MARKET IN MINUTES

Savills Research

Office Leasing

Market softening proves stubborn

Amid the continued deterioration of the office market, there is hope that the accelerated vaccine rollout could be the catalyst for post-pandemic recovery.

- Whilst the lingering changes to workstyles introduced by COVID-19 are slowly being understood, it continues to weigh on office rents in the central five wards (C5W).
- Average Grade A office market rents in the C5W fell 1.7% quarter-on-quarter (QoQ) and 7.1% year-on-year (YoY), and now stand at JPY35,157 per tsubo[1] per month.
- The average Grade A office vacancy rate in the C5W increased by 0.6 percentage points (ppts) QoQ to 1.8% in Q2/2021.
- Average large-scale Grade B office rents declined to JPY26,765 per tsubo per month – a contraction of 1.9% QoQ and 6.6% YoY.
- The average vacancy rate in the Grade B market loosened by 0.5ppts QoQ and 2.0ppts YoY to 2.7%.
- Although there are mounting concerns over the emergence of secondary vacancy from 2020, encouragingly, most new supply expected this year has been filled or pre-leased. With 2022 supply expected to be limited, the market should have time to recuperate before the large influx the year after.[2]
- Despite the continued stability of prime real estate in central locations, rental corrections observed in poorly located and older offices have weakened the overall office market.

“Non-prime areas have led the overall market contraction this quarter despite the continued stability of prime assets. Even so, with hopes that the expedited vaccine rollout will fuel the recovery in corporate performance later this year, things should look brighter for the office market. Furthermore, limited supply until late 2022 will provide some breathing space.”

SAVILLS RESEARCH & CONSULTANCY

1 1 tsubo = 3.306 sq m or 35.583 sq ft.
2 Please refer to Tokyo Office Supply June 2021 for further details.

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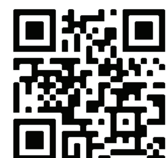
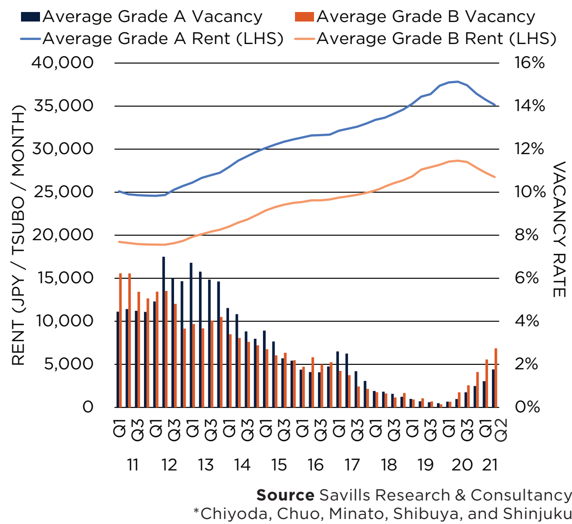
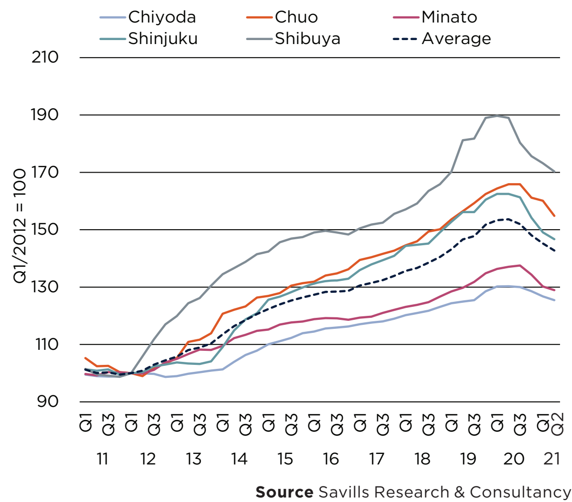


GRAPH 1: Office Rents And Vacancy In Tokyo's C5W*, 2011 to Q2/2021



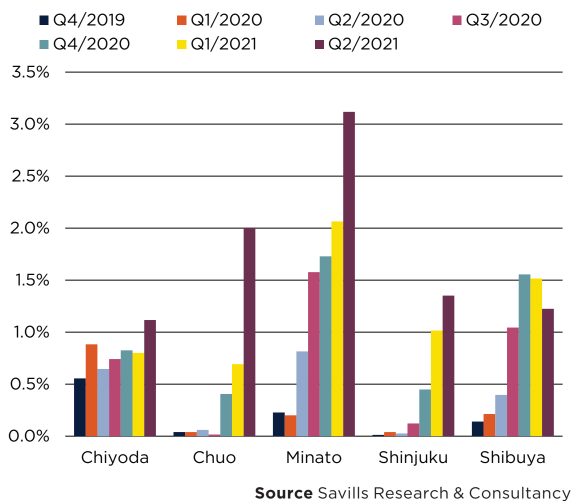
Source Savills Research & Consultancy
*Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index By Ward, 2011 to Q2/2021



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy By Ward, Q3/2019 to Q2/2021



Source Savills Research & Consultancy

GRADE A OFFICES

Burdened by the emergence of secondary vacancy from 2020, Tokyo's Grade A[3] office market continues to soften this quarter with a rental contraction of 1.7% QoQ and 7.1% YoY to JPY35,157 per tsubo. Vacancy rates, meanwhile, saw an uptick of 0.6 ppts QoQ and 1.4 ppts YoY to 1.8%. The advent of remote work has also reduced the demand from larger companies and may consequently weaken rents further. We are noticing a trend of some large Japanese corporations committing to reducing their floor space and introducing free address seating for the remaining space as in-office headcount decreases.

Considering the circumstances, the limited levels of new supply until late 2022 in the C5W are welcome and may give the market some time to recover. Furthermore, the demand for new Grade A offices in central areas remains sound. For instance, both Tokiwabashi Tower and Hibiya Fort Tower, which together represent the bulk of new supply in 2021, have high occupancy levels.

Given the current landscape, we expect the recovery of the office market to be K-shaped, mimicking the overall Japanese economy, with central offices holding strong while offices with poorer accessibility suffer. This sentiment is echoed by a survey on office use and future demand conducted by Xymax in April 2021. Here, of the estimated 1,600 corporate respondents, nearly 60% intended to concentrate operations into a central and convenient location going forward. For example, SMBC Trust Bank plans to cancel over 5,000 tsubo of leases around Tokyo to concentrate their operations into their central headquarters. Itochu Techno-Solutions has also eliminated four leases throughout the city to streamline operations into Kamiyacho Trust Tower with a 10,000 tsubo lease. With such moves expected to occur more frequently, we are likely to see central and convenient areas hold firm in value. Additionally, the same Xymax survey indicated that around 30% of respondents plan on having satellite offices near transit hubs, which could act as a tailwind for the office market post-pandemic. For now, offices away from stations are seeing higher vacancies, meaning that landlords may have to lower rents further to attract or keep tenants.

Nevertheless, there is some hope for the market overall. The expedited vaccine rollout in Tokyo should support office demand next year as the economy recovers and companies see improved performance with more workers returning to the office. In the meantime, as companies begin planning and executing their post pandemic moves, we expect Grade A markets near central transit hubs to remain competitive but, at the same time, less convenient properties should be in for a tough time.

3 "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.

LARGE-SCALE GRADE B OFFICES

On one hand, the Grade B market has loosely mimicked the Grade A market's performance this quarter by decreasing at a similar rate of 1.9% QoQ and 6.6% YoY to JPY26,765 per tsubo. As such Grade B's rent continues to remain around 70% of Grade A's rent. On the other hand, vacancy has grown at a faster rate than the Grade A office market, increasing 0.5 ppts QoQ and 2.0 ppts YoY to 2.7%. However, most of the recent supply in the market was Grade A, and with only marginal supply influxes expected over the next few years, vacancy should remain somewhat stable going forward.

At the ward level, Shibuya demonstrated the largest rental decrease this quarter, and the ward's weakening has become more pronounced. Until Q2/2020, Shibuya's rents were growing impressively, standing second highest after Chiyoda. However, the ward began to see problems during the pandemic when many IT companies quickly reduced office space and switched to remote work. As Shibuya's main tenant profile is comprised of IT companies, the ward was greatly impacted by this change. Currently, Shibuya's average Grade B rents have fallen to one of the cheapest levels in the C5W. Rental declines in Shibuya's Grade B market are particularly noticeable for office buildings that were charging much more than the market average. As such, it appears that as rents for Grade A offices in Shibuya came down, it became difficult to justify such high rents for Grade B offices in the same market.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

Chiyoda's vacancy levels have remained tight at 1.1% despite loosening 0.3 ppts QoQ and 0.5 ppts YoY. Maintaining the lowest vacancy levels in the C5W is impressive considering that Chiyoda had several large offices open in 2020. Meanwhile, rents have shrunk by 1.0% QoQ and 3.7% YoY to JPY42,200 per tsubo, slower than the market average of 1.7% QoQ and 7.1% YoY. As such, Chiyoda's premium in rent over the average Grade A rent has continued to grow, albeit marginally.

Sound demand in this submarket is still apparent as demonstrated by the strong recovery in pre-leasing for Tokiwabashi Tower after some cancellations last year. Coupled with the continued appetite for new real estate, Chiyoda's tenant profile of large Japanese and foreign companies and its central and well-connected transport system should keep it stable moving forward.

Chuo

The resilience that Chuo had shown in the past began to fade in Q2/2021 as it led the C5W in this quarter's rental corrections with a QoQ decrease of 3.3% to JPY33,600 per tsubo. Vacancy has more than doubled this quarter, increasing by 1.3 ppts QoQ and 1.9 ppts YoY to 2.0%. This signals that there may be further rental corrections to come next quarter. Nonetheless, Chuo YoY rental decline of 6.6% is still lower than the C5W average, showing that the ward has not lost as much value as its peers.

Looking at the different submarkets within the ward, more central ones have remained sound while outer submarkets have continued their downward trend. For instance, the convenient and central submarkets of Nihonbashi and Yaesu continue to have airtight vacancy of 0.1%. In fact, Tokyo Midtown Yaesu, the largest building to open in Chuo next year, has had an encouraging start to pre-leasing. This is positive news for the Yaesu submarket that will see a complete overhaul with multiple large-scale projects scheduled to be completed by 2030. At least for now, the comparatively large tenant pool of stable Japanese corporate headquarters should help curb the market degradation caused by outer submarkets.

Minato

Minato's rental decline has somewhat slowed with a 1.0% QoQ and 5.9% YoY contraction to JPY32,700 per tsubo, down from the 3.1% QoQ contraction in Q1/2021. Vacancy saw a notable uptick this quarter, loosening 1.1 ppts QoQ and 2.3 ppts YoY to 3.1%. The increasing vacancy suggests that we may see further rental corrections next quarter, especially when considering the secondary vacancy derived from tenants moving to newly supplied Grade A buildings within the ward.

At the submarket level, many of the large sized buildings in Shiodome are facing high vacancy levels, and this is expected to increase further due to its relatively inconvenient location. This situation may be exacerbated as Minato will see multiple large developments in 2023, further pulling interest away from the Shiodome submarket. In fact, just two of the leading large mixed-use developments, the Toranomon Azabudai project and the tentatively named Toranomon Hills Station Tower, will bring approximately 100,000 tsubo of NRA in 2023. In addition, there is another large project in Toranomon as well as two large projects in the Tamachi/Mita area. While the positive reception of the newly introduced Hibiya Fort Tower has shown that there is appetite for new Grade A buildings in Minato overall, it may be premature to assess if demand can keep up with the large supply influx of 2023[4].

4 Please refer to Tokyo Office Supply June 2021 for further details.

TABLE 1: Tenant Relocations, Q2/2021

ORIGIN							DESTINATION	
Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other			
16	17	17	7	6	20			
9	2	5		3	4	→	23	Chiyoda
	9	1				→	10	Chuo
4	6	11	1	1	8	→	31	Minato
			6			→	6	Shibuya
1				2	1	→	4	Shinjuku
2					7	→	9	Other

Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Q2/2021

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION		NEW LOCATION	APPROXIMATE SPACE	
						TSUBO	SQ M
Tokio Marine	Insurance	HQ Relocation	Tokio Marine & Nichido Holdings Builidng Chiyoda	→	Tokiwabashi Tower Chiyoda	10,140	33,500
Orix	Insurance	Office Consolidation	Multiple Minato	→	World Trade Center Building South Tower Minato	6,580	21,700
Line	Software and App Developer	HQ Relocation	JR Shinjuku Miraina Tower Shinjuku	→	Yotsuya Tower Shinjuku	6,200	20,500
SMBC Trust Bank	Banking	Office Consolidation	Multiple Minato & Shnjuku	→	SMBC East Tower Chiyoda	4,030	13,300
Kuraray	Chemical Manufacturer	HQ Relocation	Ote Center Building Chiyoda	→	Tokiwabashi Tower Chiyoda	3,600	11,900

Source Nikkei RE, Savills Research & Consultancy

Shibuya

Shibuya's rents saw a mild contraction of 1.7% QoQ to JPY36,400 per tsubo. However, the staggering YoY decline of 9.9% shows how rapid its decline has been over the past year. Shibuya was the only ward in the C5W to see vacancy levels tighten over the quarter with a decrease of 0.3 ppts QoQ to 1.2%. The demand for Grade A office buildings in Shibuya suggests that the ward may see a comparatively smaller contraction in rents the next quarter.

Despite its recent declines in rent, much of the rental growth that Shibuya has seen over the last decade has remained intact, and it still holds its title as the second most expensive ward in Tokyo.

The greater push in Japan for Digital Transformation and teleworking infrastructure has bolstered the IT industry, and consequentially helped to prop up demand for offices in Shibuya, where many IT companies are located. Furthermore, major developer Tokyu headquartered in Shibuya has been adapting to the new office climate through their flexible lease and pre-established office businesses. These are likely to be popular with small and medium-sized enterprises (SMEs) who are more prone to market fluctuations and could greatly benefit from such programs.

Overall, these factors should benefit the ward moving forward, and they come at an important juncture as the ward will see 20,000 tsubo NRA added to the market in 2023. The main source of new supply, a development in Sakuragaoka, will increase overall office stock in Shibuya by 10.0%. The development itself is likely to see sound performance given its proximity to the station and mixed-use nature, but at the same time, it may disturb the currently delicate equilibrium of supply and demand in Shibuya, at the very least temporarily.

Shinjuku

Shinjuku's rents contracted by 1.6% QoQ and 9.7% YoY to JPY31,000 per tsubo. However, the decline this quarter is smaller than that seen in the past two quarters. Vacancy has increased 0.3 ppts QoQ to 1.4%, half of the 0.6 ppts increase seen in the last quarter. The increases in vacancy as of late have been driven mostly by small lease cancellations.

Moving forward, sub-par leasing activity for poorly located offices in Nishi-Shinjuku, coupled with an ageing stock that is less attractive to prospective tenants, is casting a shadow on Shinjuku's future.

That said, there is thankfully some major tenants who have found reasons to remain in Shinjuku. For instance, LINE Corporation has decided on a 6,200 tsubo lease in Yotsuya Tower. Some SMEs are also following suit due to Shinjuku's reasonable rents and ease of access.

Shinjuku's potential for redevelopment remains its silver lining, given it is one of the most connected and used stations in the world. Odakyu has already released its plans for a new 50-storey skyscraper with the middle floors expected to be primarily office space. Additionally, with the rumours for Keio's redevelopment plans increasing in strength, Shinjuku may be in for a renewed future.

FURTHER POLARISATION LIKELY FOR SHINAGAWA

On course to position itself as a major player in the Tokyo office market competing with the C5W, the pre-pandemic office market in Shinagawa enjoyed high growth rates and tight vacancy. The market was driven by good accessibility, affordability, and an established tenant landscape. Altogether, this has led to huge volumes of investment committed to taking the area to the next level in the upcoming years. However, the prospects of the market have somewhat deflated over the past year and the dark cloud shadowing the office market has yet to subside. Rental corrections and vacancy loosening have been driven by office consolidation as companies begin to execute their leasing strategies and reduce space.

Compared with pre-pandemic conditions, the present rental contraction and loosening vacancy indicate a natural correction, heightened when compared to that of the C5W. As such, rents have similarly fallen across Shinagawa's two main submarkets, between 7.9% and 10.5%, whereas vacancy changes have been focussed within Higashi/Minami Shinagawa, loosening 4.3ppts from Q1/2020 (Table 3).

Higashi/Minami Shinagawa is generally characterised as having relatively older offices with large floorplates, reduced connectivity, and large exposure to middle or back-office functions which can be performed more easily via teleworking. As such, the area has experienced downsizings. Notably, Hitachi Solutions in Shinagawa Seaside has seen only 13% of its workforce come to the office since the pandemic started. In addition, with major travel related tenants such as JTB and JAL, who call Shinagawa home, significantly affected by COVID-19, we may see more availability brought to the market in the upcoming months.

Conversely, Osaki and Meguro, which are located in Shinagawa despite the names suggesting otherwise, have somewhat maintained their squeeze on vacancy levels, loosening to 1.7% from Q1/2020. Rents also appear to have declined, probably due to the rapid corrections seen in Shibuya. That said, continuing appeal is likely due to the submarkets being directly between the southern point of the C5W and the residential southern section of the city, and its direct connectivity to various parts of Tokyo. As such, the area has had a track record in attracting tech giants who anchor the submarkets with Microsoft and Samsung situated next to Shinagawa Station, whilst Amazon Japan's headquarters is located at Meguro station.

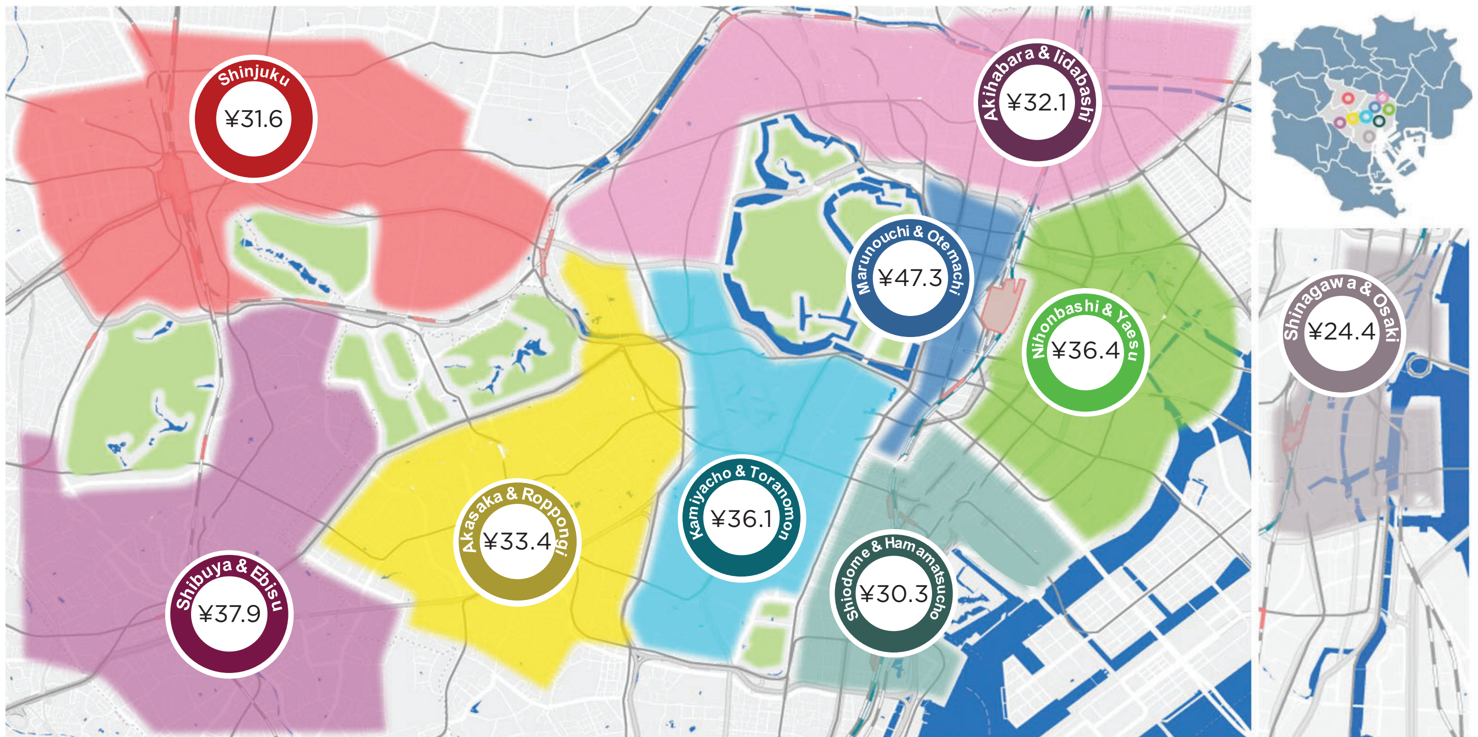
Based on the previously strong market fundamentals, there was a response to infrastructure improvement announcements that caused the Shinagawa submarket to see significant interest from market participants, hoping to capitalise on the improved connectivity and the increased worker pool. As a result, for the next few years, a flurry of developments is expected to be completed, including both Sumitomo Realty and Japan Post delivering a combined almost 20,000 tsubo of NRA in the submarket around Gotanda. Within a year after these buildings come online, the Mita Redevelopment project by Sumitomo and the TMM Project will bring over 65,000 tsubo of NRA online in 2023 in Tamachi/Mita, the southern point of Minato or northern point of Takanawa/

TABLE 3: Comparison with Pre-Pandemic Performance

	RENT JPY/TSUBO			VACANCY			AVERAGE YEAR OF CONSTRUCTION
	Q1/2020	Q2/2021	CHANGE FROM PRE-PANDEMIC LEVELS	Q1/2020	Q2/2021	CHANGE FROM PRE-PANDEMIC LEVELS	
Osaki/Meguro	31,500	28,200	-10.5%	0.0%	1.7%	1.7 ppts	2005
Higashi/Minami Shinagawa	18,900	17,400	-7.9%	0.2%	4.5%	4.3 ppts	1998
C5W	37,800	35,200	-6.9%	0.3%	1.8%	1.5 ppts	1997

Source Savills Research & Consultancy

MAP 1: Average Rents Per Tsubo In Selected Submarkets, Q2/2021



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

Shinagawa area. However, some of these projects may struggle because they are not far from the large Toranomon development due to come online in the same year. 2025 will be a major supply year, with JR East set to deliver a gigantic 260,000 tsubo of mixed-use GFA at Shinagawa Station via a JPY500 billion investment. Whether the project will see delays or possible changes is up for debate after JR East posted substantial net losses for the year ending March 2021 at JPY450 billion, as well as further delays to the Maglev plan. Regardless, whilst Shinagawa station is technically located outside of the ward, this development is a vote of confidence for the market's prospects, and the status of the area will improve as a result.

Looking ahead, as we see high-spec office space brought to the market, in conjunction with improvements in connectivity for Shinagawa's core markets around Osaki, Meguro and Gotanda, we will likely see stability as the submarkets align with the current trend for tenants' preferences. However, the southern and eastern parts of the ward are likely to continue their decline as teleworking erodes the need for office space for middle and back-office functions and ageing and poorly located properties are likely to deter prospective tenants.

OUTLOOK

Although the COVID-19 outbreak had admittedly dampened any previous optimism, the economic situation has turned around quicker than some might have expected, with corporate profits increasing and the number of bankruptcies decreasing since late 2020. Additionally, as the vaccine rolls out, the current downward pressure on consumer and discretionary spending should be curtailed and we could see corporate profits further increase towards next year, benefitting the office market as well.

Demand for new offices in good locations is still apparent with the two largest developments this year, Tokiwabashi Tower and Hibiya Fort Tower, almost entirely filled. However, the market's reaction to the proliferation of remote work continues to add to the uncertainty as rent and occupancy continue to subtly regress.

Nevertheless, the office is fundamentally necessary as a place for collaboration, nurturing corporate culture, and creating a sense of belonging. Hence, we predict that a hybrid model will gain more ground, with the presence of free-address seating increasing. Landlords who position themselves towards this style may find it advantageous to offer flexible lease contracts and pre-established office spaces. Additionally, the growing popularity of satellite offices so far into the pandemic should provide a further tailwind for the market.

Equity investors already appear to have a more optimistic outlook for the economy and office markets with office J-REITs maintaining an upward trend since late last year. Furthermore, with lower grade offices likely to see more people commuting every day due to the inadequacies of IT infrastructure associated with tenants in these kinds of buildings, there is confidence that lower grade offices can improve as the vaccine rolls out and subsequently boosts the economic condition for SMEs.

With the expedited vaccine rollout, companies are likely to begin to plan their long-term strategies and how to incorporate flexible work arrangements into their work culture. So far, we have observed limited examples of notable changes to office leasing strategies by large tenants, but we should see more towards next year as the pandemic calms down. Currently, leasing demand for buildings on the market appears to be limited, but small supply until 2023 should provide breathing room to attract new tenants. Stronger submarkets are expected to anchor their rents and vacancy where they are now but, conversely, weaker submarkets will contract and deteriorate the overall market. For the time being, we will have to see which direction the market takes as the economy fully opens and companies welcome their staff back to the office.

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.