MARKET IN MINUTES
Savills Research

Office Leasing

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Market set for segmented recovery

Gradual market recovery is expected, but segmented by office quality and location.

- Rents have remained flat for the first time since the pandemic, while vacancy saw a notable uptick. Both were mainly due to the addition of new supply.
- Average Grade A office rents in the C5W stayed flat quarter-on-quarter (QoQ) at JPY32,817 per tsubo[1] per month, but fell 4.5% year-on-year (YoY).
- The average Grade A office vacancy rate in the C5W increased 1.1 percentage points (ppts) QoQ and 1.6ppts YoY to 4.1%.
- Average large-scale Grade B office rents also stayed flat over the quarter at JPY24,632 per tsubo per month with the addition of a new building, but declined by 5.6% YoY.
- Vacancy rates in the Grade B market also increased 0.7ppts over the quarter to 4.8%, an increment of 1.5ppts YoY.
- Chiyoda ward has overall seen the most consistent performance amongst the C5W, although its premier Marunouchi & Otemachi area may face stiffer competition from upcoming developments in nearby Yaesu.
- The recovery of the office market is likely to be gradual and segmented by office quality and location.

"The overall market has remained stable over the quarter. Rents have remained flat, supported by the addition of new quality offices which also caused vacancy to rise. The office market is likely to keep seeing a gradual recovery, and this will probably be segmented by office quality and location."

SAVILLS RESEARCH & CONSULTANCY

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

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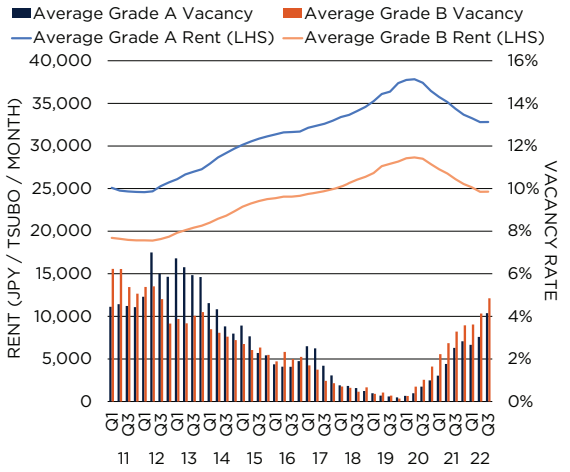
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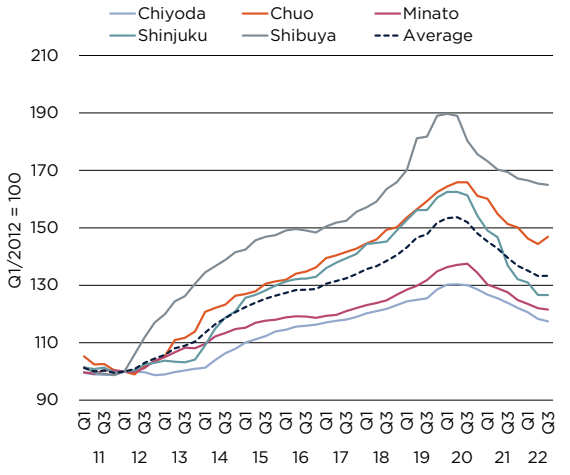
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GRAPH 1: Office Rents and Vacancy in Tokyo's C5W*, 2011 to Q3/2022



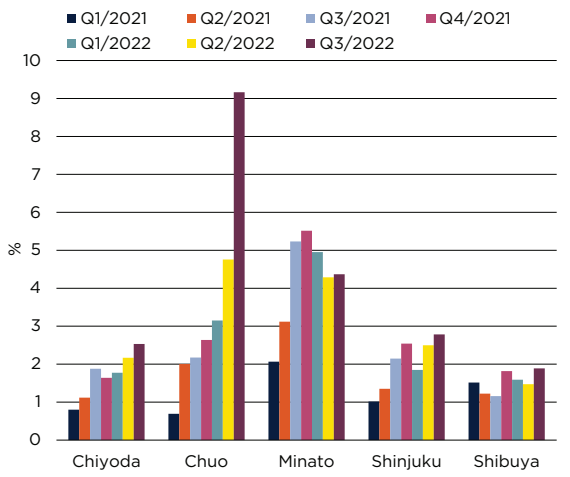
Source Savills Research & Consultancy
* Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index by Ward, 2011 to Q3/2022



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy by Ward, Q1/2021 to Q3/2022



Source Savills Research & Consultancy

GRADE A OFFICE

The Grade A office market has held steady, with rents in Q3/2022 remaining flat over the quarter at JPY32,817 per tsubo, translating to an annual decline of 4.5%. While the overall appearance of flat rents was supported by the addition of a few new offices with above average rents, the rest of the market has been lacklustre. Corrections have persisted in some areas, although a handful of buildings have also seen recovery. The addition of these new offices has also contributed to a notable loosening in vacancy rates, which increased 1.1ppts to 4.1%, and are at their highest levels since 2014.

At the ward level, Chuo saw the largest changes due to the addition of the large new Tokyo Midtown Yaesu Central Tower - vacancy almost doubled, increasing 4.4ppts QoQ to 9.2%, but the ward also saw its first increase in rent since the pandemic begun, increasing 1.8% QoQ.

Meanwhile, Minato saw the smallest change in vacancy levels, which increased 0.1ppts over the quarter. Looking at rents, the mild decline of 0.7% QoQ that Chiyoda experienced was the largest in the C5W.

Going forward, the demand for offices is expected to remain steady, and attendance at the workplace has increased over the past few months. Overall, the office market appears to have attained a reasonable state of stability, and leasing activity for large floor plates has become more active. Most of the rental changes this quarter can be ascribed to the new buildings added to the market; in fact, a majority of buildings have not seen any changes in rent. While it might take more time for new supply to be absorbed, the market appears ready to welcome these new additions. Indeed, approximately half of the major supply in 2023 appears to have been pre-leased, hence stabilising the current market sentiment.

LARGE-SCALE GRADE B OFFICES

The Grade B market has moved in the same direction as the Grade A market in Q3/2022, partly aided by the limited supply in the market. Rents have also remained flat at JPY24,632 per tsubo, to an annual decline of 5.6%. Chuo saw the largest increment in rents of 3.0% QoQ to JPY25,226 per tsubo, although the new addition to the market, the Yanmar Tokyo Building, was the primary contributor to this uptick with its above-average rents. Meanwhile, rental corrections in other wards were mild.

The Grade B market also saw a moderate increment in vacancy of 0.7ppts QoQ and 1.5ppts YoY to 4.8%. Similar to the Grade A market, vacancy in Chuo nearly doubled over the quarter – increasing 1.6ppts QoQ to 3.8%, although the new addition to the market also played a significant role in this softening. Vacancy in Minato saw the largest increase of 2.7ppts QoQ to 10.7%, with most increments still stemming from a small number of buildings rather than the ward as a whole. On the other hand, Shibuya's vacancy saw a decline of 1.2ppts QoQ to 1.8%. Indeed, most offices in Shibuya are fully occupied, showing that there is demand present for reasonably priced offices with desirable attributes.

Overall, the Grade B office market has moved mostly in tandem with the Grade A market in terms of both rents and vacancy throughout the pandemic. Rents in the Grade B market have declined 13.7% since the pandemic began compared to the Grade A market's decline of 13.1%, and vacancy in the Grade B market has increased 4.6ppts since the pandemic to the Grade A market's increment of 3.9ppts. Recovery in the Grade B market is also expected going forward as society progresses to an endemic state and the demand for offices stabilises. Nevertheless, offices that are older and in more inconvenient locations will continue to struggle disproportionately to find tenants. Hence, while most of the market should remain stable, rental corrections in these buildings could be in the crosshairs.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

Chiyoda's rents have seen a moderate decline of 0.7% QoQ and 5.2% YoY, partially attributed to the addition of the new Kudan Kaikan Terrace that opened with rents below the ward's average, to JPY39,484 per tsubo. Meanwhile, vacancy rates rose 0.3ppts QoQ and 0.6ppts YoY to 2.5%.

Overall, Chiyoda commands the highest rents in the C5W by far, and it has consistently maintained low vacancy rates throughout the pandemic. Although it has been the most stable ward, Chiyoda may face stiff competition from the upcoming new supply in locations bordering the ward like Chuo's Nihonbashi and Minato's Toranomon. The performance and prospects of the ward will be discussed further in the subsequent section: A closer look at Chiyoda.

Chuo

Chuo was the only ward to have seen average rents increase over the quarter, growing 1.8% QoQ to JPY31,824 per tsubo, although it still posted an annual decline of 2.9%. At the same time, vacancy saw a sizable increase of 4.4ppts QoQ and 7.0ppts YoY to 9.2%.

However, these changes are primarily due to the new addition of Midtown Yaesu Central Tower right next to Tokyo station, which has become one of the largest offices in the C5W and commands a notable rent premium over the average of Chuo ward due to its prime location. Midtown Yaesu Central Tower is estimated to have come to the market about half leased, and this has caused the overall increase in vacancy in Chuo; the vacancy levels of other buildings have not seen significant change from the previous quarter. The Midtown Yaesu Central Tower will still likely require some time to be fully absorbed as long as it maintains its high rent targets, as there are many other available offices at more affordable prices. Indeed, the building would have been largely filled if it were priced in line with the prevailing market sentiment.

The lukewarm reception of the Tokyo Midtown Yaesu Central Tower could be a potential cause of concern considering the large amount of high-quality office supply forecast for the market over the next few years. That said, the office portion of the building is likely to gain more traction once the whole Tokyo Midtown Yaesu opens next spring. The next large additions will be the Yaesu 1-Chome project and the Nihonbashi 1-Chome project in 2025, meaning that the market still has a few years to prepare.

Notable tenant movements include Tokyo Guarantee moving from a company owned building in Chuo to Ginza 6-Chome Square in 2023, taking a 1,800-tsubo lease. However, Mitsubishi Construction also announced that they would be moving out of the Harumi Center Building in Chuo, where they had a 1,300 tsubo lease, to the Tokyo Shiodome Building in Minato. Indeed, this exit further fuels the narrative that offices in less accessible locations like the Bay Area are likely to continue suffering.

Minato

In Minato, rents saw a small decline of 0.4% QoQ to JPY30,790 per tsubo, to an annual decline of 4.7%. Like the previous quarter, a handful of buildings saw nominal corrections, but a number of offices also saw some growth in rents. Meanwhile, vacancy in Minato has only seen a slight increment of 0.1ppts over the quarter to 4.4%, and has actually declined over the year by 0.8ppts.

The largest movement announced into Minato was by the manufacturer Kyocera, that will move out of multiple offices in different locations, including a large lease in Shinagawa's IS Building, and consolidate their offices with a large 5,600-tsubo lease in the tentatively named Tokyo Mita Redevelopment Project Office Tower that is scheduled to come to the market in spring 2023. Many other notable movements within Minato were also announced, including software company Shift's move from the Masonic 39 MT

TABLE 1: Tenant Relocations, Q3/2022

ORIGIN							DESTINATION	
Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other			
16	17	20	3	8	15			
12	3	3		1	1	→	20	Chiyoda
	11	2		1	2	→	16	Chuo
2	2	13	2	2	3	→	24	Minato
		1	1		1	→	3	Shibuya
		1		3	2	→	6	Shinjuku
2	1			1	6	→	10	Other

Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Q3/2022

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION		NEW LOCATION	APPROXIMATE SPACE	
						TSUBO	SQ M
Kyocera, Kyocera Communication Systems, etc.	Technology and Electronics	Office Relocation	IS Building Shinagawa	→	Tokyo Mita Redevelopment Project Office Tower Minato	5,600	18,500
Nihon Sekkei	Architectural Design	Undisclosed	Shinjuku i-Land Tower Shinjuku	→	Toranomon Hills Mori Tower Minato	up to 2,000	up to 6,600
Credit Guarantee Corporation of Tokyo (Tokyo Guarantee)	Financial Services	HQ Relocation	Sumitomo Fudosan Iidabashi First Tower Chuo	→	Ginza 6-chome-Square Chuo	1,800	5,900
Epark	Information Technology	Undisclosed	Shiba Park Building A Minato	→	Anzen Building Minato	1,800	5,900
Shift	Software	Undisclosed	Masonic 39 MT Building Minato	→	Tower Building in A district of Toranomon-Azabudai Project Minato	1,460	4,800

Source Nikkei RE, Savills Research & Consultancy

Building into the upcoming Toranomon Azabudai building, where they will take a 1,500-tsubo lease.

Overall, the rental decline in the market appears to have slowed considerably, and there are signs of recovery, although it will likely be segmented. Indeed, like Chuo ward, some offices in less accessible areas of Minato have notably higher vacancy levels. Nonetheless, the highly anticipated Toranomon Azabudai building in 2023 has seen promising pre-leasing activity, showing that Minato is still a popular location for offices.

Shibuya

Shibuya's vacancy inched up 0.4ppts over the quarter to 1.9%, and is 0.7ppts higher than a year ago. Despite its poorer performance at the beginning of the pandemic, Shibuya's vacancy levels are by far the lowest in the C5W as of Q3/2022. Shibuya's rents have also only seen a mild correction of 0.3% from the previous quarter to JPY35,238 per tsubo, to a 2.6% decline YoY.

Shibuya has again seen the smallest annual decline in rents in the C5W this quarter. Overall, it was the best performing ward in the C5W over the past year when looking at annual changes in rents and vacancy levels, and has also been supported by the low levels of supply in the ward in recent years. At present, a majority of offices are fully occupied, and only a handful of buildings have nominal amounts of vacancy, which is a testament to the overall strength of Shibuya. Indeed, the new supply expected next year from the Sakuragaoka Redevelopment Project has also been well received.

Shinjuku

Shinjuku's rents have also stayed flat over the quarter at JPY26,750 per tsubo. While the slowed decline in rents provides some relief for the ward, Shinjuku also experienced the largest annual drop in rents at 7.5%, and has also by far seen the greatest decline in rents since the pandemic at 22.1%, almost double the C5W average of 13.0%. Meanwhile, vacancy levels have seen a slight uptick of 0.3ppts QoQ to 2.8%, and is currently 0.7ppts higher than a year ago, worsening because old buildings in Nishi-Shinjuku appear to continue struggling.

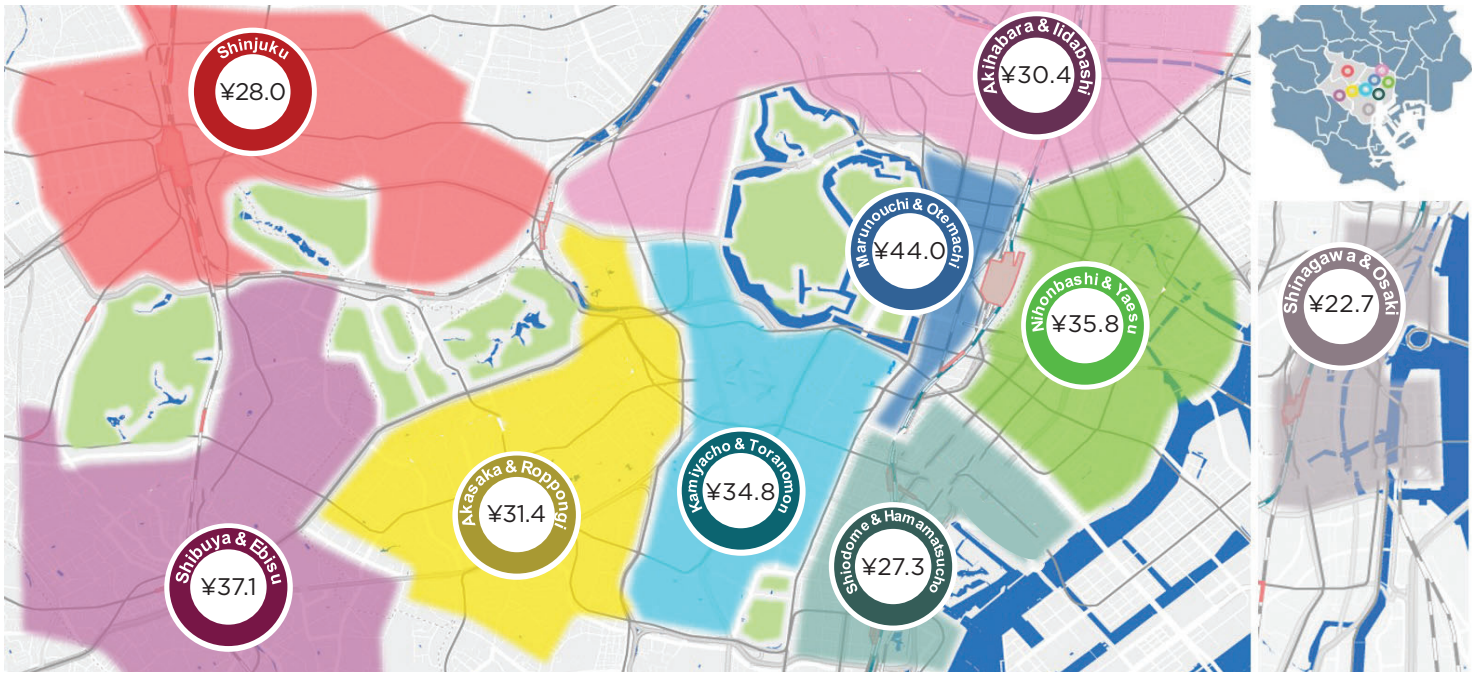
While the situation in Shinjuku has been grim overall during the pandemic, there is still hope for the ward. Indeed, Shinjuku station remains the busiest station in Japan. As part of the West Shinjuku 1-Chome project, the upcoming Meiji Yasuda Seimei Shinjuku Building which is expected to be completed in 2025 right next to the west exit is reportedly already starting pre-leasing activity and should be well received considering its prime location. This redevelopment project should help to revitalise the office market in Shinjuku by adding new high-grade supply to the ageing stock. Going forward, offices closer to the station are likely to recover sooner than later as they are still supported by Shinjuku station's extensive underground walkway.

A CLOSER LOOK AT CHIYODA

Chiyoda has consistently been the most expensive ward in the C5W by a noticeable margin. However, the premium that its rents have had over the average of the C5W has varied over the years. The premium was the highest right after the financial crisis, rising to as high as 30%, but waned down to as low as 15% right before the pandemic struck. As of Q3/2022, the premium lies at around 20% - between its peak and trough, but higher than a few years ago as corrections in Chiyoda have been milder compared to other wards.

Chiyoda ward is comprised of the land surrounding the imperial palace and can be segmented into several different areas. The Marunouchi & Otemachi area, characterised by its prime location to the west of Tokyo station, is the most expensive by far, and is home to many densely packed, large-scale trophy offices. Marunouchi & Otemachi is the premium area, with its average rents more than 40% higher than the average of the rest of the ward. However, it also experienced a considerable correction in rents of 10.2% and a large uptick in vacancy levels during the pandemic. Many tenants in Marunouchi & Otemachi are large corporations that have the capacity to implement remote work, and some tenants located in the area, such as Deloitte and Calbee, have decided to return floor space due to increased remote work. The high rents in the area may have been unaffordable for some companies, and corrections were likely necessary to cast a wider net of potential tenants. Furthermore, over the next few years, Marunouchi & Otemachi is likely to face strong competition from the large amount of high-quality supply coming from the Chuo side of Tokyo station, namely the Yaesu redevelopment projects.

MAP 1: Average Rents Per Tsubo in Selected Submarkets, Q3/2022



Source Savills Research & Consultancy

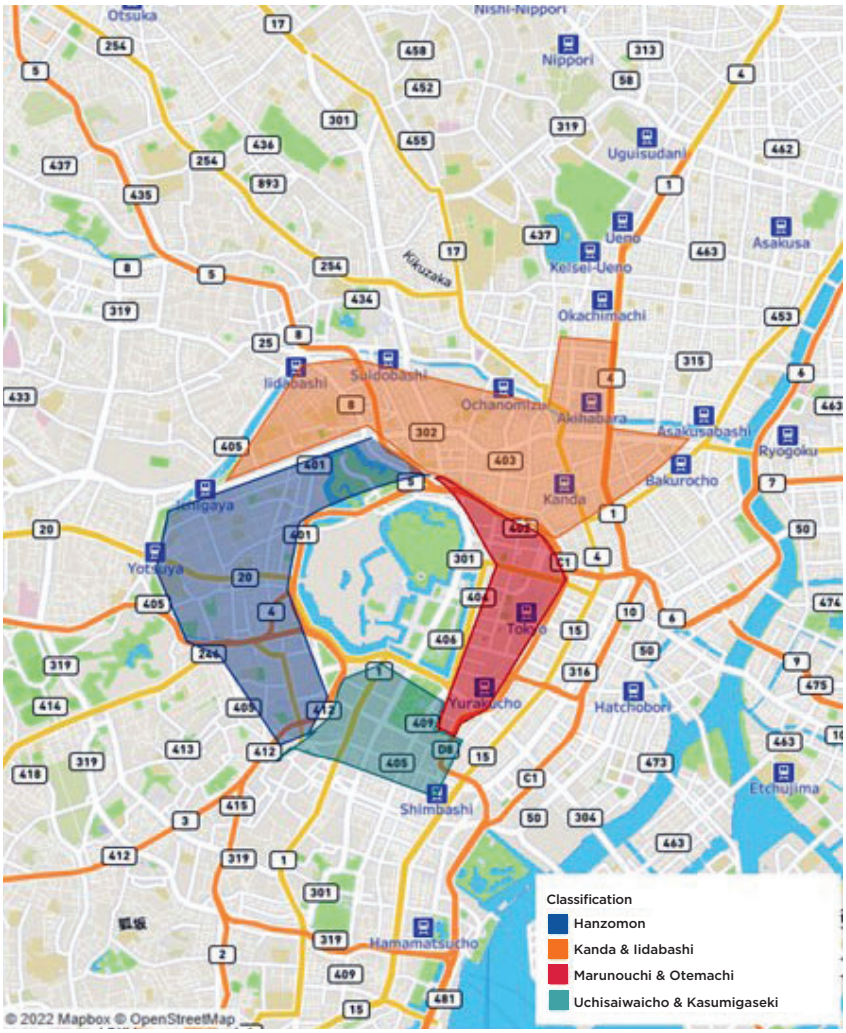
Grade A Office, average passing rent + CAM per tsubo per month in thousand JPY. Coloured areas for illustrative purposes only.

TABLE 3: Comparison of Chiyoda's Various Areas' Grade A and B Performance During the Pandemic

	RENT JPY/TSUBO			VACANCY			AVERAGE FREE RENT PERIOD (MONTHS)	AVERAGE YEAR OF CONSTRUCTION
	Q1/2020	Q3/2022	CHANGE FROM PRE-PANDEMIC LEVELS	Q1/2020	Q3/2022	CHANGE FROM PRE-PANDEMIC LEVELS		
Marunouchi & Otemachi	47,000	42,200	-10.2%	1.1%	3.1%	+2.0ppts	3.1	2004
Uchisaiwaicho & Kasumigaseki	34,000	30,200	-11.2%	0.1%	0.9%	+0.8ppts	2.8	1996
Hanzomon	31,000	28,200	-9.0%	0.0%	3.7%	+3.7ppts	3.5	2002
Kanda & Iidabashi	30,200	27,200	-9.9%	0.0%	0.7%	+0.7ppts	2.7	2004
Overall	39,000	35,100	-10.0%	0.7%	2.6%	+1.9ppts	3.1	2002

Source Savills Research & Consultancy

MAP 2: Chiyoda Area Breakdown*



Source Savills Research & Consultancy
* Highlighted for illustrative purposes only.

The second most expensive area is Uchisaiwaicho & Kasumigaseki, which is located to the south of the imperial palace and borders Minato ward. Uchisaiwaicho & Kasumigaseki saw a larger decline in rents than Marunouchi & Otemachi at 11.2%, likely because the offices in the area had to compete with the increased availability of offices in nearby Minato submarkets. Nonetheless, the offices in this area remain mostly occupied, with vacancy levels only at 0.9%. This tight vacancy might be due to a sizable rental gap between Uchisaiwaicho & Kasumigaseki and Marunouchi & Otemachi, making the former much more affordable in comparison. That said, Uchisaiwaicho & Kasumigaseki is also expected to face greater competition from the upcoming developments in nearby Toranomon, namely the Toranomon Azabudai Project and Toranomon Hills Station Tower.

The next area is Hanzomon, located to the west of the imperial palace, and borders Minato and Shinjuku. Compared to the former two areas, offices in Hanzomon are generally more spread out. Hanzomon saw the smallest decline in rents of 9.0%, and although it had the largest increment in vacancy of 3.7ppts, this uptick was contributed partially by the addition of the new Kudan Kaikan Terrace that opened with some vacancy this quarter. Going forward, the small amount of supply forecast for Hanzomon and its vicinity, in combination with its affordability of rents, should help to maintain the stability of the area.

The Kanda & Iidabashi area is slightly less expensive than the Hanzomon area. It also saw a moderate rent decline of 9.9%, but it only saw a nominal increase in vacancy rates of 0.7ppts. Like Hanzomon, offices in Kanda & Iidabashi are also more spread out and does not have much upcoming competition

from surrounding locations, and the area also has a significant portion of land for residences. Going forward, the area should remain strong as a whole due to its general affordability and spread-out office locations.

Overall, the rental decline across Chiyoda has been spread more evenly when compared to its peers, and its vacancy increments have also been mild when compared to other wards, which is a testament to its overall stability. However, there could be some challenges for the Marunouchi & Otemachi and Uchisaiwaicho & Kasumigaseki areas as they are expected to face stiffer competition from neighbouring wards. Indeed, the multiple upcoming large-scale developments in nearby Chuo and Minato could potentially lure tenants away and cause some secondary vacancy in Chiyoda. Going forward, the large premium that Marunouchi & Otemachi commands might be increasingly difficult to justify, especially if nearby competition is priced more reasonably. Nonetheless, although some corrections might slowly materialise, Chiyoda should remain strong overall due to its prime location and the prestige associated with the ward.

OUTLOOK

Rental corrections in the C5W have slowed greatly this quarter, although some vacancy increments have been observed with the addition of new office supply. In general, office attendance has also improved over the past few months. With the stabilising state of affairs and a clearer picture in mind, companies are likely to expedite reviewing office space utilisation in accordance with their respective hybrid work styles and should help facilitate the leasing activities of offices with large floor plates. Indeed, a growing number of relocations to offices of higher grade in better locations have been observed. Quality offices with good access are in line with new office strategies and will likely remain in demand.

There are still challenges for the market as a whole. While most offices appear to have stabilised, and some have even exhibited rental recovery, offices with poor accessibility are likely to continue suffering disproportionately as potential tenants have many other options to choose from. Furthermore, while the sound corporate performance is likely to support the momentum of new office strategies, recent global uncertainties might hinder new initiatives. That said, the 2023 developments have reportedly made good progress as it appears that about half of the supply has been pre-leased. The recovery of the office market will likely be gradual and segmented by the location and convenience of respective offices, but the prospects for the market as a whole should steadily improve.

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.