



Office Leasing



Grade A vacancy continues to tighten

Rents continue to rise and vacancy remains tight across the C5W, even as new supply exceeds the historical average.

- Grade A stock in Tokyo's C5W continues to be in high demand. Vacancy is pushing closer and closer to zero, having declined for eight consecutive quarters, while average rents have increased for the past seven years.
- Average passing rents for Grade A office space in the C5W grew to JPY36,100 per tsubo¹ per month, representing a gain of 2.4% quarter-on-quarter (QoQ) and 7.3% year-on-year (YoY).
- The average Grade A office vacancy rate in the C5W hit 0.3% in Q2/2019, dipping by 0.1 percentage points (ppts) QoQ and by 0.5ppts YoY.
- Average passing rents for large-scale Grade B office space rose to JPY27,632 per tsubo per month, growing by 3.0% QoQ and 7.8% YoY.
- The average large-scale Grade B office vacancy rate stands at 0.4%, ticking up 0.1ppts QoQ but still 0.2ppts lower YoY. For the more cautious, this uptick in vacancy, albeit very slight, might appear as a harbinger of a downward shift in the property cycle.
- The latest JREI survey revealed a consensus that the Tokyo office market cycle is at its peak, but is expected to remain there for at least the next six months.
- Headwinds abound, particularly in the macro-economy, but appear unlikely to affect the office market over the short term as overall demand is sound and pre-leasing has booked up the majority of new supply through 2019.

“Vacancy remains extremely low as tenants compete for limited available space, and average rents continue to march higher. Rental growth is most pronounced in offices with larger floorplates, which are ideal for workplace consolidations and inter-departmental collaboration.”

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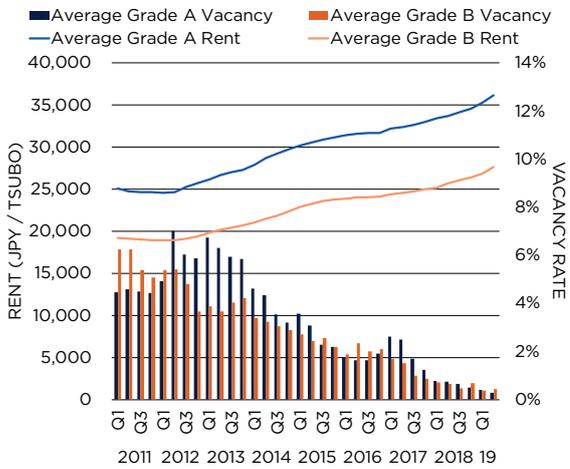
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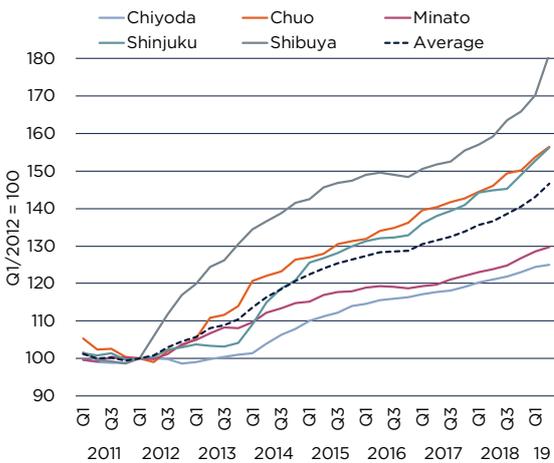
¹ 1 tsubo = 3.306 sq m or 35.583 sq ft

GRAPH 1: Office Rents And Vacancy In Tokyo's C5W*, 2011 to Q2/2019



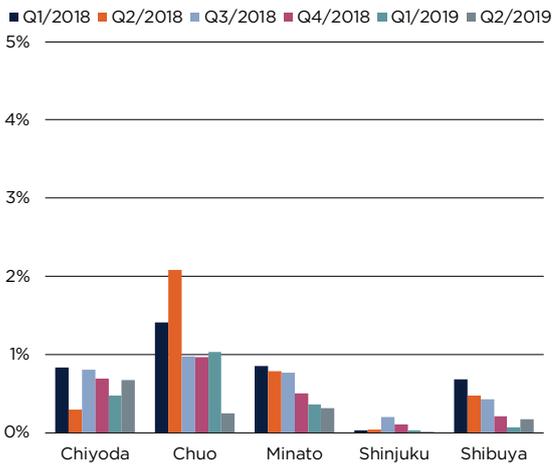
Source Savills Research & Consultancy
*Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index By Ward, 2011 to Q2/2019



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy By Ward, Q1/2018 to Q2/2019



Source Savills Research & Consultancy

GRADE A OFFICES

Grade A office rents rose 2.4% QoQ and 7.3% YoY in Q2/2019 to JPY36,100 per tsubo². Vacancy fell 0.1ppts QoQ to finish the quarter at 0.3%, some 0.5ppts lower YoY. Although Chiyoda and Shibuya saw slight upticks this quarter, average vacancy in the C5W has declined for eight consecutive quarters, even as supply over the past two years has been above average. Further, rents have increased for the past seven years, bolstered by strong demand and an influx of higher-specification buildings, with particularly pronounced growth in Shibuya. On a more cautious note, leasing negotiations are dragging on longer than before in some areas, as tenants appear more hesitant to accept higher rents in face of uncertain prospects. Indeed, business confidence remains somewhat tepid, but large companies are cash-rich and eager to expand, albeit moderately, with both profits and capital expenditure at high levels.

LARGE-SCALE GRADE B OFFICES

Large-scale Grade B office³ rents rose by 3.0% QoQ and 7.8% YoY in Q2/2019, landing at JPY27,632 per tsubo. Vacancy stands at 0.4%, 0.1ppts higher QoQ but still 0.2ppts lower YoY. As overall availability is limited, Tokyo-based corporations appear to be taking any opportunity to lease up space. With a relatively small pipeline of large-scale Grade B buildings in development, strong demand has been largely suppressing vacancy and lifting rents at an even faster pace than in the Grade A market. However, should the economy start to flip, lower-grade buildings are likely to be the first to feel the heat. The slight uptick in vacancy this quarter could be an early sign of a downward shift in the property cycle, though it is more likely to be just a small blip in an otherwise bullish trend.

GRADE A RENTS AND VACANCY RATES BY WARD
Chiyoda

Chiyoda's Grade A vacancy rate rose by 0.2ppts QoQ and 0.4ppts YoY to land at 0.7%. Grade A rents climbed by 0.5% QoQ and 3.3% YoY to JPY42,009 per tsubo. Japan Post relocated its headquarters to Otemachi Place West in early 2019, taking over 18,000 tsubo across 20 floors to accommodate some 6,000 employees. This relocation consolidated eight separate offices that were distributed around Kasumigaseki. Salesforce.com will consolidate its Tokyo headquarters and a co-working base in Nissay Marunouchi Garden Tower in the second half of 2021, leasing an estimated 9,600 tsubo over all of the 19 floors reserved for office use. While headcount is currently 1,500, the

² Throughout the report, "per tsubo" is shorthand for "per tsubo per month".
³ "Large-scale Grade B office" refers to buildings with a GFA of 4,500 tsubo (15,000 sq m) and a building age of less than 25 years. Some buildings are included that do not fit this definition.

company is preparing for future expansion to up to 4,000 employees with the move.

Chuo

Chuo's Grade A vacancy rate of 0.2% was 0.8ppts tighter than last period and 1.8ppts tighter YoY. Grade A rents grew 1.9% QoQ and 7.2% YoY, to JPY33,900 per tsubo. NEC Networks & System Integration will lease slightly less than 2,000 tsubo in Nihonbashi-Muromachi Mitsui Tower over one and a half floors. The company has had its headquarters in Sumitomo Fudosan Iidabashi First Tower in Bunkyo since the summer of 2010, but did not disclose whether its headquarters would relocate to the new location. Japan Securities Depository Center (JASDEC) will relocate its headquarters to the tentatively-named Nihonbashi-Kabutocho District 7 Development Project, which is scheduled to be completed at the end of March 2021. It will take around 1,500 tsubo across two and a half floors. WeWork will open a collaboration office in the Nippon Life Nihonbashi Building in Nihonbashi in August 2019, offering 600 tsubo across three floors.

Minato

Minato's Grade A vacancy rate tightened slightly by 0.1ppts QoQ and 0.5ppts YoY to 0.3% at the end of the quarter. Grade A rents climbed by 1.0% QoQ and 4.8% YoY to JPY32,884 per tsubo. Trading firm Itochu will tentatively relocate its Tokyo headquarters to Kamiyacho Trust Tower, expected to complete in March 2020, while its company-owned building is reconstructed in Kita-Aoyama. According to sources it is in discussions to lease around 20,000 tsubo. American Express will also lease around 4,000 tsubo in Kamiyacho Trust Tower. Hitachi High-Technologies will move into Toranomon Hills Business Tower, scheduled to complete in December 2019, taking 5,400 tsubo across six floors. Facebook Japan will also lease around 2,400 tsubo in the building, which is already nearing full occupancy, from the second half of 2020.

Shibuya

Shibuya's Grade A vacancy rate rose by a slight 0.1ppts QoQ, but was 0.3ppts tighter YoY, landing at 0.2%. Grade A rents climbed by 6.5% QoQ to JPY38,706 per tsubo, growing by 13.8% YoY. Fabric Tokyo, an e-commerce retailer focused on clothing, will move its offices to the sixth floor of the South Shinjuku Hoshino Building, taking an estimated 100 tsubo. There were no other announced leasing transactions for Shibuya this quarter, highlighting the extremely low availability in the area. Although many large offices are due to complete in 2019, much of the available space has already been pre-leased.

Shinjuku

Shinjuku's Grade A rents climbed by 2.3% QoQ and 7.9% YoY to JPY33,000 per

TABLE 1: Tenant Relocations, Q2/2019

ORIGIN						DESTINATION	
Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other		
6	7	11	3	3	16		
↓	↓	↓	↓	↓	↓		
4	2	4		1	5	→	16
1	4	1			3	→	9
		5		1	4	→	10
			1			→	1
			1	1		→	2
1	1	1	1		4	→	8
							Chiyoda
							Chuo
							Minato
							Shibuya
							Shinjuku
							Other

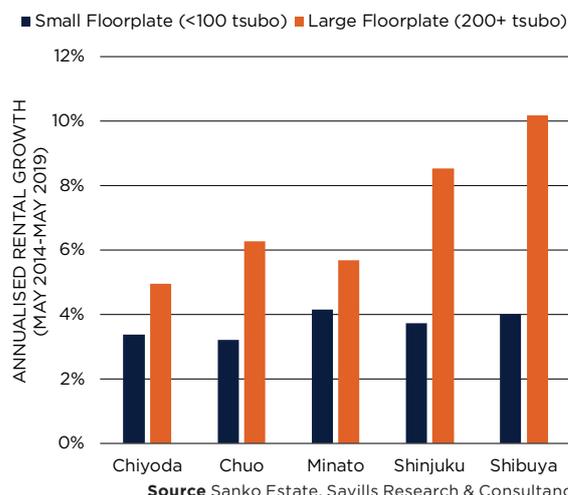
Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Q2/2019

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION	NEW LOCATION	APPROXIMATE SPACE	
					TSUBO	SQ M
Itochu	Trading firm	HQ relocation	Company owned building	Kamiyacho Trust Tower	20,000	66,100
			Minato-ku			
Japan Post Group	Delivery services	HQ relocation	Various	Otemachi Place West Tower	18,150	60,000
			Various			
Salesforce.com	Software development & services	Consolidation	JP Tower	Nissay Marunouchi Garden Tower	9,600	31,700
			Chiyoda-ku			
Hitachi High-Technologies	Industrial systems	HQ relocation	Hitachi High-Tech Building	Toranomom Hills Business Tower	5,400	17,900
			Minato-ku			
American Express International	Financial services	HQ relocation	Fujisawa Building	Kamiyacho Trust Tower	4,000	13,200
			Suginami-ku			

Source Nikkei RE, Savills Research & Consultancy

GRAPH 4: Rental Growth By Floorplate, May 2014 to May 2019



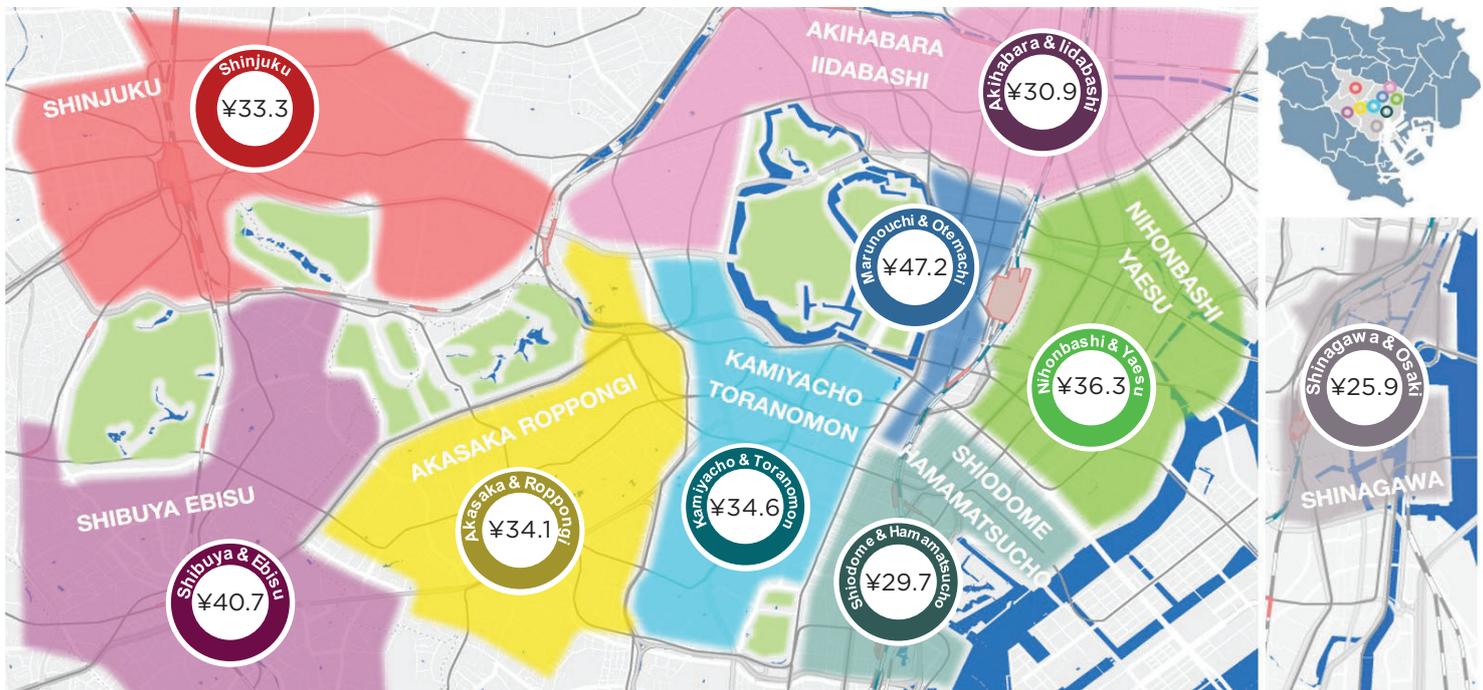
tsubo. The Grade A vacancy rate tightened marginally by less than 0.1ppts QoQ and YoY, ending the quarter at just 1 basis point (0.01%), effectively zero. Takachiho Koheki will relocate its headquarters to the seventh floor of Yotsuya Tower in May 2020, taking around 650 tsubo. The Tokyo Metropolitan Town Creation Center for Disaster Prevention and Construction will relocate its headquarters to the tentatively-named Odakyu Real Estate Nishi-Shinjuku 7-chome Project, taking just under 390 tsubo over two floors.

STRONG DEMAND FOR LARGE FLOORPLATES

Companies are looking to increase productivity as one solution to a scarcity of labour, and a popular measure to boost productivity is to consolidate office locations and foster inter-departmental collaboration,

which requires securing locations with larger floorplates. As Graph 4 shows, over the past five years, which coincides with the rapid decline in unemployment, large floorplate offices have seen greater rental growth than small floorplate offices in each of the central five wards. While stronger rental growth for large floorplate offices is surely in some part a result of newer buildings – with their cutting-edge specifications – generally having larger floorplates, tenants regularly cite large floorplates as a factor in relocation decisions. The trend is strongest in Shibuya and Shinjuku, which have arguably had a higher share of new large floorplate supply against relatively lower levels of existing large floorplate stock than the other three central wards of Chiyoda, Chuo and Minato (the central three wards, or C3W). Indeed, over 80% of large floorplate stock in the whole of the C5W is located in the C3W,

MAP 1: Average Rents Per Tsubo In Selected Submarkets, Q2/2019



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

while just over 70% of small floorplate stock is concentrated in the C3W.

On the other hand, preferences can change, and while it can take a long time for a new trend to be established, the latest trend of co-working and smaller satellite offices is undeniable. While companies have favoured large floorplates over the past decade, the rapid expansion of co-working has filled a need which many were not aware of: the need for smaller, dispersed office locations which can meet the varying demands of a diverse workforce. For example, Regus, a major serviced office provider, has announced it will expand into residential areas as part of its business plan.

According to a 2019 Xymax report, 66% of corporations agreed that consolidating their headquarters in the city centre with good accessibility was important, and 48.2% valued the ability to measure or visualise the productivity of offices. This supports the argument of strong demand for large floorplate offices which can accommodate consolidated headquarters functions. Where branch offices are concerned, however, corporations gave less importance to consolidation, instead preferring to provide a diverse range of office locations – and even the option to work from home.

Thus, in the C5W, large floorplate offices should continue to see strong demand, but outside of the city centre, more flexible office space such as co-working, serviced offices, or mixed-use facilities could prove more popular going forward.

OUTLOOK

Companies have enjoyed increasing profits for many years now, and many corporations are increasing capital expenditure. Unemployment is low, and companies are looking to obtain top-quality offices to secure workforce, which bodes well for demand for new Grade A buildings and, to a certain extent, for large-scale Grade B buildings. Companies are also attempting to improve productivity through better inter-departmental collaboration by

consolidating locations and taking larger floorplate offices where available. This same driver is supporting demand for co-working locations, which are increasingly catering to corporate clients and sweeping up new supply at a rapid pace. Pre-leasing activity looks strong, cap rates notched lower again in 1H/2019, and large transactions continue to close, supporting a positive short-term outlook.

However, corporate profits for FY2019, though still at a high level, posted the first decline in three years as demand from China weakened and costs – such as labour and raw materials – continued to rise. Business confidence is also somewhat depressed, and geopolitical risks have resurfaced as the US administration is ramping up trade pressures on China. In the latest survey of real estate professionals by the Japan Real Estate Institute (JREI), respondents formed a consensus that Tokyo is at the peak of the property cycle, though this has been the modal response for the past few years. If any of these risks grows into a true concern, it could put downward pressure on occupancy and rents.

These risks seem unlikely to influence the property market over the short term. However, if these risks materialise, they may adversely affect corporate activity, and eventually, the office leasing market. The world economy has so far managed to push through recent volatility in capital markets and global uncertainty, but a turning point could emerge abruptly. Prolonged leasing negotiations in some areas of the Grade A market and the slight uptick in Grade B office vacancy could be harbingers of a turning point in the property market, as companies may be more cautious to expand, lease up new space, or accept higher rents given the conditions mentioned above. However, with vacancy at such airtight levels, mild shifts in tenancy have an outsized impact on overall market data. For now, tight vacancy and strong pre-leasing in the face of large supply are encouraging signs for the real estate market.

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.