MARKET IN MINUTES

*Savills Research*

# Office Leasing

## Minor market corrections continue

Prime offices have maintained a strong performance, while poorly located offices continue to suffer.

- While rental corrections and vacancy increments have persisted in the central five wards (C5W), they remain minor.
- Average Grade A office market rents in the C5W fell 1.4% quarter-on-quarter (QoQ) and 6.7% year-on-year (YoY), and now stand at JPY32,809 per tsubo[1] per month.
- The average Grade A office vacancy rate in the C5W increased 0.3 percentage points (ppts) QoQ and 1.2ppts YoY to 3.0% in Q2/2022.
- Average large-scale Grade B office rents contracted 2.1% QoQ and 8.0% YoY to JPY 24,627 per tsubo per month.
- Vacancy rates in the Grade B market increased 0.5ppts over the quarter and 1.4ppts annually to 4.1%.
- Performance in Chuo can be dichotomised into the major inland submarkets and the Bay Area, with the latter suffering disproportionately due to its poor accessibility.
- As the pandemic reaches an endemic state, companies will better understand the amount of office space required for their needs and gradually move toward it.

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

"While overall minor rental corrections have persisted this quarter, some offices have seen rents inch up and vacancy tighten at the property level – an ostensible sign of some recovery in the market. Nonetheless, a dichotomy remains between prime offices and poorly located offices, with the latter expected to suffer disproportionately for the time being."

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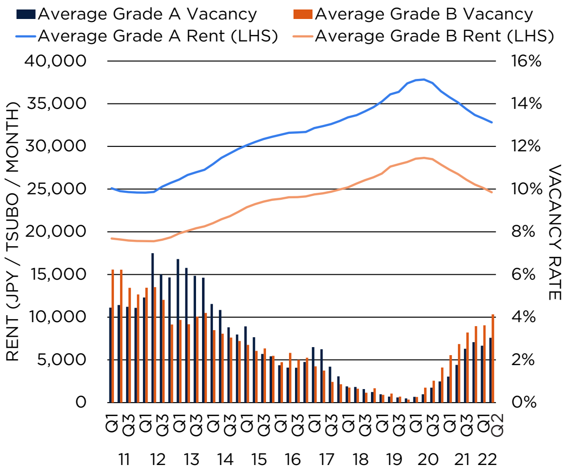
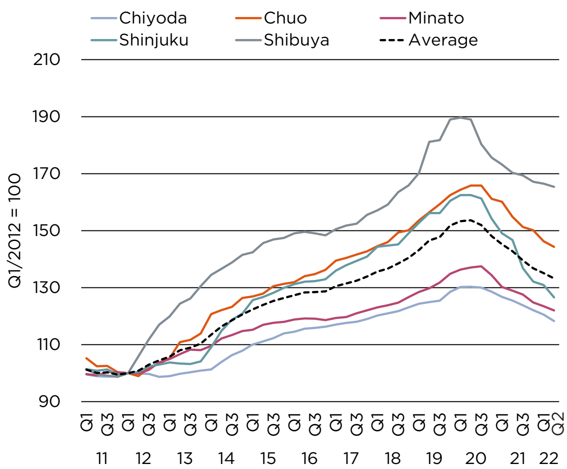
**GRAPH 1: Office Rents and Vacancy in Tokyo's C5W*, 2011 to Q2/2022**



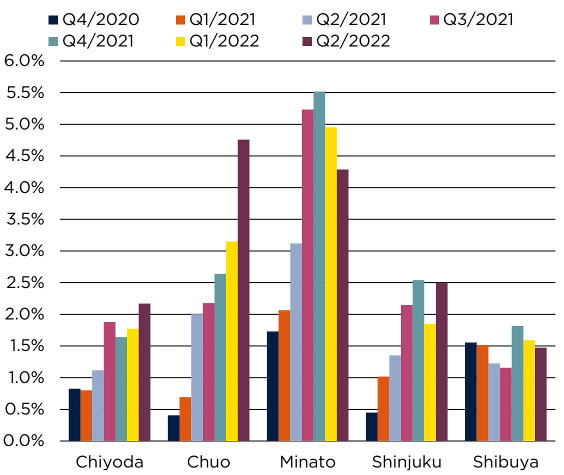

**Source** Savills Research & Consultancy
*Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

**GRAPH 2: Grade A Office Rental Index by Ward, 2011 to Q2/2022**




**Source** Savills Research & Consultancy

**GRAPH 3: Grade A Office Vacancy by Ward, Q4/2020 to Q2/2022**




**Source** Savills Research & Consultancy

## GRADE A OFFICES

The Grade A office market is still on a gentle downward trend, with rents having contracted 1.4% QoQ in Q2/2022 to JPY32,809. That said, the rental decline appears to have softened and may soon reach an equilibrium. In addition, although vacancy rates remain 1.2ppts higher than one year ago, they have only seen a small uptick of 0.3ppts QoQ since Q1/2022 to 3.0%, which is another encouraging sign for the market. According to Google Mobility Reports, attendance in the workplace has increased from around 80% to above 85% over the past quarter, demonstrating that companies are increasingly welcoming employees back into the office. Indeed, the sentiment in the office market appears to be improving overall.

At the submarket level, Minato and Shibuya saw vacancy levels improve, with rates tightening 0.7ppts and 0.1ppts QoQ, respectively. On the other hand, Chuo saw a notable jump in vacancy of 1.6ppts QoQ. Regarding rents, Shinjuku observed the largest decline of 3.3% QoQ. As mentioned in the previous quarter's report, many offices further away from the main station in Shinjuku appear to be suffering, and some have had to lower rents in order to attract tenants.

Q2/2022 saw the announcements and completions of multiple large leasing transactions. In general, mixed trends have been observed in the market. Some companies appear to be downsizing their floor space, while others are moving to larger offices. As society progresses toward an endemic state, companies are likely to have an idea of the amount of floor space needed to implement their respective ideal work models, including potentially foregoing remote work altogether. It will likely take time for the dust to settle as companies deliberate on their best course of action, and it is possible that some will end up in inaction. Overall, demand is expected to recover gradually and steadily.

The most notable move in this quarter was Sony moving out of Shinagawa Seaside TS Tower, where it previously leased all floors totalling 9,300 tsubo. Part of its business will be moved to Yokohama Grangate, which it has already leased in its entirety. The largest project of 2022, Tokyo Midtown Yaesu, is scheduled to open in August, and has managed to secure major tenants such as Sumitomo Life and Mitsui Chemicals despite its somewhat bullish asking rents (for more details, please see [Tokyo Office Supply 2022]).

## LARGE-SCALE GRADE B OFFICES

The Grade B market slightly underperformed the Grade A market in Q2/2022. Rents have contracted 2.1% QoQ to JPY24,627 per tsubo, with Chiyoda observing the largest decline of 3.0% QoQ to JPY27,923 per tsubo – the result of a number of buildings seeing mild corrections. All other submarkets also experienced mild corrections over the quarter, with the exception of Chuo, where rents stayed flat. Meanwhile, vacancy has loosened 0.5ppts QoQ to 4.1%. While Chuo saw a mild improvement in vacancy of 0.2ppts QoQ, all other wards experienced the opposite and saw vacancy rise. Notably, vacancy increased by 0.8ppts QoQ in Shibuya and by 0.7ppts QoQ in Minato and Shinjuku.

While this trend might appear worrisome, it should be noted that a majority of buildings in the Grade B market are either fully occupied or close to. The upticks in vacancy stem primarily from a handful of buildings that are performing poorly and have large amount of vacant space. Indeed, some buildings that have come to the market recently are almost empty, and distort the market's average vacancy.

Many buildings with high vacancy in the Grade B market tend to be older, poorly located, or have other undesirable traits. Unlike pre-COVID times where available office space was scarce, in the current market environment, potential tenants have more options to choose from and can afford to be more picky in finding suitable office space at the right price. This is especially true for Minato, where a handful of buildings are less than half occupied, including a new building with exceptionally high vacancy.

## GRADE A RENTS AND VACANCY RATES BY WARD

### Chiyoda

Chiyoda's vacancy levels increased by 0.4ppts QoQ and 1.1ppts YoY to 2.2%. While these are highest vacancy levels that Chiyoda has experienced since the pandemic began, the ward has the second lowest vacancy in the C5W. Rents contracted 1.4% QoQ to JPY39,770 per tsubo, making it the first time that average rents in the ward have dipped below the JPY40,000 mark since 2017. However, Chiyoda has also seen the smallest decline of 9.2% in rents since the pandemic began – a testament to the ward's overall stability.

A few inter-ward tenant movements have been reported, including engineering company Oriental Giken moving from the Confort Yasuda Building to the Keihan Otemachi Building, where it will take a 950 tsubo lease. At the same time, Chiyoda will also see some notable tenants moving to other wards. For instance, Deutsche Bank will move from Sanno Park Tower, where it had a 3,000 tsubo lease, to the Toranomon-Azabudai Project in Minato.

While Chiyoda will only see nominal supply until 2024, it faces some competition from other wards, especially those with buildings that are priced reasonably. Indeed, many office buildings in Chiyoda still maintain rents notably higher than those in other wards, including new buildings. Furthermore, some buildings like the Meiji Yasuda Life Insurance Main Building and Otemachi Financial City Grand Cube are rumoured to have signs of potentially large vacancies. While some corrections in rents, especially in buildings with larger vacancies, might be in the crosshairs going forward, the ward's strong access to major transport networks and its tenant profile of large Japanese and international companies should allow it to remain the premier ward in Tokyo.

## Chuo

Chuo's rents contracted at a rate on par with the C5W's average of 1.3% to JPY31,273 per tsubo – an annual decline of 6.8%. It appears that some buildings in the ward with moderate vacancy saw mild corrections in a bid to attract tenants quickly. Chuo saw a particularly large increase in vacancy this quarter of 1.6ppts QoQ to 4.8%, and now has the largest vacancy in the C5W. However, it must be noted that most buildings in the ward are fully occupied, and it is mainly a small number of older buildings that are driving vacancy levels up. Indeed, many buildings in Chuo are supported by a base of large Japanese corporation headquarters, and the ward as a whole is unlikely to see major changes going forward.

In Chuo, it appears that the offices that are less accessible, particularly those located in the Bay Area, are performing disproportionately poorly. In contrast, offices in other areas are faring notably better, especially Nihonbashi & Yaesu. This will be discussed in greater detail in the subsequent section: A closer look at Chuo.

## MINATO

Rents in Minato have seen another slight dip of 1.2% QoQ to JPY30,919 per tsubo, to an annual decline of 5.4%. While a number of buildings have seen nominal corrections, a few have also experienced mild increments in rent, suggesting that market sentiment could be improving for desirable buildings. Meanwhile, vacancy levels in Minato have seen their second consecutive quarter of improvement, tightening 0.7ppts QoQ to 4.3%, although they still remain 1.2ppts higher YoY.

Minato will see some large movements into and out of the ward. For instance, IT company NEC will move from Bunkyo to the Shibaura Kodai Building, taking a 3,800 tsubo lease. However, Mitsui Chemicals, and air-conditioner manufacturer Daikin will both move out of their Minato offices, vacating a total of 5,700 tsubo, into Chuo's new Tokyo Midtown Yaesu Building. While vacancy rates have declined this quarter, large vacancies in

**TABLE 1: Tenant Relocations, Q2/2022**

| | ORIGIN | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Chiyoda | Chuo | Minato | Shibuya | Shinjuku | Other | DESTINATION | |
| | 19 | 8 | 15 | 7 | 7 | 26 | | |
| | 12 | 1 | | 1 | | 4 | 18 | Chiyoda |
| | 2 | 4 | 5 | 1 | | 2 | 14 | Chuo |
| | 4 | 3 | 7 | 2 | 1 | 5 | 22 | Minato |
| | | | 1 | 3 | | 1 | 5 | Shibuya |
| | | | | | 3 | 1 | 4 | Shinjuku |
| | 1 | | 2 | | 3 | 13 | 19 | Other |

**Source** Nikkei RE, Savills Research & Consultancy

**TABLE 2: Notable Office Leasing Transactions, Q2/2022**

| COMPANY | BUSINESS SECTOR | TYPE | FORMER/CURRENT LOCATION | NEW LOCATION | APPROXIMATE SPACE | |
|---|---|---|---|---|---|---|
| | | | | | TSUBO | SQ M |
| Sony | Technology and Electronics | HQ Relocation & Office Consolidation | Shinagawa Seaside TS Tower<br>Shinagawa | Yokohama Grangate<br>Nishi | 9,300 | 30,700 |
| NEC Networks & System Integration | Information Technology | HQ Relocation | Sumitomo Fudosan Iidabashi First Tower<br>Bunkyo | Shibaura Kodai Building<br>Minato | 3,779 | 12,400 |
| Mitsui Chemicals, Prime Polymer | Chemical Manufacturer | HQ Relocation | Shiodome City Center<br>Minato | Yaesu Central Tower in Tokyo Midtown Yaesu<br>Chuo | 3,720 | 12,200 |
| Morinaga Milk Industry | Confectionary Manufacturer | Reconstruction of HQ | Morinaga Plaza Building<br>Minato | Shiodome City Center<br>Minato | 3,000 | 9,920 |
| Daikin Industries | Air Conditioner Manufacturer | HQ Relocation | JR Shinagawa East Building<br>Minato | Yaesu Central Tower in Tokyo Midtown Yaesu<br>Chuo | 2,000 | 6,600 |

**Source** Nikkei RE, Savills Research & Consultancy non-prime areas may materialise and remain vacant the following quarter given the lukewarm market sentiment.

The largest development in 2023, the Toranomon Azabudai Project, appears to have been well received, and is reportedly on the way to becoming fully leased. The new building is expected to have rents in the mid-to-high JPY30,000 range; higher than the market average, but could be considered reasonable given the building's amenities and location, especially when compared to other buildings with high specifications.

### Shibuya

Shibuya's vacancy contracted 0.1ppts QoQ to 1.5%, becoming the ward with the lowest vacancy rate in the C5W for the second quarter running. Rents have seen the most gentle decline this quarter, dipping 0.7% QoQ to JPY35,333 per tsubo. It is still clearly the second most expensive ward in the C5W, with a notable gap between first place Chiyoda and third place Chuo.

Shibuya experienced the largest decline in rents at the start of the pandemic, contracting by 9.9% YoY in Q2/2021, due to its large pool of tenants in the IT industry that were quick to implement remote work policies and reduce their office space requirements. However, rents appear to have stabilised over the past year, especially when compared to other wards. Its annual rental decline of 2.4% was less than half of that of Minato, the ward with the second largest decline. Indeed, the corrections that the ward has seen appear to have helped it regain popularity and maintain low vacancy rates.

Overall, Shibuya is performing well as a submarket. In particular, Grade A offices located in the vicinity of Shibuya station appear to be doing exceptionally well, and are currently all fully occupied. Indeed, Shibuya station is a key terminal train station that can be conveniently accessed from surrounding areas, and this strength will remain a key foundation for upcoming developments in the market, including the Sakuragaoka Redevelopment Project that will come to the market within the next year and looks to be making good progress this year.

### Shinjuku

Shinjuku's rents contracted by 3.3% QoQ to JPY26,750 per tsubo, translating to an annual decline of 13.7% - the largest in the C5W by far. It is also clearly the cheapest ward in the C5W, and the only member to have seen average rents dip below JPY30,000 per tsubo. Meanwhile, vacancy has loosened by 0.7ppts this quarter to 2.5%.

There have also reportedly been some movements into the ward. For instance, system integrator Otsuka will be moving from its current premises in Koto to the Sumitomo Fudosan Iidabashi Building No. 3 where it will take a 1,300 tsubo lease. With the largely corrected rents in Shinjuku and the pandemic approaching an endemic stage, the ward could see some recovery as some opportunistic companies look to take advantage of the situation and secure discounted rents.

Despite the grim situation in Shinjuku, it is important to note that some buildings are faring notably better than others. In general, buildings that are older and located further away from main stations are doing poorly, while newer buildings with good accessibility are performing well. Overall, Shinjuku station is a key terminal station in Tokyo, and offices that have good access to it should remain stable while some other buildings might take a longer time to recover. Upcoming developments around Shinjuku station should also improve the attractiveness of the area and spark new interest in the submarket.

## A CLOSER LOOK AT CHUO

Since the financial crisis, Chuo was consistently the second most affordable ward in the C5W until 2018, when it overtook Minato to become the eponymous median in the C5W. Unlike wards such as Shinjuku and Shibuya whose office markets revolve predominantly around one central train station, a number of Tokyo Metro and JR train lines provide access to offices that tend to be more spread out in Chuo. Chuo is traditionally characterised as being occupied by many large Japanese corporations which contributed to its overall stability before the pandemic when all Grade A and Grade B offices in the ward were effectively fully occupied.

However, some cracks appeared in the ward's stability when the pandemic struck. Chuo's Grade A rents have declined 12.2% since the pandemic, while Grade B rents saw a shallower decline at 9.3% over the same period. Grade B rents in Chuo have seen the smallest rental corrections amongst the C5W since the pandemic began, which could possibly be attributed to the fact that many buildings have remained fully occupied during the pandemic, meaning that rental corrections were primarily from a small handful of buildings that tenants moved out of. Grade B buildings are more likely to be occupied by smaller firms that lack the infrastructure to implement remote work, and that consequentially do not have the need to reduce office space. This has likely contributed to the Grade B market's stronger performance in terms of vacancy, which increased by 2.2ppts versus pre-pandemic times compared to the Grade A market's increase of 4.7ppts.

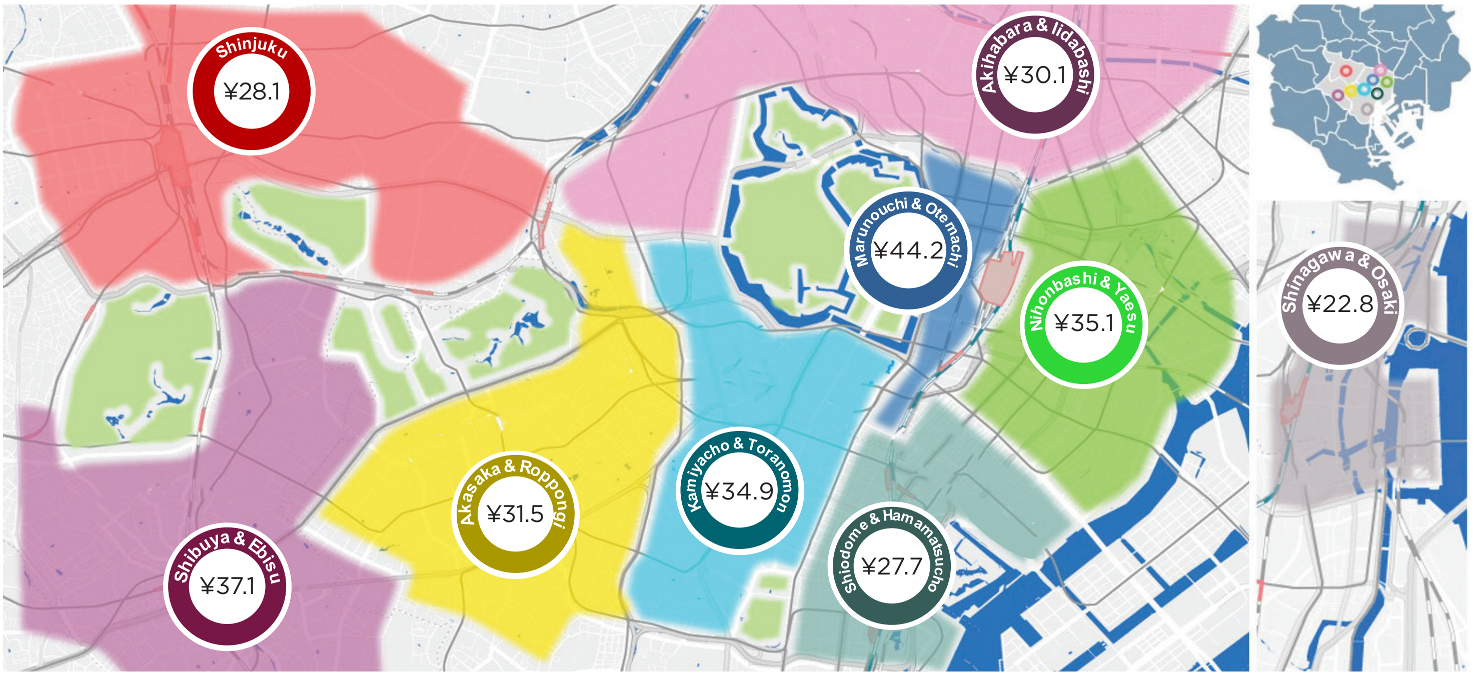
At the same time, the deterioration of Chuo has not been spread out evenly within the ward. Looking more closely, the Bay Area, comprising locations including Tsukiji, Tsukishima, Kachidoki, and Harumi, has clearly borne the brunt of the pandemic. Rents in this area have declined 22.6% since the pandemic, while vacancy has loosened 8.7ppts over the same period – both measures surpassing the average of the ward by far. This submarket also has the longest average period of free rent offered. The downside of offices in the Bay Area lies in its location and accessibility. Made up mostly of reclaimed land, the Bay Area features only a limited number of train stations and train lines that it is accessible from, and many offices are located somewhat far away from these stations. The pandemic has greatly emphasised the importance of office accessibility, and some companies previously located in the Bay Area have moved to other offices that have better access. Indeed, the general rental declines in Tokyo and the increased availability of vacant office space have helped facilitate this trend. However, the future extension of the Yurakucho line that will connect Toyosu station with other train lines should increase the area's accessibility and popularity when completed.

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

| | RENT JPY/TSUBO | | | VACANCY | | | AVERAGE FREE RENT PERIOD (MONTHS) | AVERAGE YEAR OF CONSTRUCTION |
|---|---|---|---|---|---|---|---|---|
| | Q1/2020 | Q2/2022 | CHANGE FROM PRE-PANDEMIC LEVELS | Q1/2020 | Q2/2022 | CHANGE FROM PRE-PANDEMIC LEVELS | | |
| Nihonbashi & Yaesu | 38,500 | 36,000 | -6.5% | 0.0% | 1.4% | +1.4ppts | 1.6 | 2009 |
| Ginza | 33,700 | 28,800 | -14.5% | 0.0% | 5.5% | +5.5ppts | 2.8 | 2004 |
| Hatchobori & Ningyocho | 21,400 | 19,800 | -7.5% | 0.0% | 2.3% | +2.3ppts | 1.7 | 1996 |
| Bay Area | 22,600 | 17,500 | -22.6% | 0.1% | 8.7% | +8.6ppts | 5.5 | 1999 |
| Overall | 31,200 | 28,000 | -10.3% | 0.0% | 4.1% | +4.1ppts | 2.7 | 2004 |

**Source** Savills Research & Consultancy

**MAP 1: Average Rents Per Tsubo in Selected Submarkets, Q2/2022**




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

Other submarkets in Chuo appear to be doing significantly better in comparison. Nihonbashi & Yaesu is the premier submarket in the ward, with its prime location close to Tokyo station. This submarket also features the newest offices in Chuo. Rents have only declined 6.5%, since the pandemic, and vacancy has only increased 1.4ppts. The submarket looks to maintain its strengths with new additions like Tokyo Midtown Yaesu and the future Torch Tower, which are likely to boost the popularity of the submarket overall.

Ginza is the next most expensive submarket in Chuo. While it experienced an above-average decline in rent compared to the rest of the ward, this is largely due to the submarket's smaller sample size and a few buildings that underperformed because of their relatively poorer locations. Furthermore, its vacancy was close to zero until this quarter when Dai-ichi Life moved out of Ginza Six to Kioi Tower in Chiyoda, returning a 1,800 tsubo lease. All things considered, Ginza has still performed amicably, and its prime location should allow it to easily attract new tenants. Meanwhile, rents in the Hatchobori & Ningyocho submarket are notably more affordable than Nihonbashi & Yaesu and Ginza due to their somewhat off-central locations and the older age of the buildings. Nonetheless, the convenient access to these locations has allowed offices in the areas to see a smaller correction in rents.

Overall, the trends in Chuo purport the narrative that accessibility is the most important factor for office performance entering the post-pandemic era. Many offices in the Bay Area are located far from train stations, and few train lines have access to them, resulting in the submarket's poor performance. In contrast, other submarkets in the ward are faring much better, with only mild increments in vacancy and rental corrections.

Going forward, Chuo has a number of redevelopment projects in the pipeline that look to further revitalise the area. In particular, Nihonbashi & Yaesu will see major developments like the Yaesu 1-Chome and 2-Chome projects, which include Tokyo Midtown Yaesu, the Nihonbashi 1-Chome project, and Torch Tower. These developments are likely to change the landscape of the area, and gravitate more attention from the Marunouchi side of Tokyo station to the Yaesu side. In the long-term, the prospects of Chuo ward look promising, although there could be an even greater dichotomy between these prime areas and the Bay Area.

## OUTLOOK

Listed companies in Japan have seen notable financial improvements, with annual net profits increasing 36% YoY for the recent fiscal year ending in March 2022. While further economic recovery is expected to slow down because of soaring commodities and energy prices, there is some optimism elsewhere as society emerges from the pandemic and progresses towards normalcy.

In general, rental corrections have become more gentle over the past few quarters, and vacancy increments have also become milder. However, a closer inspection of many wards has unveiled a common trend: offices with poorer accessibility are doing disproportionately poorly. Indeed, many offices that are located far away from, or are only accessible via minor train stations, have seen large increments in vacancy and drops in rents. Overall, a handful of offices are the primary contributors of the decline seen in the office market, whereas a majority of offices are faring well, with nominal rental corrections and little increases in vacancy, if at all. This dichotomy could persist as a large amount of high-quality office supply is forecast to be added to the market next year, which is likely to intensify the competition for tenants, and may consequently put less popular offices in a more precarious position.

As the pandemic reaches an endemic state, more companies are likely to have a clearer idea about the amount of office space required to implement their desired work models that incorporate telework. Some companies might possibly be waiting in anticipation for better deals available as new large office supply will be released to the market soon. Therefore, while office demand is expected to gradually recover, it may take some time to have a clear idea of the actual demand present in the market.

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.