MARKET IN MINUTES
Savills Research

Office Leasing

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Growing confidence in steady recovery

Robust corporate performance, the steady return to offices, and limited new incoming supply should support sustained growth in 2024.

- Office markets witnessed further rental growth in Q1/2024, albeit marginal, and the outlook continues to improve. Vacancy rates have also tightened overall.
- Average Grade A office[1] rents in the C5W increased by 0.2% quarter-on-quarter (QoQ) and 0.3% year-on-year (YoY) to JPY32,656 per tsubo[2] per month.
- The average Grade A office vacancy rate in the C5W tightened by 0.2 percentage points (ppts) QoQ, while remaining flat YoY at 3.0%.
- Average large-scale Grade B office[3] rents experienced a moderate increase of 1.4% QoQ and 1.7% YoY to JPY24,895 per tsubo per month.
- Vacancy rates in the Grade B market tightened by 0.2ppts QoQ and 0.7ppts YoY to 3.4%.
- Satellite offices/flexible office spaces were an emerging trend even before the pandemic, and have been further proliferated by the continuation of hybrid work arrangements in the post-pandemic environment.

“The Tokyo office market is expected to see further gradual growth in 2024. Average rents and vacancy rates have kept demonstrating positive performance. The large supply from 2023 has been absorbed well and the small supply in 2024 should provide breathing room for further absorption. However, older and less accessible offices continue to face challenges.”

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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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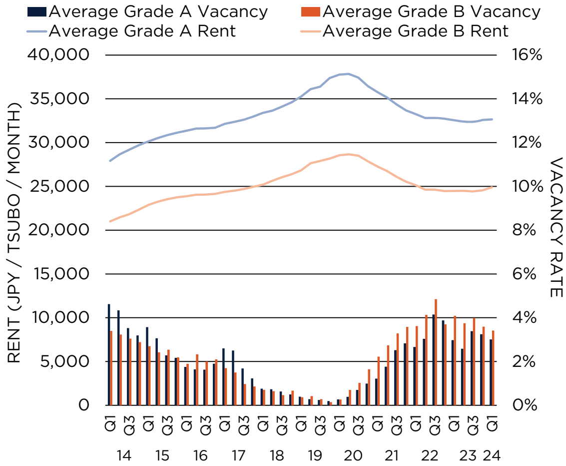
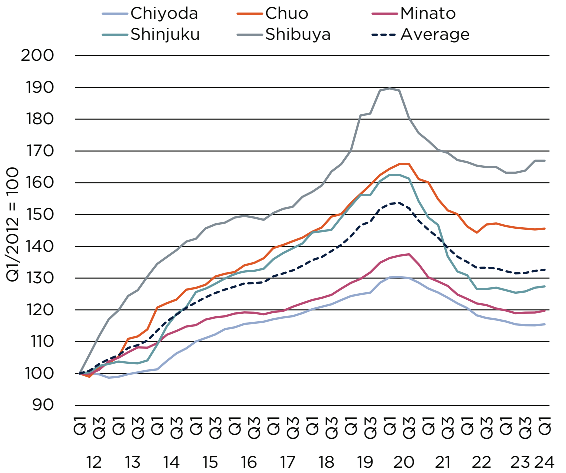
GRAPH 1: Office Rents and Vacancy in Tokyo's C5W*, 2014 to Q1/2024



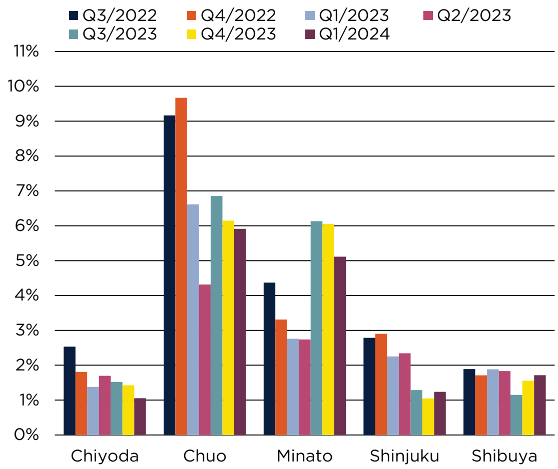
Source Savills Research & Consultancy
* Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index by Ward, 2012 to Q1/2024



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy by Ward, Q3/2022 to Q1/2024



Source Savills Research & Consultancy

GRADE A OFFICE

Momentum has been positive throughout 2023 in the Tokyo Grade A office market, with a steady improvement in both rental rates and vacancy levels observed. This trend has continued moving into 2024, and average rents in the central five wards (C5W) experienced a slight uptick on both a quarterly and annual basis in Q1/2024, rising by 0.2% and 0.3%, respectively, to JPY32,656 per tsubo. Accordingly, the total rental correction from the peak levels of Q2/2020 decreased moderately to 13.7% for the Tokyo C5W Grade A office market. Rental changes across the C5W were largely positive, albeit nominal, in Q1/2024, and the Grade A office market appears to have attained a greater sense of stability in the post-pandemic era. Minato recorded the largest rental growth at 0.5% QoQ, while Chiyoda, Shinjuku and Chuo also witnessed moderate rental growth between 0.3% and 0.2% QoQ. Elsewhere, rents remained flat in Shibuya over the quarter.

Meanwhile, the average vacancy rates for Grade A offices in the C5W tightened further by 0.2ppts QoQ to 3.0%. As with rental growth, Minato witnessed the most significant improvement this quarter, with vacancy rates decreasing by 1.0ppt QoQ to 5.1%, which is a sign of the healthy absorption of the enormous supply introduced in the second half of 2023. Improvements were also seen in Chiyoda and Chuo over the quarter, with vacancy tightening by 0.3ppts and 0.2ppts QoQ, respectively. On the other hand, vacancy loosened marginally in Shibuya and Shinjuku by 0.2ppts and 0.1ppts, respectively, albeit remaining at low levels for both wards. Indeed, vacancy rates in the C5W appear to be recovering well, although it will likely take time to return close to pre-pandemic levels, especially with the current prevalence of hybrid work arrangements.

Observers anticipate a quiet year in 2024 due to the limited amount of new office supply set for completion in the C5W, which should provide breathing room for further absorption of existing office space. This is in stark contrast to the large supply introduced in 2023, and to the significant uptick in supply due for 2025. Improvements in the first half of 2024 will likely be steady, while many five-year, fixed-term lease contracts signed prior to the pandemic will be approaching expiration over the coming year. Indeed, some tenants may choose not to renew or may negotiate more favourable terms due to their changing needs in the post-pandemic landscape, which comes against a background of large new office supply and stronger tenant negotiation power, which might contribute to some persistent vacancies.

Moreover, hybrid work arrangements appear to persist as a corporate benefit in the longer-term, which may dampen some demand for the meantime, though there has been a noticeable increase in office attendance over the past year. Given the large incoming new supply expected in 2025, landlords who currently own large vacant floor space are likely to exercise caution as the office market is poised to become progressively more competitive in the coming year. Nevertheless, the overall market should continue to experience positive momentum in 2024, with prime offices, particularly modern ones with strong ESG certifications, set to perform well, and some rental increments should be anticipated among such properties.

LARGE-SCALE GRADE B OFFICES

The large-scale Grade B market continues to improve in tandem with the Grade A market since the second half of 2023. Average rents increased significantly by 1.4% QoQ and 1.7% YoY to JPY24,895 per tsubo. Shinjuku and Minato experienced the most prominent rental improvements, rising by 2.7% and 2.6% QoQ, respectively. Shibuya and Chiyoda also witnessed moderate growth of 1.5% and 0.8% QoQ, respectively. On the other hand, average rents in Chuo declined by 0.4% QoQ. Overall, diverging trends continue to be observed within the C5W Grade B market. Some offices in prime areas with virtually no vacancies enjoyed rental growth over the quarter, given the strong demand and favourable position of landlords. However, a handful of offices in areas with poor transport access struggled, which subsequently led to rental discounts.

Meanwhile, average Grade B vacancy tightened for a second consecutive quarter, decreasing by 0.2ppts to 3.4%. Notably, Minato, which recently struggled with high vacancy levels, has observed the largest improvement of 0.8ppts this quarter, indicating a gradual yet sound recovery. Looking at other constituent C5W submarkets, vacancy tightened by 0.3ppts QoQ in Chuo, and 0.2ppts QoQ in Chiyoda. Meanwhile, Shinjuku saw no change in vacancy while Shibuya's vacancy loosened slightly by 0.4 ppts.

According to a monthly survey conducted by Mitsubishi Real Estate Services in January 2024, the proportion of respondents considering office space expansion has steadily risen from 38% in Q3/2022 to 58% in Q3/2023. The main drivers for this trend include the expansion of business operations and headcounts, as well as the desire for improved office environments, which has been encouraged by continuous strong growth in corporate profits. However, the bifurcation between newer modern offices with good transport access, and older, inconvenient offices persists. Tenants looking to relocate or expand their office footprints increasingly prefer new buildings with useful amenities to attract and retain their workforce, especially with scarcer skilled resources. Newer modern offices also tend to be better equipped to facilitate hybrid work arrangements, with features such as private booths for individual video conferences and meeting rooms for seamless communication between main office and remote workers. However, older offices located in less accessible areas that lack many of these features look to struggle, and higher levels of vacancy may persist among a handful of such properties.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

In Q1/2024, Chiyoda's rents witnessed a slight uptick of 0.3% QoQ to JPY38,823 per tsubo, but declined by 0.8% YoY, while average vacancy tightened by 0.3ppts to 1.1% QoQ. Chiyoda has a reputation for stability and commands the highest rents among the C5W by a significant margin, owing to its concentration of leading blue-chip companies. Demonstrated by its consistently tight vacancy rates, Chiyoda maintains its position as the premier business district in Tokyo.

Office movement activity was limited relative to its C5W counterparts this quarter. The most significant relocation to the ward will be Shinwa Wise Holdings, which will reportedly lease just under 380 tsubo in the Marunouchi Yusen Building, relocating its headquarters. Elsewhere, E'grand and Energy Solutions also relocated their headquarters to Work Villa Mitoshiro and the Hulic Ochanomizu Building, respectively, each leasing 200 tsubo of office space.

Chuo

Average rents in Chuo increased slightly by 0.2% QoQ, albeit falling by 0.6% YoY to JPY31,544 per tsubo, and average vacancy decreased by 0.2ppts QoQ to 5.9%. The strong leasing performance of modern properties in prime areas such as Yaesu, Nihonbashi and Ginza contributed to consistently low vacancies. The situation in Harumi appears to have improved, with a slight contraction in vacancies observed across multiple buildings in the area. Nevertheless, bifurcation between well-performing offices and struggling offices within Chuo Ward looks to persist for the meantime, with older properties in non-prime areas likely considered less desirable.

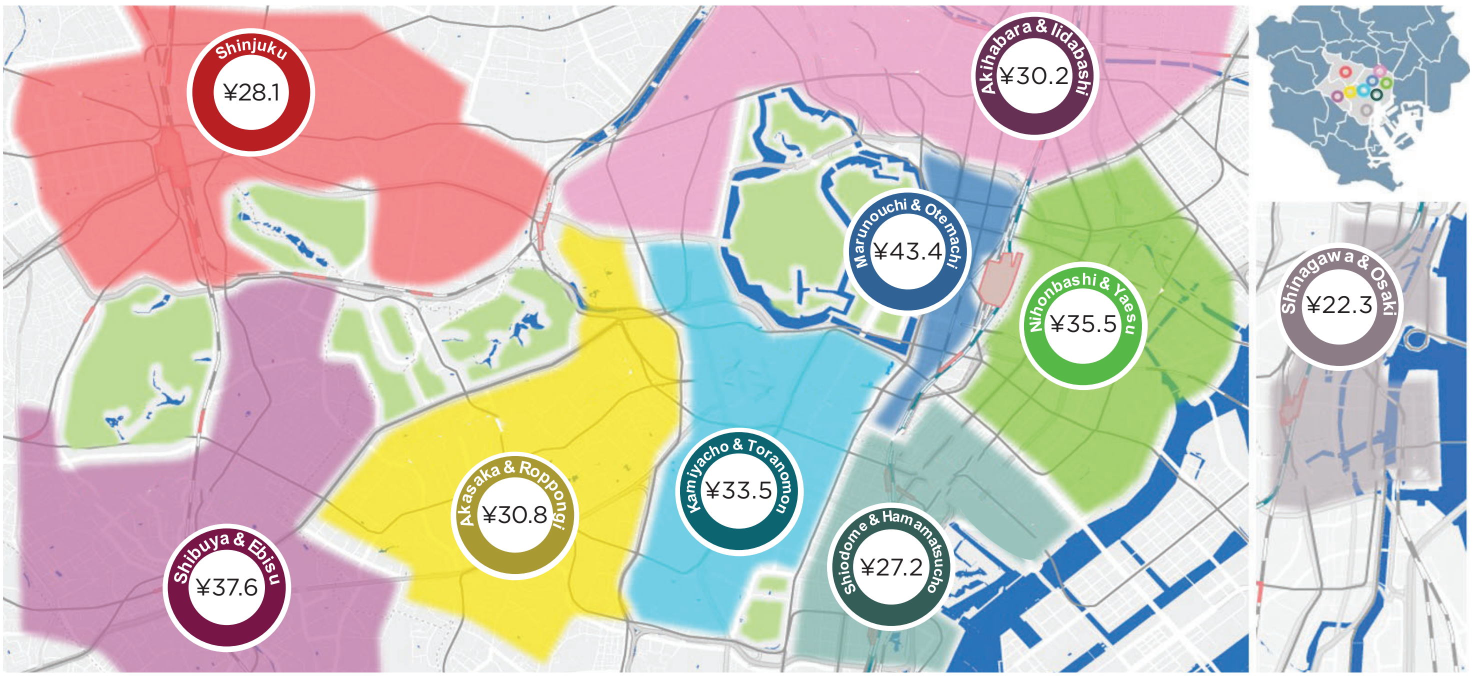
The largest leasing activity announced in Q1/2024 was Chanel's relocation to Tokyo Square Garden, leasing a total of 1,300 tsubo of office space. Elsewhere, multiple companies affiliated with Tosoh will reportedly lease 1,000 tsubo in Kyobashi Trust Tower in mid-2024. LayerX will also move to the Tsukiji Shochiku Building, leasing 700 tsubo, more than double its previous office space, as part of preparations for future business expansion. Additionally, Gakujo will relocate its headquarters from Chiyoda to Ginza Six, leasing around 530 tsubo of office space.

Minato

Average rents in Minato increased moderately by 0.5% QoQ, albeit declining by 0.1% YoY to JPY30,338 per tsubo, while vacancy dropped significantly by 1.0ppts QoQ to 5.1%. Azabudai Hills Mori JP Tower, Toranomon Hills Station Tower and Tamachi Tower, which came to market in the latter half of 2023 saw consistent absorption, contributing to an overall improvement in vacancy performance within Minato. Overall, despite a handful of moderately large relocations out of the ward, such as Nikon, a positive net-inflow of tenants to Minato has gradually been reducing the average vacancy rate, and the ward looks to perform well moving forward.

Azabudai Hills Mori JP Tower has been a significant addition to the Minato office market, and despite some initial hiccups, has captured sound interest from prospective tenants. Indeed, Persol Career, RAKSUL INC., and Merck will reportedly move to the property in Q1/2024, leasing 4,200 tsubo, 1,700 tsubo, and 1,400 tsubo, respectively. Toranomon Hills Station Tower continues to perform well and is close to full occupancy, with Japan Business Systems reportedly relocating its headquarters to the building, leasing approximately 2,000 tsubo of floor area in April 2024. Meanwhile, Nihon Chouzai and Mitsubishi Auto Leasing will relocate their headquarters to Tamachi Tower, leasing approximately 2,000 tsubo and 1,600 tsubo, respectively.

MAP 1: Average Rents Per Tsubo in Selected Submarkets, Q1/2024



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

TABLE 1: Tenant Relocations, Q1/2024

ORIGIN: Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other	DESTINATION	
7	14	14	5	1	12		
3	2					5	Chiyoda
1	6	1			1	9	Chuo
3	5	10	1		4	23	Minato
		1	3			4	Shibuya
				1	1	2	Shinjuku
	1	2	1		6	10	Other

Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Q1/2024

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION	NEW LOCATION	APPROXIMATE SPACE	
					TSUBO	SQ M
Persol Career	Recruitment	HQ Relocation & Office Consolidation	Multiple Multiple	Azabudai Hills Mori JP Tower Minato	4,200	13,900
Japan Business Systems	Financial Services	HQ Relocation	Toranomon Hills Mori Tower Minato	Toranomon Hills Station Tower Minato	2,000	6,600
Nihon Chouzai	Technology and Electronics	Office Relocation	GranTokyo North Tower Chiyoda	Tamachi Tower Minato	2,000	6,600
Olympus	Information Technology	HQ Relocation & Office Consolidation	Daiwa Sasazuka Tower Shibuya	Hachioji Facility Technology Development Center Ishikawa Hachioji	1,700	5,600
RAKSUL INC.	Software	HQ Relocation	IK Building Shinagawa	Azabudai Hills Mori JP Tower Minato	1,700	5,600

Source Nikkei RE, Savills Research & Consultancy

Shibuya

Shibuya's average rents held steady this quarter, translating to a 2.3% YoY increase, at JPY35,659 per tsubo. Meanwhile, vacancy loosened marginally by 0.1ppts QoQ to 1.7%. The vacancy situation in the Shibuya market has remained tight and this positive situation should continue moving forward. Overall, there is minimal office supply entering the Shibuya market over the coming year and the majority of prime buildings are fully occupied.

Tenant movement in Shibuya has been relatively limited this quarter, owing to the short supply of available office space. For example, au Commerce & Life will lease approximately 600 tsubo across two floors in the Sumitomo Fudosan Shinjuku Minamiguchi Building, which is scheduled to be completed in April 2024. This represents an expansion compared to its current office footprint, despite the company having plans to continue with hybrid work arrangements after relocation.

Shinjuku

Average rents in Shinjuku experienced a modest increase of 0.3% QoQ and 0.9% YoY to JPY26,917 per tsubo, while vacancy loosened moderately by 0.2ppts QoQ to 1.2%. Given the limited new office supply scheduled to arrive to the market over the coming years, the Shinjuku office market should continue to perform well, with limited vacancies and sound prospects for rental growth.

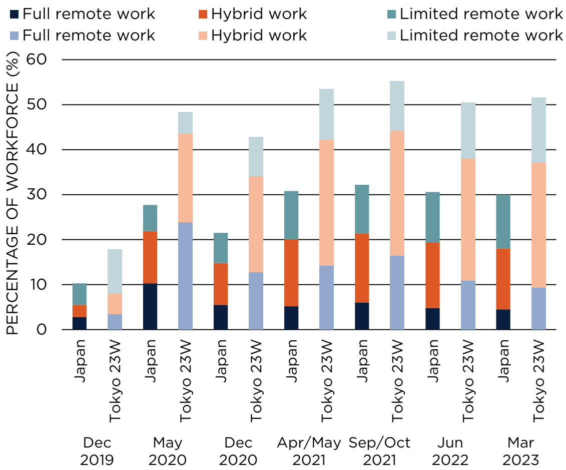
The largest office movement reported in Q1/2024 in Shinjuku is an office consolidation by Infotec Holdings and its affiliate companies, which will relocate to a new headquarters in Shinjuku Park Tower, leasing a total of 1,300 tsubo in April 2024. Anticipating an expansion in its headcount, the company chose this office building as it has sufficient room for future expansion in operations. Elsewhere, Tokio Marine Assistance will lease between 300 and 500 tsubo of office space in JR Shinjuku Miraina Tower. With the only new supply in the Shinjuku market set to be the Meiji Yasuda Seimei Building in 2026, the market will likely remain firm for the time being.

EMERGING TREND OF SATELLITE OFFICES / FLEXIBLE SPACES

During the pandemic, many large companies in the Tokyo 23W swiftly transitioned to remote work arrangements. Now, while many employees have returned to offices, hybrid work arrangements remain prevalent in Tokyo. According to a survey by the Cabinet Office, in March 2023, approximately 50% of the workforce in the Tokyo 23W practices remote work at least one day a week, which is significantly higher than the pre-pandemic level of 18% in December 2019 (Graph 4). Indeed, hybrid work arrangements are likely to linger as a company perk, particularly at large corporations, to attract and retain their workforces.

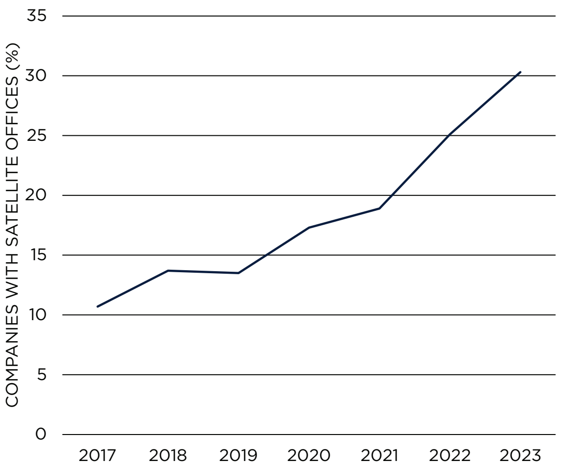
Meanwhile, satellite offices with flexible spaces also began gaining traction even before the pandemic, driven by the rising trend of freelancers

GRAPH 4: Change in Remote Work Trends in Japan and Tokyo 23W



Source Cabinet Office, Savills Research & Consultancy

GRAPH 5: Adoption Rate of Satellite Offices in Japan, 2017 to 2023



Source Xymax, Savills Research & Consultancy

and startups, with research by Xymax demonstrating that the percentage of companies in Japan with satellite offices had tripled between 2017 and 2023 (Graph 5), many of which were likely to have had flexible plans. As companies embrace hybrid work arrangements, the demand for smaller and more cost-efficient office spaces that can facilitate seamless communication has grown. Furthermore, potential security concerns with working from home, cafes or restaurants may have driven the demand for a conducive “third place” for remote workers further. These satellite offices have a widespread presence in major cities like Tokyo, Osaka, and Nagoya, and employees can choose a location near their home, reducing commuting time to the main office. Furthermore, given the convenience and flexibility afforded to tenants, such satellite flexible offices are also receiving noticeable interest, especially among SMEs and startups, to be used as their main office. The pandemic has proved the feasibility of hybrid work arrangements to employers, and some shift towards flexible office space should continue, particularly in office markets like Shibuya and Shinjuku, which aligns well to their tenant profile.

According to Xymax, more than 90% of the office buildings in Tokyo 23W are small and medium-sized, with a majority of these buildings constructed during the bubble period (1987 to 1993). Many of these older office buildings tend to lose competitiveness, due to the demand for stylish, modern work environments with more sophisticated features and amenities that boost productivity and communication. To capitalise on the challenges faced by older office buildings, some domestic players, including Ichigo Group and Sun Frontier, have been carrying out renovations to older properties to add additional value, and leasing them out as set-up offices, which are often used as satellite flexible work spaces. For instance, Ichigo Group carried out renovations to the Ichigo Jimbocho Building and the Ichigo Uchikanda Building, resulting in rental increments of 75% and 46%, respectively.

These types of flexible office spaces can be found not only in small and medium-sized office buildings but also in large Grade A buildings in prime locations. For instance, a number of well-known international flexible space operators focus on high-end serviced offices tailored to the needs of tenants seeking top-quality amenities and prestigious locations. Regional cities have also experienced an uptick in the establishment of satellite flexible offices, supported by government subsidies, incentivising the relocation of companies from metropolitan areas to regional areas. Indeed, in 2021, approximately one-third of satellite flexible offices benefitted from local government support.

Furthermore, these set-up office spaces offer flexibility and convenience for smaller companies. Unlike traditional standard lease contracts, these flexible contracts offer shorter term options, some as short as one month. They typically require smaller or no deposits unlike traditional leases, which often require a few months’ rent equivalent in advance. Additionally, termination notices are also shorter, typically around 30 days. With elevated construction costs and prolonged lead time, companies can also circumvent hefty renovation costs when moving in and out as traditional leases typically require tenants to return the space to its original condition. As such, a flexible office spaces appear to make more economic sense to many SMEs and startups, enabling them to swiftly move into office spaces with minimal initial investment and hassle. Hence these types of offices are more widely prevalent in submarkets like Shibuya.

As hybrid work arrangements become more commonplace, the demand for satellite offices and flexible spaces may grow in tandem as companies and workers explore alternatives to working from home. More developers and investors in office buildings may consider incorporating flexible spaces and set-up office concepts to cater to the growing demand for such specifications, which may also enhance the competitiveness of existing office buildings.

OUTLOOK

The Tokyo Grade A and large-scale Grade B office market experienced sound growth in Q1/2024, supported by strong corporate performance, one of the key determinants of the office market’s performance. This can be seen from a growing proportion of businesses expanding their operations and increasing their workforce, consequently driving demand for larger and higher-quality office spaces.

The overall market has responded well to the large influx of supply in 2023, evidenced by the steadily increasing average rental level and continuous tightening of vacancies since the second half of 2023, which are signs of sound demand and market stability. In addition, the limited new supply expected in 2024 should further drive the ongoing improvement of the office market.

Bifurcation between modern, well-located buildings and older, less convenient buildings is expected to persist. Despite the steady return to offices, flexible work arrangements remain prevalent in the Tokyo 23W. Hence, large companies, especially those that are performing well, are compelled to invest in larger and higher-quality office spaces with excellent accessibility to encourage employees to return to the office. Japan’s work ethos generally puts emphasis on face-to-face communication and values in-office collaboration. Furthermore, high-grade offices are essential for companies to attract and retain skilled talent, which has become scarcer in the market. Therefore, modern and accessible buildings should experience firm demand, whereas older and inaccessible offices are likely to continue facing challenges in this evolving workplace landscape.

Looking forward, a large influx of new office supply is expected in 2025. Landlords holding significant amounts of vacant office space should proceed with prudence as competition for tenants is expected to intensify later this year. The fact that the large influx of new supply in 2023 was absorbed well, coupled with the sound pre-leasing activities observed in 2024, signals sound demand in the office market. Moreover, the overall office market should perform well going forward, further supported by the sustained improvement in the broader economy, and a steady return to the office.