MARKET IN MINUTES

Savills Research

Office Leasing

Greater optimism for gradual recovery

Conditions are picking up in the post-pandemic market, but further recovery may take time

- Rental contractions have been gentle over the quarter, and vacancy has been low overall.
- Average Grade A office[1] rents in the C5W decreased by 0.7% quarter-on-quarter (QoQ) to JPY32,549 per tsubo[2] per month, falling 2.2% year-on-year (YoY).
- The average Grade A office vacancy rate in the C5W tightened by 0.9 percentage points (ppts) QoQ, but rose 0.3ppts YoY to 3.0%.
- Average large-scale Grade B office[3] rents increased slightly by 0.1% over the quarter to JPY24,483 per tsubo per month, translating to a decline of 2.6% YoY.
- Vacancy rates in the Grade B market rose moderately by 0.4ppts over the quarter to 4.1%, to a yearly increment of 0.5ppts.
- Small and medium-sized offices comprise a significant proportion of the market, and demand from tenants has remained mostly stable. Given that many such properties are likely in need of renovations, there should be multiple opportunities for savvy investors to enter the market.

“Overall, the office market continues to see steady improvement going into 2023. Rental corrections have been gentle, and vacancy rates have dropped across the C5W. Indeed, pre-leasing activity has been firm, and some Japanese companies are expanding their office footprints. That said, some foreign companies are looking to return floor space, and the large amount of new supply might dampen recovery going forward.”

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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.

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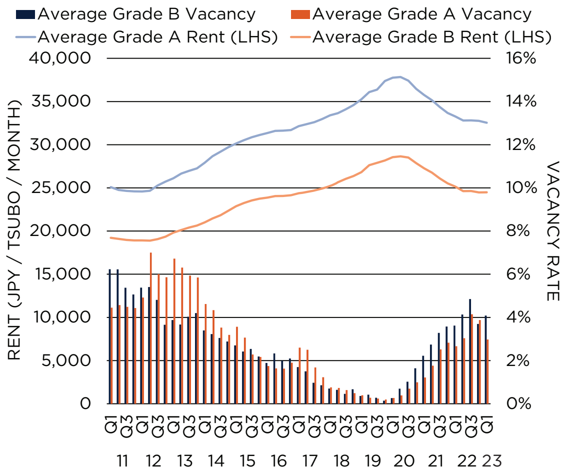
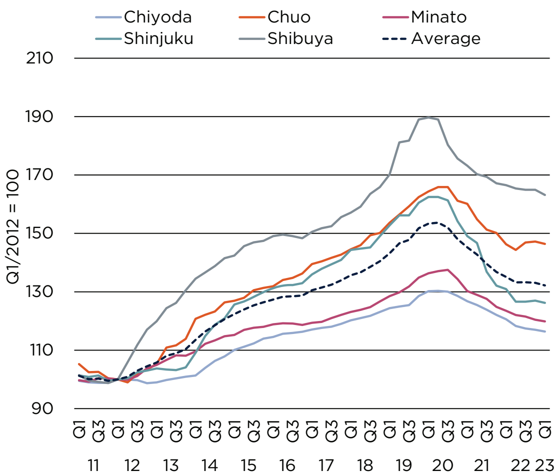
GRAPH 1: Office Rents and Vacancy in Tokyo's C5W*, 2011 to Q1/2023



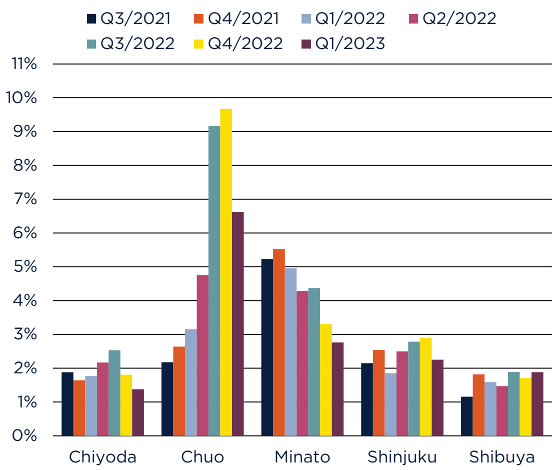
Source Savills Research & Consultancy
* Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index by Ward, 2011 to Q1/2023



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy by Ward, Q3/2021 to Q1/2023



Source Savills Research & Consultancy

GRADE A OFFICE

The Grade A office market continues to show signs of stabilisation, and rental revisions have become increasingly gentle over recent quarters. Average rents in the central five wards (C5W) contracted by a moderate 0.7% over the quarter Q1/2023 to JPY32,549 per tsubo, an annual decline of 2.2%. As a result, the total rental correction from the peak seen in Q2/2020 grew to 14.0% for the Tokyo C5W Grade A office market.

All constituent wards in the C5W still experienced some minor correction in rents. Although increasing in the previous quarter, rents in Shibuya saw the largest correction of 1.1% QoQ in Q1/2023. Rents in Chiyoda and Minato contracted 0.5% QoQ, while rents in Chuo and Shinjuku fell 0.6% QoQ.

On the other hand, the average vacancy rate improved for a second consecutive quarter to 3.0%, tightening by 0.9ppts QoQ, although it loosened 0.3ppts YoY. Most wards saw vacancy rates fall moderately, and the most notable decrease in vacancy occurred in Chuo ward, contracting 3.1ppts from 9.7% to 6.6%. Although the partial opening of Midtown Yaesu Central Tower in 2022 initially skewed vacancy rates upward in Chuo, the building appears to be effectively fully occupied as of its full opening in March, demonstrating that leasing demand has been resilient even for units at the highest rental points. Elsewhere, vacancy is low in both Chiyoda and Shibuya at 1.4% and 1.9%, respectively, while vacancy fell in Shinjuku and Minato to 2.3% and 2.8%, respectively. Overall, vacancy rates remain low across the C5W market, demonstrating the stability and strength of leasing demand for prime office space.

Many companies are reportedly looking to push office attendance closer to pre-pandemic levels, and there are rumours that several Japanese companies are looking to expand their office footprints in 2023. That said, some foreign companies appear to be returning office space, and the global economic slowdown may delay some plans for office expansion. Indeed, this may be worrisome for the large amount of new supply coming to the market in 2023. Nonetheless, a notable amount of this space has already been pre-leased, and should not have an overt effect on the market. Overall, observers should anticipate stability in Grade A office demand going forward.

LARGE-SCALE GRADE B OFFICES

The large-scale Grade B market has displayed similar stability as the Grade A market over the past half-year. Indeed, rents in the large-scale Grade B market rebounded by a modest 0.1% QoQ to JPY24,483 per tsubo, amounting to a YoY contraction of 2.6%. As a result, the total rental decline from the peak seen in Q2/2020 at the onset of the pandemic remains around 14.6%. While slight quarterly rental contractions were seen in Minato, Chiyoda, and Shibuya, average rents rose marginally in Shinjuku and Chuo by 1.3% QoQ and 0.1% QoQ, respectively. These wards have witnessed more buildings begin to adjust rents upwards, showing that the market may have begun seeing recovery in some areas.

Contrary to the Grade A market, average Grade B office vacancy rose slightly by 0.4ppts QoQ to 4.1%. Although vacancy rates decreased 0.7ppts over the quarter, Minato still features the highest average vacancy rate at 8.5% due to a handful of buildings exhibiting stark amounts of available space. Elsewhere, the other constituent wards had more moderate levels of vacancy, ranging from 5.2% in Chuo to 1.3% in Shibuya, although Chuo saw the largest quarterly increment of 4.0ppts due to some major tenants moving out of the ward.

Overall, rents appear to have stabilised in the large-scale Grade B office market. That said, with more companies forced to compete for increasingly scarce skilled human resources, tenants will likely favour newer buildings that may help in recruiting and retaining talented workers, as well as facilitating hybrid work. Hence, some bifurcation is likely to be observed between different Grade B offices, even within the same submarket, and the market might see some vacancies persist, particularly in older offices located in inconvenient areas.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

Chiyoda's rents declined moderately by 0.5% QoQ and 3.5% YoY to JPY39,129 per tsubo. The ward experienced a slight decrease in vacancy at 0.4ppts QoQ, and vacancy is on the low end of the spectrum at 1.4%.

This quarter, Moore Mirai will reportedly be returning space in the Marunouchi Mitsui Building and the Hirakawacho Front Building in Chiyoda and consolidate offices in the Toho Hibiya Promenade Building. The auditing firm aims to merge the two corporate cultures by operating in a single location. Subaru Enterprise will also reportedly be relocating its headquarters to the same building from the Yurakucho Building, and will likely lease an estimated 300 tsubo of space, although additional details have yet to be announced. Meanwhile, Norinchukin Zenkyoren Asset Management has reportedly relocated its headquarters to Kudan-Kaikan Terrace in February 2023, BSP Group will also make a similar move in May 2023.

Overall, owing to its concentration of many leading domestic and international companies, Chiyoda has held its reputation for stability and retains the most expensive rents among the C5W by a notable margin. As such, vacancies are few and far between, although the ward may face competition from modern developments in nearby wards in the future.

Chuo

Following the rental increment in the last quarters, average rents fell in Chuo by 0.6% QoQ to JPY31,721 per tsubo, although it was the only ward to experience a yearly increment at 0.1%. Chuo's vacancy rate remains the highest in the C5W at 6.6%, primarily due to the addition of the almost 40,000 tsubo Midtown Yaesu Central Tower in 2022. That said, leasing demand has been strong this quarter, and Midtown Yaesu Central Tower appears to have secured tenants to effectively fully occupy the building at its full opening in March. Overall, vacancy has fallen by 2.1ppts QoQ, and looks set for further improvements before the additions of the Yaesu 1-Chome project and the Nihonbashi 1-Chome project in 2025.

In Chuo, both Tosoh and JBCC will occupy 2,400 tsubo and 1,200 tsubo of space in Midtown Yaesu Central Tower, respectively, while Legacy and Funai Soken will also relocate to the building. Meanwhile, JASSO is looking to temporarily move out of its existing headquarters in Shinjuku as it undergoes renovations and expansion, and will lease 2,400 tsubo in the Nomura Ginza Building, which also recently welcomed Tokium. Medipal Holdings and Hakuten will relocate to Tokyo Square Garden from their respective headquarters in Chuo.

Minato

Rents declined modestly in Minato by 0.5% QoQ to JPY30,371 per tsubo, which equated to a yearly decline of 3.5%. This was again slightly higher than the C5W average. Vacancy rates tightened further by 0.5ppts QoQ and 2.2ppts YoY to 2.8%, and are low overall.

In Minato, Dentsu subsidiary Carta Holdings will reportedly relocate its headquarters to Toranomon Hills Station Tower, which is slated for completion in July 2023, and will occupy an estimated 3,000 tsubo. Meanwhile, Panasonic Industry will reportedly consolidate roughly 800 employees into the same building across two floors, returning an aggregate 2,000 tsubo in three buildings across Minato and Shinagawa in the process. Additionally, Mitsui DM Sugar Holdings acquired Tamachi M-Square Garden in 2022, which the company reportedly plans to use

TABLE 1: Tenant Relocations, Q1/2023

ORIGIN						DESTINATION	
Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other		
14	12	14	7	3	18		
9	3		1		2	15	Chiyoda
3	7	3		1	3	17	Chuo
1	1	9	2		6	19	Minato
	1	1	4		1	7	Shibuya
				2		2	Shinjuku
1		1			6	8	Other

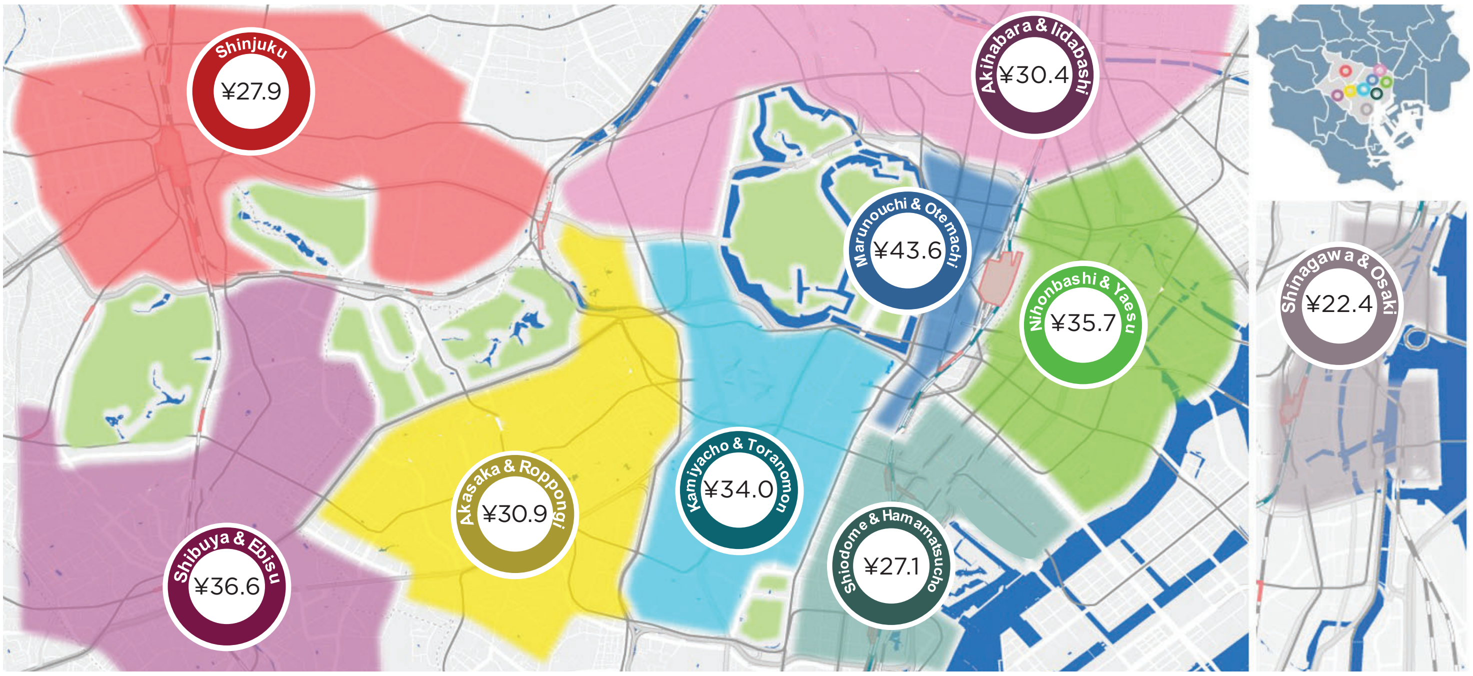
Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Q1/2023

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION	NEW LOCATION	APPROXIMATE SPACE	
					TSUBO	SQ M
Restar Electronics	Electronics	HQ Relocation	Rikkoukai Sogo Building Shinagawa	Oak Konan Shinagawa Minato	4,900 (GFA)	16,300 (GFA)
Carta Holdings	Advertising	HQ Relocation	Shibuya Solasta/ Tsukiji Shochiku Building Shibuya/Chuo	Toranomon Hills Station Tower Minato	3,000	9,900
Japan Student Services Organisation (JASSO)	Education administration	Office Relocation	Company owned building Shinjuku	Nomura Ginza Building Chuo	2,400	8,000
Tosoh	Chemicals manufacturing	HQ Relocation	Sumitomo Fudosan Shiba-Koen First Building Minato	Midtown Yaesu Central Tower Chuo	2,400	8,000
Panasonic Industry	Electronics	Office Relocation	Toranomon 35 Mori Building Minato	Toranomon Hills Station Tower Minato	2,100	6,800

Source Nikkei RE, Savills Research & Consultancy

MAP 1: Average Rents Per Tsubo in Selected Submarkets, Q1/2023



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

as its headquarters from May 2023. The company will use floors five through eleven, which will house an estimated 300 employees.

Minato continues to steadily improve, and optimism is growing in the ward. Indeed, expectations are high that Azabudai Hills will attract more tenants as it nears completion in late 2023, potentially easing some concerns about its impact on the market. That said, market players should pay attention to some variation depending on location, with some elevated vacancies observed in less easily accessible areas such as the Bay area.

Shibuya

Although rents remained largely flat in previous quarters in Shibuya, they decreased by 1.1% QoQ to JPY34,857 per tsubo, the largest rental decline among the C5W constituent wards this quarter. This amounted to a yearly decline of 2.0%, which was relatively moderate. Meanwhile, Shibuya was the only ward to experience a vacancy increment, increasing slightly by 0.2ppts to 1.9%. That said, there are a number of large-scale high-quality projects under construction around the station area that have received particular interest from potential tenants.

Tenant movement has been relatively limited in Q1/2023, with only small-scale transactions observed. For instance, Amazia will reportedly relocate its headquarters in 2024 to Building A-2 in the Shibuya Sakura Stage, which is due for completion in late 2023, and will lease an estimated 200 tsubo. At the same time, Shibuya saw a number of moderately large exits, with the aforementioned Carta Holdings returning around 1,600 tsubo in Shibuya Solasta, and TDC Soft set to return 1,500 tsubo in its current headquarters in the Shinjuku Bunka Quint Building in October 2023.

Although a number of large international technology firms have been undergoing global restructuring, occupancy remains firm and there are no signs of imminent vacancy increments. Indeed, Shibuya's vacancy rate has remained below 2% and the lowest among the C5W, together with Chiyoda.

Shinjuku

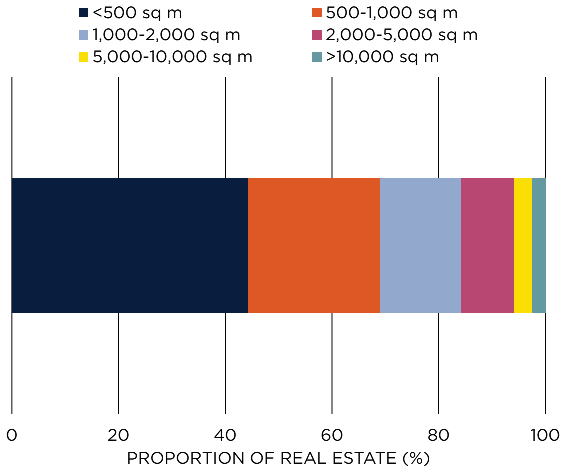
Shinjuku's rents moderately declined by 0.6% QoQ and 3.6% YoY to JPY26,667 per tsubo, which are the lowest average rents in the C5W by a considerable margin. This led to a further increment in the accumulated rental correction since the previous peak in Q2/2020 at 22.3%, which is also significantly larger than the other constituent wards. Meanwhile, vacancy declined by 0.6ppts QoQ to 2.3%, indicating that the Shinjuku market will still hold out overall despite the slight rental correction this quarter.

This quarter has been another quiet period for leasing activity in Shinjuku. Equipment engineering company Chudenko will relocate its headquarters, moving from Shinjuku Square Tower to Sumitomo Fudosan Shinjuku First Tower in May 2023, leasing approximately 300 tsubo. The company aims to expand on its current office space, and will strengthen its business continuity planning measures by relocating to a newly constructed building. Meanwhile, ESP will return 1,200 tsubo of office space in the Iidabashi area. This move was due to a decreasing need for space because of ongoing flexible working arrangements.

THE SMALL AND MEDIUM-SCALE OFFICE MARKET

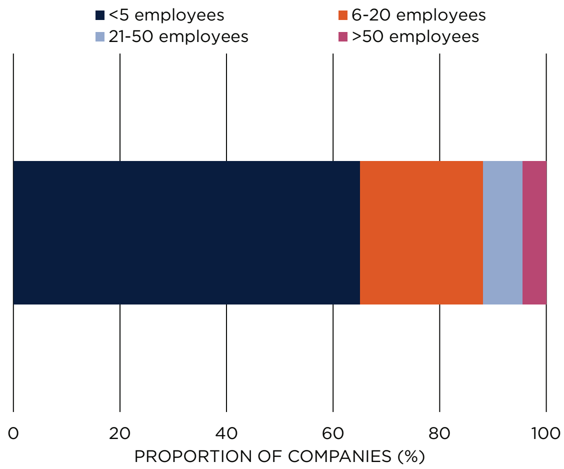
Grade A and large-scale Grade B offices are usually popular acquisition targets for investors, but opportunities are rare. On the other hand, there are many value-add opportunities for investors involving smaller-scale and older office buildings. Indeed, small and medium-sized properties comprise a vast majority of real estate in Japan (Graph 4). Additionally, around 96% of companies in Japan have fewer than 50 employees (Graph 5), according to the Small and Medium Enterprise Agency. This suggests that there is ample demand for small to medium-sized offices, as well as a large and diversified potential tenant pool. However, this strategy may have gone unnoticed among some international investors, especially relatively new players, due to the risks surrounding time-consuming renovations, and a lack of experience and expertise about the market.

GRAPH 4: Proportion of Real Estate by Size (%), 2018



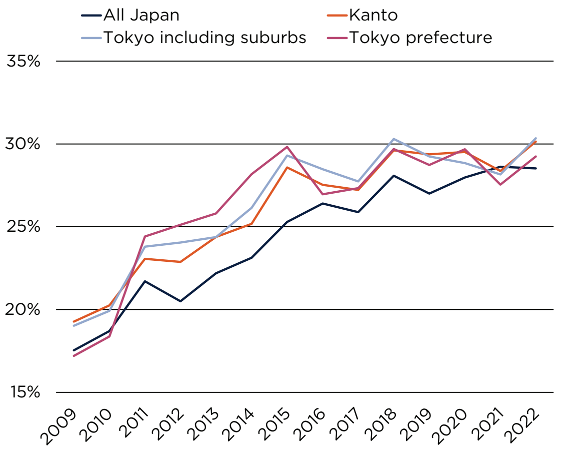
Source Ministry of Land, Infrastructure, Transport and Tourism, Savills Research & Consultancy

GRAPH 5: Proportion of Companies by Number of Employees (%), 2021



Source The Small and Medium Enterprise Agency, Savills Research & Consultancy

GRAPH 6: Proportion of Office Transactions Sold from Individuals to Corporations by Region, 2009 to 2022



Source Ministry of Land, Infrastructure, Transport and Tourism, Savills Research & Consultancy

The number of small and medium-sized office stocks significantly exceeds that of large offices in terms of building count, and they are generally much older. In fact, around 85% of offices are below 5,000 tsubo in Tokyo and are over 20 years old, and around 25% were built before the 1981 Building Standards Law Amendment. Due to their age and the need to conform with modern safety standards, a large proportion of these properties will likely require renovations over the coming years. Given that many owners of these buildings tend to be individuals or small companies that lack the capital and expertise to conduct the necessary renovations, there are likely many opportunities available in the market for knowledgeable investors. Moreover, the supply of small and medium-sized offices has been limited in recent years and looks set to remain limited going forward, meaning that offices of these sizes may see comparatively more demand.

Many small building owners also face problems regarding business continuity. According to a survey by Xymax, a majority of respondents mentioned that renovation and management costs are becoming excessive, while many struggle with raising capital, suggesting that many owners have shallow pockets and may be incentivised to exit at the right opportunity. Additionally, often-cited reasons among those who are looking to exit building ownership include a lack of a successor and the time-consuming nature of managing their own buildings. Many owners don't appear to be real estate professionals and may be unwilling to invest time and money into redevelopment.

The proportion of office transactions between individual sellers and corporations has increased over the past decade (Graph 6), and the strategy of value-add renovations appears to be gaining popularity. Some investors recognise the investment potential of small and medium-sized offices, especially due to their overall favourable performance during the pandemic in Tokyo. Indeed, some listed players like Sun Frontier and Ichigo Group have implemented multiple successful renovation strategies with sizable increments in rent. With limited opportunities in the Grade A and large-scale Grade B office market, more investors may turn to the small to medium-sized market going forward especially considering that typical tenants are usually stable and are less likely to implement hybrid working arrangements, unlike their larger counterparts.

OUTLOOK

Optimism is growing in the Tokyo office market, and greater stability is anticipated in the market in 2023. Although there is still some way to go before the market recovers towards pre-pandemic levels, rental corrections have been gentler over recent quarters and are showing more signs of bottoming-out. Moreover, vacancies have been low overall, and there are also fewer signs of secondary vacancies in the C5W.

Many companies appear keen to adjust their office strategies to a post-pandemic state and encourage greater in-person participation by employees. Hence, more companies are expanding their office footprints in 2023, boosting demand for office leasing. Pre-leasing activity for upcoming new office supply has also been firm in most wards of the C5W. For instance, despite concerns that the extremely large Midtown Central Yaesu Tower would cause disruptions in the market, it appears to have effectively been filled up ahead of its full opening in March. Significant upcoming development projects have likewise displayed encouraging pre-leasing, which will likely improve as they approach completion in 2023, demonstrating that the appetite for quality office space is firm as long as they are priced reasonably.

At the same time, global trends are likely to curtail this optimism to some extent. Several major overseas companies are undergoing restructuring, and there have been instances of office space being returned throughout the C5W, partly due to downsizing. Furthermore, a large amount of new supply set to enter the market this year. These factors may cause some disruptions in the market.

Overall, the Tokyo office market will likely see greater stability and some improvements in 2023, and observers should be cautiously optimistic going forward. Indeed, some properties have seen rental increments over the quarter, and rental demand looks set to grow gradually. That said, the market still faces some constraints, and property-level disparities will likely persist for the meantime, depending particularly on location and property age.

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 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, our benchmark figures, particularly vacancy rates, tend to be lower than other market indices.