MARKET IN MINUTES
Savills Research

Office Leasing

Market softening continues

The rapid vaccine rollout, increasing corporate profits, and limited supply should give the market some much needed breathing room.

- The lukewarm market sentiment continued to weigh on office rents and vacancy in the central five wards (C5W) this quarter.
- Average Grade A office market rents in the C5W fell 2.2% quarter-on-quarter (QoQ) and 8.2% year-on-year (YoY), and now stand at JPY34,370 per tsubo[1] per month.
- The average Grade A office vacancy rate in the C5W increased by 0.8 percentage points (ppts) QoQ and 1.8ppts YoY to 2.5% in Q3/2021.
- Average large-scale Grade B office rents declined to JPY26,106 per tsubo per month – a contraction of 2.5% QoQ and 8.4% YoY.
- The average vacancy rate in the Grade B market loosened by 0.5ppts QoQ and 2.3ppts YoY to 3.3%.
- With the rapid vaccination rollout, strong corporate profit growth and limited supply until 2023, market sentiment should begin to stabilise or even improve.
- The poor performance of less accessible and older offices remains a drag on the office market overall. Meanwhile, tenant preferences for easily accessible and new offices persist.

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

"Rents for well-located and newer offices are likely to remain stable while older offices with poor accessibility will struggle. This trend is expected to continue to soften the overall market as a result, although there are some signs of recovery."

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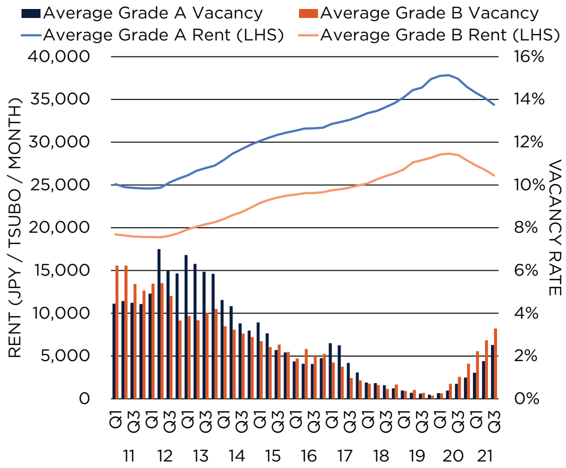
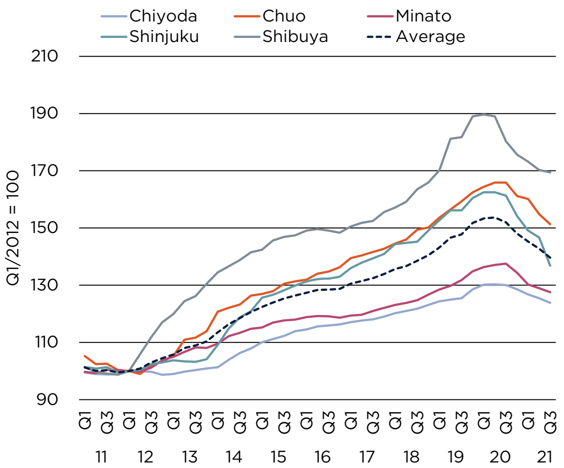
GRAPH 1: Office Rents And Vacancy In Tokyo's C5W*, 2011 to Q3/2021



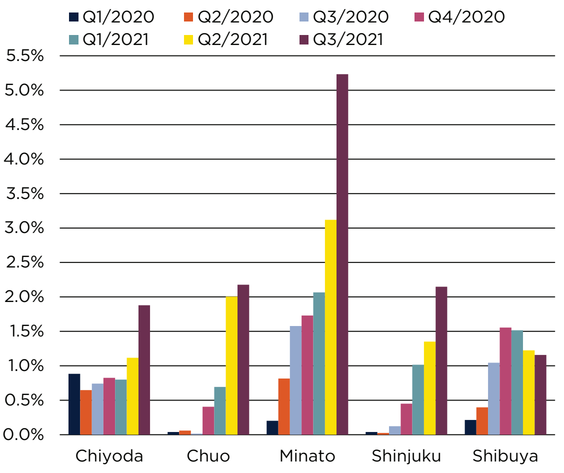
Source Savills Research & Consultancy
*Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index By Ward, 2011 to Q3/2021



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy By Ward, Q1/2020 to Q3/2021



Source Savills Research & Consultancy

GRADE A OFFICES

Burdened by secondary vacancy from 2020 as well as the bearish market sentiment, Tokyo's Grade A[2] market continued softening in Q3/2021. Specifically, rents contracted by 2.2% QoQ and 8.2% YoY to JPY34,400 per tsubo. Vacancy rates increased at a slightly higher pace to what was seen in the previous quarter, with an uptick of 0.8 ppts QoQ and 1.8 ppts YoY to 2.5%. However, there are some positive signs that market fundamentals may start to gradually improve.

Looking at rental trends by submarket, QoQ declines slowed among the C5W this quarter, with the exception of Shinjuku. Furthermore, Shibuya only had a minor correction of 0.5% QoQ in Q3/2021, a major improvement considering the market's sharp correction over the last year and a half. Similarly, although vacancies loosened this quarter, the increments were not as steep as Q2/2021. Minato was the only exception to this trend and largely underperformed compared to the other wards with an increase of 2.1ppts QoQ to 5.2%.

Overall, demand for new buildings still appears to be sound. For instance, a Grade A building that opened this quarter, Kabuto One, with an NRA of 7,200 tsubo, appears fully occupied. Furthermore, other offices that opened earlier this year have continued to fill their remaining vacant space. In addition, although it was hard to find tenants for spaces larger than 100 tsubo until the last quarter, we are now seeing more movement in spaces up to 300 tsubo, indicating that the leasing market is becoming more active, albeit at a gradual pace. Some movements of large-scale tenants have also been reported.

Looking ahead, no more large offices are set for completion in 2021, and only a few major buildings are expected to open in 2022. During this period of low supply, demand should have time to catch up and pick up the slack in the market. Moreover, improving corporate profits and the increased vaccination rate should help office demand recover. Some buildings scheduled to open in 2023 have already shown a decent start to their pre-leasing activity.

Nonetheless, we continue to expect the office market's recovery to be K-shaped, especially as secondary vacancy from last year's large supply continues to materialise in the Grade A market. While well-located and new offices should remain stable, older offices with poor accessibility will suffer, thus affecting the market overall.

LARGE-SCALE GRADE B OFFICES

This quarter, the Grade B market continues to loosely mimic the Grade A market's performance with a rental decrease of 2.5% QoQ and 8.4% YoY to JPY26,100 per tsubo. Similarly, vacancy increments almost matched those of the Grade A market with a loosening of 0.5ppts QoQ and 2.3ppts YoY to 3.3%.

The ward level trends of Grade B offices are also similar to those observed in the Grade A market, with Shinjuku leading the rental decline this quarter at 5.1% QoQ and Minato leading the vacancy increment at 3.4ppts QoQ. Shinjuku's rent corrections are mainly a result of higher vacancies in office buildings away from stations. Indeed, accessibility and convenience have become increasingly important attributes for tenants during the pandemic. A similar trend is also present in Minato, and these less accessible buildings have been negatively affecting the overall performance of the ward.

Going forward, some secondary vacancy may materialise in the Grade B market if tenants looking for higher-end facilities become enticed to make the move to Grade A office buildings, which have become increasingly available and affordable in this downturn.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

Chiyoda's vacancy levels loosened by 0.8ppts QoQ and 1.1ppts YoY to 1.9%. Meanwhile, rents have contracted by 1.3% QoQ and 4.8% YoY to JPY41,600 per tsubo. Despite the softening, the QoQ rental contraction was slightly milder than the average change seen in the C5W. As such, Chiyoda's premium in rent over that of the Grade A market's average has continued to grow, standing at 21% this quarter, up from the 16% spread at the start of the pandemic in Q1/2020.

Chiyoda continues to demonstrate its strength as the premier ward with only a limited number of lease cancellations and tenant movements out of the ward. There has also been notable leasing activity such as JFE Shoji who will take a 4,300 tsubo lease in the Shin-Otemachi Building. Additionally, Daichi Life Insurance will acquire a 1,500 tsubo lease in Kioi Tower while Uzabase will acquire a 1,400 tsubo lease in the Mitsubishi Building early next year. Even the newly opened Tokiwabashi Tower has seen a series of smaller tenant movements into the building that should help decrease its vacancy. Taken together, these new leases in the ward should reduce Chiyoda's vacancy going forward.

Looking ahead, Tokyu Fudosan's Kudanminami-1-chome project is the next Grade A building set to open in Chiyoda with completion slated for July 2022, and has had a decent start to pre-leasing. The limited supply in the ward following this project should also give the rest of Chiyoda breathing room to address the recent upticks in vacancy. As such, Chiyoda's position looks to stay firm.

2 "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.

Chuo

Chuo's rental contraction almost matched that of the C5W at 2.3% QoQ to JPY32,800 per tsubo. Despite the downturn in rents, vacancy experienced only a slight uptick by 0.2ppts QoQ at 2.2%, a sign of the ward's stability. In fact, the ward's newest addition, Kabuto One, appears to have come onto the market fully occupied with tenants such as Quick, Japan Securities Depository Center, and WeWork.

The outer submarkets away from the central area will likely soften due in part to the Tokyo Olympic offices expected to close in Harumi early next year. The good news, however, is that the inner submarkets of Chuo are still performing well and have anchored Chuo's overall performance. Moreover, there were only minimal vacancy increments this quarter, and the Custody Bank of Japan will also be moving into KDX Harumi, providing some additional relief.

Mitsui Fudosan, Kajima, and Hulic recognise Chuo's sound fundamentals as well and have revealed new details for the next building in the Yaesu 2-chome Center District Redevelopment Project, on the south side of Tokyo Midtown Yeasu that will be opened in summer 2022. According to the revised plan submitted in August for public inspection, the demolition of the existing buildings is scheduled to begin in May 2023, which would create some displaced demand in the area during the construction period. This project will be mixed-use, containing an office, serviced apartments, an international school, a theatre, retail spaces, and a bus terminal. The mixed-use nature is likely to attract tenants that have grown to prefer office buildings with such characteristics, and should aid in further revitalising the Yaesu area.

Minato

Minato's rental decline has continued with a 1.1% QoQ and 7.2% YoY contraction to JPY32,300 per tsubo in Q3/2021. However, vacancy saw another notable uptick this quarter due to the effects of some large-scale lease cancellations and relocations in addition to the poor performance of submarkets that are not easily accessible. Specifically, vacancy loosened 2.1ppts QoQ and 3.7ppts YoY to 5.2%.

Nonetheless, vacancy adjustments may slow down next quarter as a large office with sizeable vacancy in Shiodome will have new tenants move in. Additionally, Hibiya Fort Tower, which opened mostly occupied earlier this summer, has some tenants moving in, such as Dai-ichi Frontier Life, which will take a roughly 2,200 tsubo lease. These expected relocations mean that the vacancy of Hibiya Fort Tower should be near zero towards the end of this year. Moreover, pre-leasing amongst some developments planned for completion in 2023 are going well. For instance, TTM Project now appears over half pre-leased.

Shibuya

Shibuya's vacancy has tightened for the second consecutive quarter, decreasing 0.1ppts QoQ to 1.2%, though there was a slight uptick YoY at 0.1ppts. In fact, as of Q3/2021, Shibuya became the ward with the lowest vacancy among the C5W. Vacancy may continue to drop next quarter due to tenant relocations into Ebisu over the next few months. This bodes well for Shibuya, especially considering that Ebisu has the highest vacancy among its submarkets.

TABLE 1: Tenant Relocations, Q3/2021

ORIGIN						DESTINATION	
Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other		
9	13	7	8	3	21		
6	5				7	18	Chiyoda
2	4				2	8	Chuo
	3	4	1		2	10	Minato
		1	5			6	Shibuya
1				3	1	5	Shinjuku
	1	2	2		9	14	Other

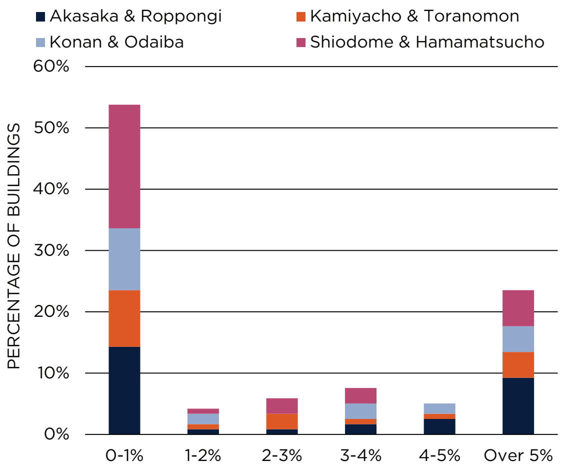
Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Q3/2021

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION	NEW LOCATION	APPROXIMATE SPACE TSUBO	APPROXIMATE SPACE SQ M
JFE Shoji	Trading	HQ Relocation & Office Consolidation	JFE Shoji Building Chiyoda	Shin-Otemachi Building Chiyoda	4,300	14,300
SBS Holdings	Logistics	HQ Relocation	Olinas Tower Sumida, Tokyo	Sumitomo Fudosan Shinjuku Grand Tower Shinjuku	2,400	7,900
Dai-ichi Frontier Life Insurance	Insurance	HQ Relocation	Osaki Wiztower Shinagawa	Hibiya Fort Tower Minato	2,200	7,100
Avex	Music Software	HQ Relocation	Avex Building Minato	Sumitomo Fudosan Azabu Juban Building Minato	2,000	6,600
D2C	Marketing	HQ Relocation	Nomura Fudosan Ginza Building Chuo	Tokyo Shiodome Building Minato	1,700	5,600

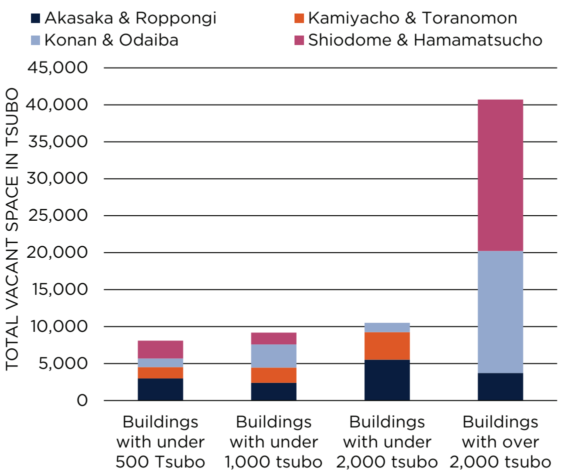
Source Nikkei RE, Savills Research & Consultancy

GRAPH 4: Percentage Of Grade A Offices In Each Vacancy Band In Minato, Q3/2021



Source Savills Research & Consultancy

GRAPH 5: Total Amount Of Vacant Space Contributed By Minato Grade A Offices, Q3/2021



Source Savills Research & Consultancy

Moreover, the ward saw only a slight rent contraction at 0.5% QoQ to JPY36,200, down from the 1.7% QoQ contraction of last quarter. This observation implies that tenants are likely to have found a suitable price point, or sense of affordability, in the Shibuya market. Other submarkets may need to find this equilibrium price point before bottoming out. With vacancy in central Shibuya airtight, rents are expected to be stable.

Looking ahead, Tokyo Tatemono submitted a large-scale redevelopment plan called Shibuya 2-chome-West Redevelopment for review to the Tokyo Metropolitan Government. The project will introduce nearly 77,000 of GFA tsubo in the main tower that will consist of mostly office space among some retail spaces and a hotel. The construction is estimated to start in 2025, with completion estimated around 2029.

Shinjuku

This quarter, Shinjuku's rents contracted by a staggering 6.7% QoQ and 15.2% YoY to JPY28,900 per tsubo – the largest decline in the C5W. At the same time, vacancy continued to loosen by 0.8ppts QoQ and 2.0ppts YoY to 2.2%. A driver for the increasing vacancy for Shinjuku is the loosening vacancy of less accessible office towers located further away from major stations. Additionally, Shinjuku's older office stock appears especially disadvantageous as other wards have already seen major facelifts.

That said, Shinjuku is still pulling some tenants, such as SBS Holdings and Kokusai Kogyo, into the ward. The former has recently announced its plan to move its headquarters from Sumida to a 2,400 tsubo lease in Sumitomo Fudosan Shinjuku Grand Tower. The latter will also take a 1,000 tsubo lease in Shinjuku Front Tower citing the commuting convenience of Shinjuku.

In the long term, redevelopment projects in Shinjuku should help refresh the ward. Meiji Yasuda Life Insurance's next foray into real estate will be in Shinjuku, and has selected Mori Building to lead the management of the 30,000-tsubo mixed-use project slated to open in 2025. Odakyu is also going ahead with its redevelopment plans as it officially announced plans to close the existing store sitting on the development site in September 2022.

DIVERGING PERFORMANCES IN MINATO

Until Q1/2020, Minato was performing well with a vacancy rate at 0.2%. Furthermore, its rents had maintained growth until Q3/2020 while wards such as Shibuya and Shinjuku started experiencing declines in Q2/2020 once the pandemic struck. Nonetheless, the rapid increases in vacancy since the onset of the pandemic in Minato seem worrisome to some extent. Compared to Q1/2020, Minato's vacancy rates have loosened by over 5.0ppts to 5.2% in Q3/2021, and are currently more than double the C5W average.

However, a closer look at property-level performances reveals that most office buildings in Minato are performing soundly with low vacancy rates (Graph 4). As of Q3/2021, over half of Grade A office buildings in Minato have maintained vacancy rates lower than 1.0%. On the other hand, a few select buildings have seen significantly increased vacancy rates in recent quarters due to major tenant relocations or large lease cancellations. For instance, Fujitsu reportedly returned a total of nearly 12,900 tsubo of office space around Minato, particularly in the Shiodome & Hamamatsucho and Konan & Odaiba submarkets. Elsewhere, SoftBank Group's relocation to the newly built Tokyo Portcity Takeshiba and Fujifilm Business Innovation Corporation's (formerly Fuji Xerox) relocation to a newly-built Toyosu Bayside Cross Tower have dealt major blows to specific buildings around Minato.

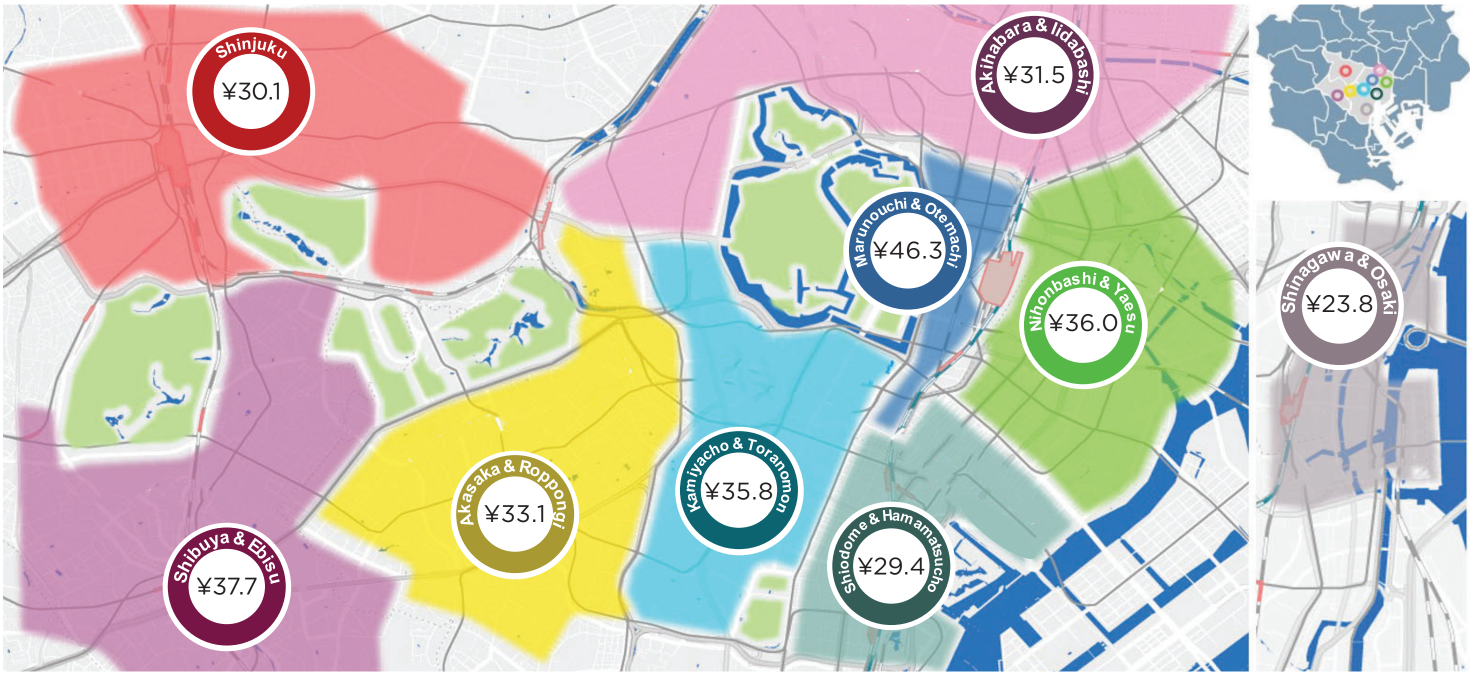
Although major relocations and cancellations such as these have significantly affected Minato's average vacancy, the overall market fundamentals appear sound when taking individual property performances into account. Graph 5

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

	RENT JPY/TSUBO			VACANCY			AVERAGE YEAR OF CONSTRUCTION OF GRADE A
	Q1/2020	Q3/2021	CHANGE FROM PRE-PANDEMIC LEVELS	Q1/2020	Q3/2021	CHANGE FROM PRE-PANDEMIC LEVELS	
Akasaka & Roppongi	36,150	33,350	-7.7%	0.0%	4.0%	4.0 ppts	2004
Kamiyacho & Toranomon	35,500	35,000	-1.4%	0.5%	3.2%	2.7 ppts	2011
Shidome & Hamamatsucho	32,958	32,375	-1.8%	0.0%	7.2%	7.2 ppts	2010
Konan & Odaiba	32,929	28,500	-13.5%	0.4%	6.4%	6.0 ppts	2004

Source Savills Research & Consultancy
*In each submarket within the table, only buildings located in Minato are included.

MAP 1: Average Rents Per Tsubo In Selected Submarkets, Q3/2021



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

supports this point by showing that just six buildings that have over 2,000 tsubo vacant each comprise most of the existing vacancy.

Looking at the submarket level, a trend of diverging performance is also clear. For instance, compared to the other submarkets, Kamiyacho & Toranomon has maintained a low vacancy rate of 3.2% in Q3/2021 (Table 3). This submarket's rental correction has also been relatively limited at 1.4% compared to Q1/2020. Meanwhile, another inland submarket, Akasaka & Roppongi, has the second lowest vacancy at 4.0%, but its rental decline was much larger at 7.7%, which is largely attributable to some properties with large vacancy that have lowered rents. It is important to note, however, that Akasaka & Roppongi remains the most expensive submarket in Minato even with this rental decline.

Looking ahead, Kamiyacho & Toranomon's sound performance thus far may be reassuring as the submarket has to absorb a large influx of supply in 2023. Fortunately, Goldman Sachs is rumoured to have plans to move to Toranomon Hills Station Tower when it opens in 2023. While it means that Roppongi Hills Mori Tower, which currently houses the company, will have vacancy to fill, considering its status as Mori Building's flagship property, the secondary vacancy created should be easily filled.

In comparison to the inland submarkets, the bay-side submarkets, especially Konan & Odaiba, are underperforming. Konan & Odaiba currently has a vacancy rate of 6.4% as of Q3/2021 and its rent has declined by 13.5% since the pandemic began. Shiodome & Hamamatsucho has the highest vacancy at 7.2% in Minato, and it might increase as NTT Communications reportedly plans to cancel about 9,000 tsubo in the Shiodome Building in June 2022. That said, there are some leasing activities in the bay-side submarkets, which should help office demand in these areas going forward. For instance, Ando Hazama, D2C, NCS&A, and Gunze are reportedly moving to Tokyo Shiodome Building, taking up about 5,200 tsubo in total.

Overall, Minato's market fundamentals remain sound for most of the properties in the ward. While relatively older offices in less accessible locations appear to be struggling, the better located and newer properties will likely hold well, supported by sound leasing demand. Furthermore, in the long term, Minato is expected to remain a strong office market. In particular, the ongoing large-scale developments by Mori Building should have a wide positive impact on the surrounding areas like Roppongi Hills did almost two decades ago. The bay-side areas are also expected to see a major makeover, especially around Hamamatsucho Station. Improving accessibility and new landmarks should continue to help the attractiveness of offices in those areas.

OUTLOOK

In its September monthly report, the Cabinet Office stated that corporate profits at large had improved despite some sectors still suffering. Indeed, listed companies set a new historical high for net profit margins in Q2/2021. Furthermore, there are signs that the economy may start expanding in earnest early next year as the vaccine rollout continues its rapid expansion. The number of fully vaccinated increased to a higher level than the Unites States and is likely to become one of the highest in the world in due course given Japan's strong peer pressure culture.

Office attendance should increase according to a recent Xymax survey in August, with many companies expressing their intention to reduce teleworking after the risks from COVID-19 subside. In addition, many respondents have continued to express their desire to centralise their operations into central and easily accessible areas, while over half the respondents said they would like to utilise satellite offices. Indeed, the office is still considered as a key point of collaboration and innovation for companies, with 80% of respondents believing working in the office makes communication easier.

With limited supply until 2023, the office market has breathing room to address the softening caused by the pandemic. That said, outside of a few select projects, pre-leasing of most brand-new buildings remains somewhat shaky. The shifting tenant preference toward easily accessible, central, and modern office buildings will continue to anchor the market. However, we are likely to see some submarkets continue to weaken, decreasing overall rental levels and occupancy rates. With the prospect of most citizens being fully vaccinated on the horizon, public discussion surrounding post-pandemic life has begun. With it, we are likely to see calls for a return to the office gain some momentum towards the end of this year, and new trends may emerge next year.

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.