, while the economic recovery to pre-COVID levels should be achieved in 2022 or later. In the meantime, the secondary vacancy derived from the large supply in 2020 is a concern.

In the short term, many large companies look to maintain their current office spaces. In a survey conducted by Mori Building in late 2020 of a little under 2,000 respondents, nearly 60% of those surveyed said that they expect over 80% of their staff to return to the office once the pandemic winds down. To boot, nearly 50% of companies reported that they had little to no intention in adjusting their leasing afterwards. However, these companies do plan on changing the workplace to increase collaboration and productivity while providing employees with a flexible workplace. This subsequent change in office layout means that the lease spaces may stay at their current level or even need to increase for a few companies to meet the new diversified needs for a flexible workplace. Needless to say, some companies will shrink or release office space and thus somewhat decrease overall office demand, but the deterioration will likely be manageable.

Thus far, the only meaningful movement is mainly from SMEs who are more sensitive to market changes. Unfortunately, the prospects of SMEs are not optimistic and the subsequent negative impact on the office market is likely to continue, which will keep deteriorating rent and occupancy overall, especially as few plan to expand. In many prime areas though, we are seeing larger tenants hold steady. And with more companies prioritising better located and quality facilities when looking for new office space based on the previously mentioned survey, prime areas and their office buildings should hold up. Meanwhile, there should be a negative impact on ill located and ageing buildings moving forward. Given that only a small number of vaccines have been distributed at the start of Q2, the sentiments on the office market are unlikely to recover soon, and the market will keep looking for a point from which to commence recovery. While the overall prospects are not distressing, we should carefully monitor how the market develops.

Savills monitors rents and vacancy levels at more than 450 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.