MARKET IN MINUTES
Savills Research

Office Leasing

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Market corrections see further slowdown

Rental corrections have become less marked, and an equilibrium point could be reached soon.

- Corrections in rent and changes in vacancy seen in the central five wards (C5W) have become increasingly gentle.
- Average Grade A office market rents in the C5W fell 1.2% quarter-on-quarter (QoQ) and 7.0% year-on-year (YoY), and now stand at JPY33,266 per tsubo[1] per month.
- The average Grade A office vacancy rate in the C5W declined 0.1ppts over the quarter but increased 1.5ppts YoY to 2.7% in Q1/2022.
- Average large-scale Grade B office rents declined to JPY25,143 per tsubo per month – a contraction of 1.5% QoQ and 7.8% YoY.
- The average vacancy rate in the Grade B market stayed flat over the quarter at 3.6%, translating to an increment of 1.4ppts YoY.
- Shinjuku has seen the largest correction in rents amongst the C5W since the pandemic. However, there is some divergence between the performances of different submarkets.
- There is uncertainty in the global economy, and high commodity and energy prices are likely to slow recovery. However, the Japanese market is likely to steadily continue approaching normalcy.

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

> "Rental corrections in Japan's office market have slowed over the past few quarters, suggesting that an equilibrium point might soon be reached. While uncertainty in the global economy is likely to slow recovery, Japan's market should gradually approach normalcy."
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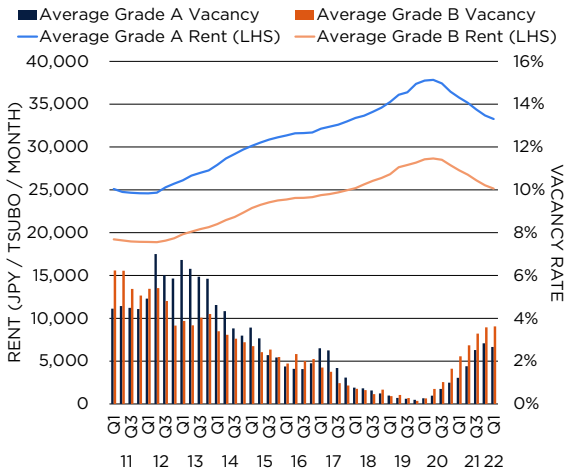
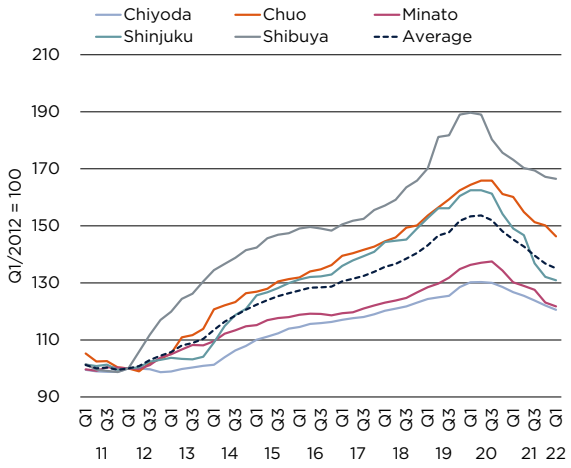
GRAPH 1: Office Rents and Vacancy in Tokyo's C5W*, 2011 to Q1/2022



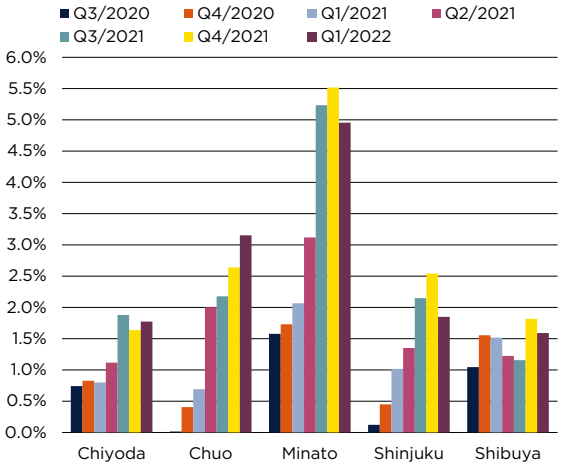
Source Savills Research & Consultancy
*Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index by Ward, 2011 to Q1/2022



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy by Ward, Q3/2020 to Q1/2022



Source Savills Research & Consultancy

GRADE A OFFICES

In Q1/2022, the Grade A office market saw another mild correction of 1.2% QoQ to JPY33,266 per tsubo, a decline of 7.0% YoY. Although rents have been contracting continuously since the pandemic began, the rate of decline has softened notably, suggesting that the market might be approaching an inflection point. For the first time since the pandemic began, vacancy rates saw an improvement, tightening 0.1ppts QoQ to 2.7% - an increment of 1.5ppts YoY. According to a Xymax survey[2] in March 2022, only 19.5% of respondents indicated a desire to reduce office space, compared to 30.0% in the same period in 2021. This improving sentiment could partly explain the gentler changes and gradual recovery seen recently.

At the submarket level, Shinjuku and Minato saw their vacancy improve, with rates decreasing 0.7ppts and 0.5ppts QoQ, respectively. On the other hand, Chuo's vacancy loosened 0.5ppts QoQ, partially due to the closing of the Olympics offices in the Harumi area. Looking at rents, Chuo had the most pronounced decline of 2.6% QoQ while other wards saw declines of 0.4% to 1.2%.

A notable number of leasing transactions have been observed this quarter. For instance, one of the latest buildings to open in the C5W, Tokiwabashi Tower, continues to fill its vacant space. Elsewhere, the next Grade A building to open this year in July, Kudan Kaikan Terrace, has attracted large leases, likely due to its effective marketing and sales strategy, and is on course to come online fully pre-leased. In Chuo, Tokyo Midtown Yaesu that is scheduled to be completed in August had a mediocre start in pre-leasing, but it is garnering interest, particularly from financial institutions and prestigious firms based around Tokyo station.

While 2022 has the smallest supply seen in the last decade, 2023 is forecast to introduce nearly three times that amount. Nonetheless, the average supply between 2022 and 2025 will be lower than the average of the past ten years, providing some breathing room for the market overall. The performance of new supply is expected to be K-shaped, depending on the location and amenities. For instance, the Sakuragaoka Redevelopment next to Shibuya station has had a positive start to pre-leasing. On the other hand, some projects in inconvenient areas in Minato might face difficulties.

LARGE-SCALE GRADE B OFFICES

The Grade B market continued to loosely mimic the performance of the Grade A market in Q1/2022, as it has done throughout most of the pandemic. Rents saw a decline of 1.5% QoQ and 7.8% YoY to JPY25,143 per tsubo. Meanwhile, vacancy stayed flat over the quarter, but increased 1.4ppts YoY to 3.6%.

Minato saw the largest quarterly and annual increment in vacancy in the Grade B market, increasing 0.7ppts QoQ and 6.0ppts YoY to 7.5%, stemming mostly from older buildings that are located further from stations. Minato also had the largest rental decline in the C5W Grade B market at 2.0% QoQ and 8.9% YoY to JPY24,053 per tsubo, concentrated mostly around the Hamamatsucho area and other bay areas that are somewhat inconvenient to access. In contrast, as we have seen throughout the pandemic, newer buildings with good access are performing better.

Some of the largest leasing transactions this quarter involved Grade B buildings (Table 2), showing the market's sound performance. For instance, Infineon Technologies Japan, a semi-conductor company, will take 3,700 tsubo lease in NBF Shibuya Garden Front. Elsewhere, Nihon Setsubi Kogyo, a facilities equipment maintenance company, leased a combined 1,200 tsubo in Daiwa River Gate.

As discussed last quarter in our [Tokyo Grade B Office] report, we expect the Grade B office market to stabilise before the Grade A office market given that small-to-medium-sized companies have a lower implementation rate of telework compared to their larger counterparts.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

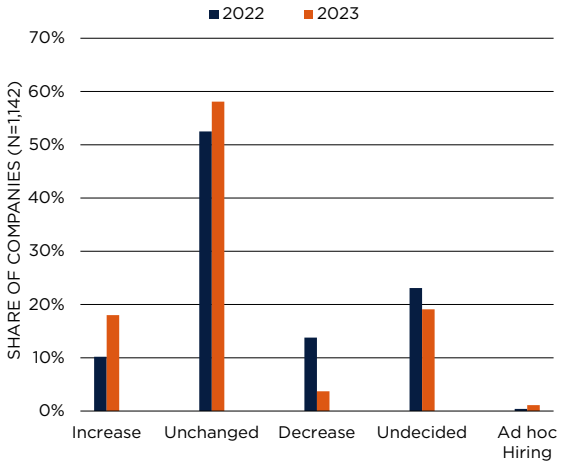
Chiyoda's vacancy levels loosened by 0.2ppts QoQ and 1.0ppts YoY to 1.8%, but still remain tight compared to the C5W average. Meanwhile, rents contracted 1.2% QoQ to JPY40,541 per tsubo, on par with the average rental decline in the C5W. Chiyoda remains the most expensive ward in the C5W, and its premium rent over the Grade A market's average is around 22%, the largest since 2013, showing the strong performance of the ward overall.

Chiyoda has overall seen a sound amount of leasing activity. In particular, Otemachi has seen deals of around 1,000 tsubo move forward. The latest building to open in the ward, Tokiwabashi Tower, which opened in June 2021, is almost fully occupied while Kanda Square, a building that opened in February 2020, has become fully occupied. Kioi Tower, which saw a major lease cancellation last year, appears to being acquiring new tenants such as JLL, which is taking a 1,100 tsubo lease.

Looking ahead, the only Grade A building to open in 2022 in Chiyoda, Kudan Kaikan Terrace, has seen steady pre-leasing activity, and could be expected to come to the market fully leased. For instance, the video game developer Creatures has pre-leased 1,000 tsubo in the building. The limited supply after this building until 2024 should give Chiyoda some breathing room. As such, Chiyoda should be able to continue holding onto its position as the premier ward in the C5W.

2 Over 250 respondents whose offices are located primarily in Tokyo

GRAPH 4: Hiring Forecast of Large Companies (>1,000 employees), 2022 vs 2023



Source Recruit, Savills Research & Consultancy

Chuo

Chuo's rents saw the largest quarterly contraction at 2.6% QoQ to JPY31,697 per tsubo, translating to an annual decline of 8.6%. The ward also experienced the largest quarterly vacancy increment, loosening 0.5ppts QoQ and 2.5ppts YoY to 3.2%, suggesting that further rental contractions might be needed to find an equilibrium point with prospective tenants. The Harumi area is the primary source of these corrections, partly because the Olympics offices that it housed have closed. In addition, there are other rumoured lease cancellations that are likely to further impact the submarket. Elsewhere, the Tsukiji area has seen some loosening in vacancy as well.

The upcoming Tokyo Midtown Yaesu scheduled to complete in August 2022 has recently seen an increased amount of interest from financial institutions and is assumed to be 40% pre-leased. The building is directly connected to Tokyo station, which places it in a strong position, especially as the market has become more receptive of easily accessible offices. Chuo may also see a temporary increase in demand as tenants in other areas are displaced by upcoming redevelopment projects.

Minato

Minato was the only member of the C5W to have seen vacancy levels exceed 5% during the pandemic. However, in Q1/2022, it saw its vacancy decline for the first time since the pandemic started, with rates tightening 0.5ppts QoQ to 5.0%. A number of leasing transactions into the ward helped to improve vacancy levels. Meanwhile, rents contracted 1.1% QoQ and 6.5% YoY to JPY30,855 per tsubo. The slowing decline in rents suggests that rental levels in Minato may

TABLE 1: Tenant Relocations, Q1/2022

ORIGIN						DESTINATION	
Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other		
16	4	17	8	5	15		
11		2			5	18	Chiyoda
3	3	1				7	Chuo
1	1	12		2	3	19	Minato
		1	5	1	2	9	Shibuya
			1	2		3	Shinjuku
1		1	2		5	9	Other

Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Q1/2022

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION	NEW LOCATION	APPROXIMATE SPACE	
					TSUBO	SQ M
ByteDance	Application Developer	Relocation	Shinjuku Sumitomo Building Shinjuku	Shibuya Hikarie Shibuya	4,600	15,200
Infineon Technologies Japan	Semiconductor Manufacturer	Relocation	Gate City Ohsaki East Tower Shinagawa	NBF Shibuya Garden Front Shibuya	3,700	12,200
TSI Holdings	Apparel	Consolidation	Various Various	Sumitomo Fudosan Aoyama Building East Minato	2,668	8,800
Nissin	Logistics	Relocation	Eishin Building Chiyoda	Sumitomo Fudosan Hanzomon Ekimae Building Chiyoda	1,500	4,900
Recruit	Publishing and Staffing	Expansion	Gran Tokyo South Tower Chiyoda	Gran Tokyo South Tower Chiyoda	1,300	4,300

Source Nikkei RE, Savills Research & Consultancy

be approaching a price point in line with tenant expectations.

Some buildings that previously saw notable lease cancellations during the pandemic have seen some recovery. For example, Yokohama Rubber will take a 600 tsubo lease in Shinagawa Intercity Tower C, where Fujitsu made a large lease cancellation in late 2021. The company reportedly plans to consolidate and centralise its operations to support remote work. In addition, Akasaka K-Tower has become fully occupied after Nikkeisha, an advertising agency, took a 800 tsubo lease in the building. Texas Instruments will also take a 1,000 tsubo lease in Shinagawa Season Terrace, a building that experienced some difficulty during the pandemic.

Looking ahead, a large amount of high-quality supply is forecast for the ward in 2023, and the relatively slow pace of the pre-leasing activity of these new buildings might be a cause for worry. That said, the A District of the Toranomon Azabudai Project is assumed to be 40% pre-leased. Furthermore, the minimal supply in 2022 will give the market some time to recover, especially the older buildings with more inconvenient access. Indeed, the high level of leasing activity again this quarter from various industries, in particular in the bay area that has struggled during the pandemic, should help to absorb the glut of supply and potential secondary vacancy. Furthermore, multiple ongoing infrastructure projects should improve accessibility and help various areas of Minato that suffer from poor access.

Shibuya

Shibuya's vacancy contracted 0.2ppts QoQ, loosening 0.1ppts YoY to 1.6% and becoming the ward with the lowest vacancy rate in the C5W. Rents saw a mild contraction of 0.4% QoQ and 3.9% YoY to JPY35,571 per tsubo. Shibuya has maintained its position as the second most expensive ward in the C5W.

The rental corrections in Shibuya have likely contributed to some newfound interest in the ward. For instance, TikTok operator ByteDance has leased 4,600 tsubo in Shibuya Hikarie, taking up around the same amount of space cancelled by DeNA in 2021. In addition, Rakus, a cloud service provider, is taking a 1,000 tsubo lease in Shinjuku Maynds Tower. While the outer edges of the ward, such as Ebisu, have struggled since the pandemic began, market rumours suggest upcoming movements into some of these areas, which should contribute to the overall recovery of Shibuya.

Looking ahead, the Sakuragaoka Redevelopment project, which will open in 2023, has had an impressive start to pre-leasing. The project's strategic location next to Shibuya station, its mixed-use nature, and the ongoing improvements to the walking infrastructure around the station should ensure its popularity overall.

Shinjuku

Shinjuku's rents contracted by 0.9% QoQ and 12.2% YoY to JPY27,667 per tsubo. Rents have overall seen a decline of nearly 20% since the pandemic began – close to double what any other wards have seen. Indeed, the market has seen a shift toward the popularity of newer and easily accessible buildings, in contrast with the older stock in Shinjuku with poor accessibility. There are market rumours of large tenant movements out of the ward, suggesting that Shinjuku is likely to continue struggling in the near future.

However, the correction in rents has also allowed it to experience the largest improvement in vacancy this quarter, with rates decreasing 0.7ppts QoQ to 1.8%, with leasing transactions of around 100 tsubo observed. Overall, while the current climate of the market is not favourable for Shinjuku, there is still much potential in the ward to be explored, which is discussed in greater detail in the next section.

A CLOSER LOOK AT SHINJUKU

Since the financial crisis, Shinjuku's rents have consistently been the cheapest in the C5W, lagging around 10% behind the average of the C5W. Its relative affordability contributed to helping it maintain low vacancy rates, which were virtually 0% since 2016 until the pandemic. The excellent accessibility of Shinjuku station from primary residential areas played a part in the popularity of the ward overall.

However, the pandemic has exposed many of Shinjuku's weaknesses. Indeed, many of Shinjuku's buildings are old and have relatively poor accessibility. Overall, its Grade A rents have contracted 19.4% since the pandemic – close to double what any other ward has seen. The robust office market in pre-pandemic times and lack of availability meant that some offices in Shinjuku had bullish rents and had to face notable corrections when the pandemic struck. In comparison, Shinjuku's Grade B rents, which were not priced as expensively, have contracted 13.5%, the second largest decline in the Grade B market, behind Shibuya. At the same time, vacancy rates in Grade A offices increased 1.8ppts versus pre-pandemic times, whereas Grade B offices increased 3.7ppts, suggesting that there is greater demand for higher-quality offices if they are priced correctly.

Nonetheless, a closer inspection of Shinjuku reveals that the performances of different areas vary significantly. For instance, Grade A and B offices located within a seven-minute walk from Shinjuku station in the "Shinjuku Station Area" submarket only saw a 15.7% decline in rents, and an increment of 2.3ppts in vacancy versus pre-pandemic times (Table 3). While the office stock in this submarket is ageing, the submarket's proximity to Shinjuku, the principal terminal station in Tokyo, has strongly aided its popularity. This submarket has the oldest office stock because there were very few redevelopments. However, the Shinjuku West Exit Redevelopment Project in 2029, spearheaded by large corporations including Odakyu and Tokyu, will add new high-quality office space right next to the station and redevelop the Odakyu Department Store. This is a major project for the submarket, and is expected to increase the popularity of the area.

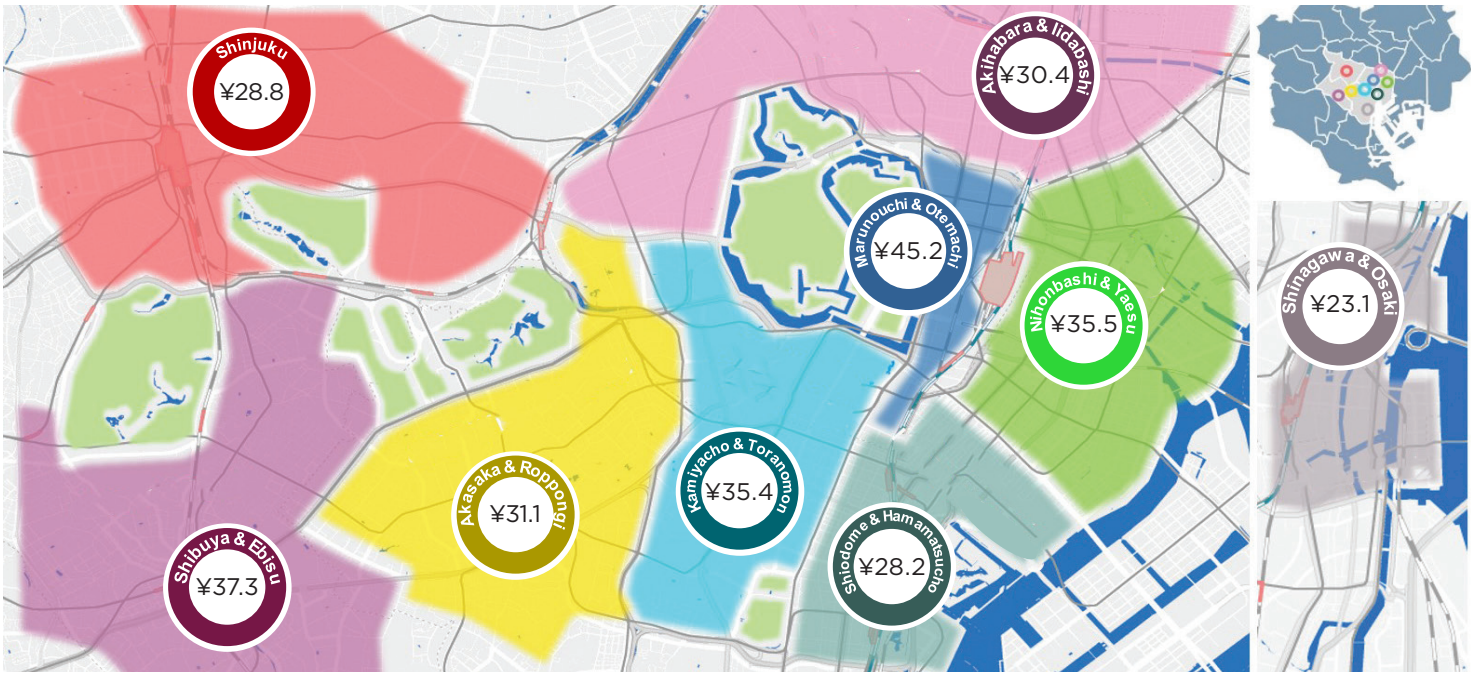
In contrast, offices located in West Shinjuku that are further than or equal to eight minutes away from Shinjuku station (categorised as "West Shinjuku" in Table 3) have seen a 19.4% decline in rents, and a 3.0ppts increment in vacancy versus pre-pandemic times. Many of these offices are

TABLE 3: Comparison of Shinjuku's Various Submarkets' Grade A and B Performance During the Pandemic

	RENT JPY/TSUBO/MONTH			VACANCY			AVERAGE FREE RENT PERIOD (MONTHS)	AVERAGE YEAR OF CONSTRUCTION
	Q1/2020	Q1/2022	CHANGE FROM PRE-PANDEMIC LEVELS	Q1/2020	Q1/2022	CHANGE FROM PRE-PANDEMIC LEVELS		
Shinjuku Station Area	34,500	29,100	-15.7%	0.0%	2.3%	2.3ppts	2.6	1988
West Shinjuku (≥8 minutes from Shinjuku station)	29,900	24,100	-19.4%	0.0%	3.0%	3.0ppts	4.0	1993
Other Areas	25,900	23,000	-11.2%	0.0%	1.6%	1.6ppts	2.3	1999
Overall	29,800	25,000	-16.1%	0.0%	2.5%	2.5ppts	3.2	1993

Source Savills Research & Consultancy

MAP 1: Average Rents Per Tsubo in Selected Submarkets, Q1/2022



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

located more than ten minutes away from Shinjuku station, or are only accessible via relatively minor train stations, and this comparatively poorer accessibility has negatively impacted the submarket. Indeed, West Shinjuku has the highest average amount of free rent offered to new tenants, and some of the offices with notable amounts of vacancy are also located in this submarket, suggesting the difficulties faced in attracting new tenants. However, one consolation for this submarket is that many offices are connected to Shinjuku station through an extensive underground network, which provides some level of convenience, and might help with the eventual recovery of the submarket.

In Table 3, offices that are located in other parts of Shinjuku, including Yotsuya, Takadanobaba, and Iidabashi, are categorised in the "Other" submarket. This submarket has performed the best overall, with rents only decreasing 11.2% and vacancy increasing 1.6ppts. Many of the buildings in this submarket tend to be newer, and are located close to train stations. Furthermore, unlike many offices concentrated around West Shinjuku, offices in the submarket tend to be more spread out, which makes the supply easier to absorb. This combination of newer buildings, good accessibility, and achieving niches in specific areas have helped the submarket perform well during the pandemic.

Overall, the trends observed in the Shinjuku submarkets reaffirm the notion that newer offices with greater accessibility are faring better, while older offices with poor accessibility have been struggling. Shinjuku station is the busiest in the world and serves as an important hub for commuters, and the offices surrounding the station have seen amicable performance despite their age. In contrast, offices located more than a seven-minute walk away from Shinjuku station have suffered more from the pandemic, and might take longer to recover. Elsewhere, offices located in other hubs of Shinjuku that tend to be newer and close to stations have seen the best performance overall.

Going forward, Shinjuku will see major improvements to its infrastructure around West Shinjuku and Shinjuku Station that will help revitalise the area. The major players in Shinjuku, Odakyu and Keio, both have major redevelopment plans for the ward over the next decade. For instance, Odakyu will start construction on their 85,200 tsubo mix-used skyscraper west of the station in October of this year, and include walking infrastructure improvements like a sky walkway around the west exit that should improve the accessibility of West Shinjuku.

OUTLOOK

Rising corporate profits in Q4/2021 and some decline in remote work initially boosted business and consumer confidence in the market. However, tensions surrounding the conflict in Ukraine have clouded such optimism. Rising commodity and energy prices will put additional pressure on the global economy and will likely slow recovery from the pandemic. Furthermore, the spike of COVID-19 cases in Q1/2022 stemming from the Omicron variant has also delayed some return to the office.

Despite the worldwide uncertainty, the office market in Japan has made some progress toward normalcy. Rental corrections have become increasingly gentle over the past few quarters, and vacancy increments have also been mild. The slower adjustments observed suggest that the market could be approaching an equilibrium point between rent pricing and tenant demand. Furthermore, the low office supply forecast for 2022 should aid the market in achieving greater stability.

Going forward, many companies are likely to continue a hybrid work model where employees predominantly commute to the office, with some flexibility of conducting remote work. On the other hand, the number of companies looking to reduce office space has decreased, which is a positive sign for the market. Indeed, many companies appear eager to welcome new employees entering in April to the office, which should be able to provide a more conducive training environment. Overall, the Japanese economy is gradually opening up, and should become like many countries in the west where people have started to choose to coexist with COVID-19.

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.