MARKET IN MINUTES

Savills Research

Office Leasing

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Stability with widening gaps in performance

The Tokyo office market continues on a positive trajectory, but older offices with poor accessibility may continue to struggle.

- Rental changes were nominal in Q3/2023 and the outlook appears cautiously optimistic overall. Vacancy rates generally remain low.
- Average Grade A office[1] rents in the C5W increased by 0.1% quarter-on-quarter (QoQ) to JPY32,410 per tsubo[2] per month, while decreasing by 1.2% year-on-year (YoY).
- Grade A office vacancy in the C5W softened by 0.8 percentage points (ppts) QoQ, but tightened by 0.7 ppts YoY to 3.4%.
- Average large-scale Grade B office[3] rents contracted marginally at 0.3% over the quarter to JPY24,424 per tsubo per month, translating to a decline of 0.8% YoY.
- Vacancy rates in the Grade B market loosened slightly by 0.2ppts over the quarter to 4.0%.
- Tenant relocations have picked up in earnest. Many office consolidations have taken place, with prospective tenants appearing to favour modern offices.
- Older and poorly located offices have struggled since the pandemic, and landlords are increasingly resorting to new initiatives.

1 Grade A offices refer to buildings with a GFA of 9,000 tsubo (30,000 sq m) and a building age of less than 15 years. Some buildings that do not fit this definition are included.
2 1 tsubo = 3.306 sq m or 35.583 sq ft.
3 Large-scale Grade B offices refer to buildings with a GFA of 4,500 tsubo (15,000 sq m) and a building age of less than 25 years. Some buildings that do not fit this definition are included.

"The Tokyo office market looks to remain largely stable, with some marginal quarterly rental growth. Vacancy rates remain low and stable overall, and a majority of new major developments have been absorbed with limited issues. That said, bifurcation based on office age and location persists in the market, and large-scale new supply may threaten the current stability."

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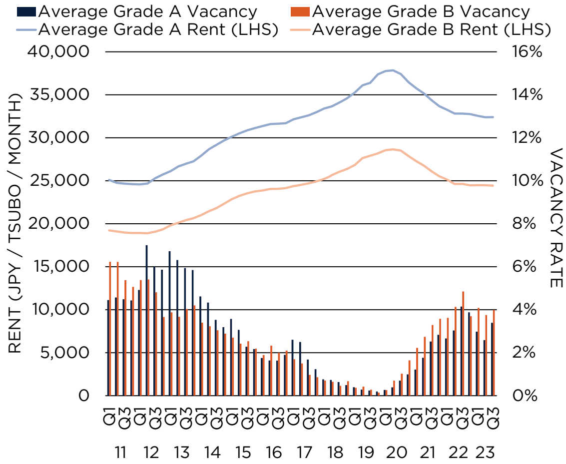
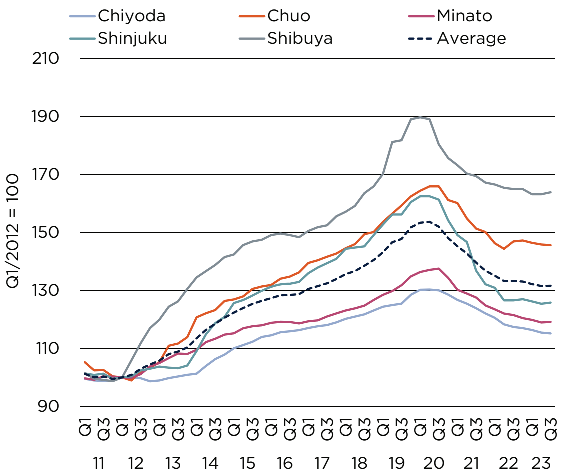
GRAPH 1: Office Rents and Vacancy in Tokyo's C5W*, 2011 to Q3/2023



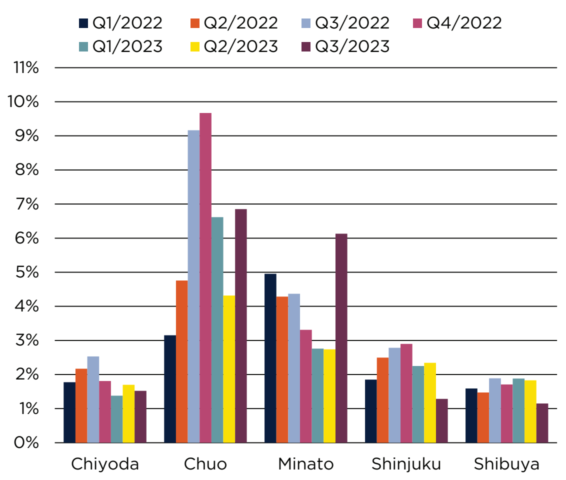
Source Savills Research & Consultancy
* Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index by Ward, 2011 to Q3/2023



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy by Ward, Q1/2022 to Q3/2023



Source Savills Research & Consultancy

GRADE A OFFICE

The optimistic situation appears to be continuing in the Grade A office market in Q3/2023. Indeed, the market had been growing increasingly stable throughout previous quarters in 2023, and now appears to be charting a course of recovery. Average rents in the central five wards (C5W) experienced a modest increment over the quarter at 0.1% to JPY32,410 per tsubo, which translates to an annual decline of 1.2%. Consequently, the total rental contraction from the peak levels of Q2/2020 were around 14.4% for the Tokyo C5W Grade A office market.

Average rents remained stable across the constituent wards of the C5W in Q3/2023, with only modest changes in rents recorded over the quarter. The largest rental increments were in Shibuya and Shinjuku, where rents increased by 0.4% QoQ and 0.3% QoQ, respectively, while Minato rents increased by 0.1% QoQ. Elsewhere, rents contracted marginally at 0.2% QoQ in Chiyoda and Chuo. While rental changes have been nominal this quarter, the gentle upswing in average rents is undoubtedly a positive sign following the declining trend since the pandemic.

On the other hand, the average vacancy rate for Grade A offices softened moderately at 0.8ppts QoQ to 3.4%, following some tightening in recent consecutive quarters. An outsized proportion of this took place in Minato ward, which experienced a quarterly increase in vacancy of 3.4ppts, largely due to the recent addition of a large amount of new supply in the ward. Elsewhere, despite the uneventful absorption of Midtown Yaesu Central Tower, vacancy in Chuo loosened by 2.6ppts QoQ, particularly given the poor performance of offices in Harumi. Meanwhile, vacancy decreased in Shinjuku and Shibuya by 1.0ppts QoQ and 0.7ppts QoQ, respectively.

Corporate performance has been strong, and the competition for talent continues to intensify. In addition, more companies are mandating greater office participation. As such, the appetite for larger office footprints should increase going forward. Well-located and modern offices with strong ESG features, which also support hybrid working arrangements will likely be particularly attractive. As such, several Grade A office buildings in prime locations with low vacancies have begun to increase rents.

However, there are some concerns regarding the "2023 problem", whereby the large upcoming office supply may cause further temporal increases in vacancies, consequently dampening the recovery of the market. Additionally, hybrid work arrangements remain commonplace in Tokyo, with the Tokyo Metropolitan Government Survey reporting that over 45% of companies in the Tokyo 23W have employees working at home as of July 2023. As such, some major new additions to the market arrived with large amounts of empty space, and many building owners are offering further incentives to attract and retain tenants. Nonetheless, the Japanese economy has been performing relatively well, and should form a base for firm demand for office space, which, in conjunction with the current low levels of vacancy, is a good sign for the market.

LARGE-SCALE GRADE B OFFICES

Average rents in the large-scale Grade B market experienced a marginal correction in rents at 0.3% QoQ to JPY24,424 per tsubo in Q3/2023, which translates to a YoY decline of 0.8%. Nonetheless, the Grade B market appears to be following a stable trajectory, with rental revisions attributable to only a handful of underperforming properties. Indeed, the Shinjuku Grade B market experienced the largest contraction of 1.2% QoQ, triggered by a handful of older offices slightly outside the central area of the city revising rents downwards to remain competitive. Elsewhere, Minato also experienced a marginal contraction in rents at 0.6% QoQ, while rents remained unchanged in Chuo, and increased marginally in Shibuya and Chiyoda at 0.3% QoQ and 0.1% QoQ, respectively.

Average Grade B office vacancy saw a slight uptick at 0.2ppts in Q3/2023 to 4.0%. Shinjuku was the only ward to experience some tightening at 0.1ppts QoQ, while vacancy in Chiyoda was unchanged over the quarter. Vacancy in Minato and Shibuya loosened by 0.7ppts QoQ, while Chuo loosened by 0.1ppt QoQ. Like in the previous quarter, the highest level of vacancy among Grade B offices persists in Minato at 8.2%, and has remained elevated since the pandemic. That said, Minato appears to be recovering steadily, with vacancy tightening 2.7ppts YoY, although hybrid work arrangements and the consequent bifurcation between offices may hinder this progress in the meantime. Chuo ward's Grade B market also appears to be struggling with similar circumstances, and also exhibits relatively high levels of vacancy at 4.9%.

Despite the marginal quarterly contraction in average rents, the situation in the Grade B office market looks to remain stable for the time being. The market was largely unchanged in terms of rents and vacancies, with a limited number of specific properties contributing an outsized proportion of fluctuations this quarter. Such offices may keep struggling with attracting and retaining tenants due to poor transport access and a lack of modern facilities. As such, bifurcation between properties will likely persist, and some further rental revisions may be necessary for certain offices to remain attractive to tenants.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

Chiyoda's rents decreased marginally by 0.2% QoQ, and declined by 1.9% YoY to JPY38,734 per tsubo. Meanwhile, vacancy tightened by 0.2ppt QoQ to 1.5%, which is still slightly above the pre-pandemic level in Chiyoda. The ward is a standout performer among the C5W constituent wards, demonstrated by its average rents being by far the highest compared to its counterparts, and its vacancy among the lowest despite its sizable stock of Grade A office buildings. Given the large concentration of major domestic and international conglomerate headquarters in Chiyoda, the strong corporate performance in Japan should be an encouraging tailwind for the ward going forward.

The largest recently reported office movement in Chiyoda was by Yasui Architects & Engineers, which will relocate its Tokyo office to the Sumitomo Shoji Mitoshiro Building in January 2024, leasing approximately 900 tsubo in the building. Bizmates will relocate its headquarters to the Daiwa Akihabara Building, which is scheduled to be completed in October 2024, and will lease approximately 480 tsubo in the building. Meanwhile, Urbanet Corporation will relocate its headquarters to the Kasumigaseki Building in July 2024, leasing half a floor at approximately 400 tsubo.

Chuo

Average rents in Chuo contracted by 0.2% over the quarter to JPY31,544 per tsubo in Q3/2023. Furthermore, Chuo witnessed a noticeable uptick in vacancy at 2.6ppts QoQ to 6.9%, which is the highest level of Grade A office vacancy among the C5W, primarily due to the vacation of a large tenant in the ward, and a few rental corrections among some older offices with relatively poor access. Submarket-level bifurcation has been particularly apparent in Chuo, with strong performance observed in prime areas near Tokyo Station, particularly with the uneventful absorption of the enormous Tokyo Midtown Yaesu. However, the Tokyo Bay area appears to be struggling, which has skewed the average vacancy level in the ward.

Harumi stands out in this regard, due to its relatively poor proximity and transport access. Workers must either walk from metro stations in nearby Kachidoki or rely on slower buses to commute to Harumi. As such, the area is likely considered relatively unattractive among potential tenants, and several grade A and large-scale grade B office buildings in Harumi recorded high vacancy levels of over 10% in Q3/2023. Additionally, some owners appear to have been forced to offer between six and twelve months of free rent in order to attract tenants.

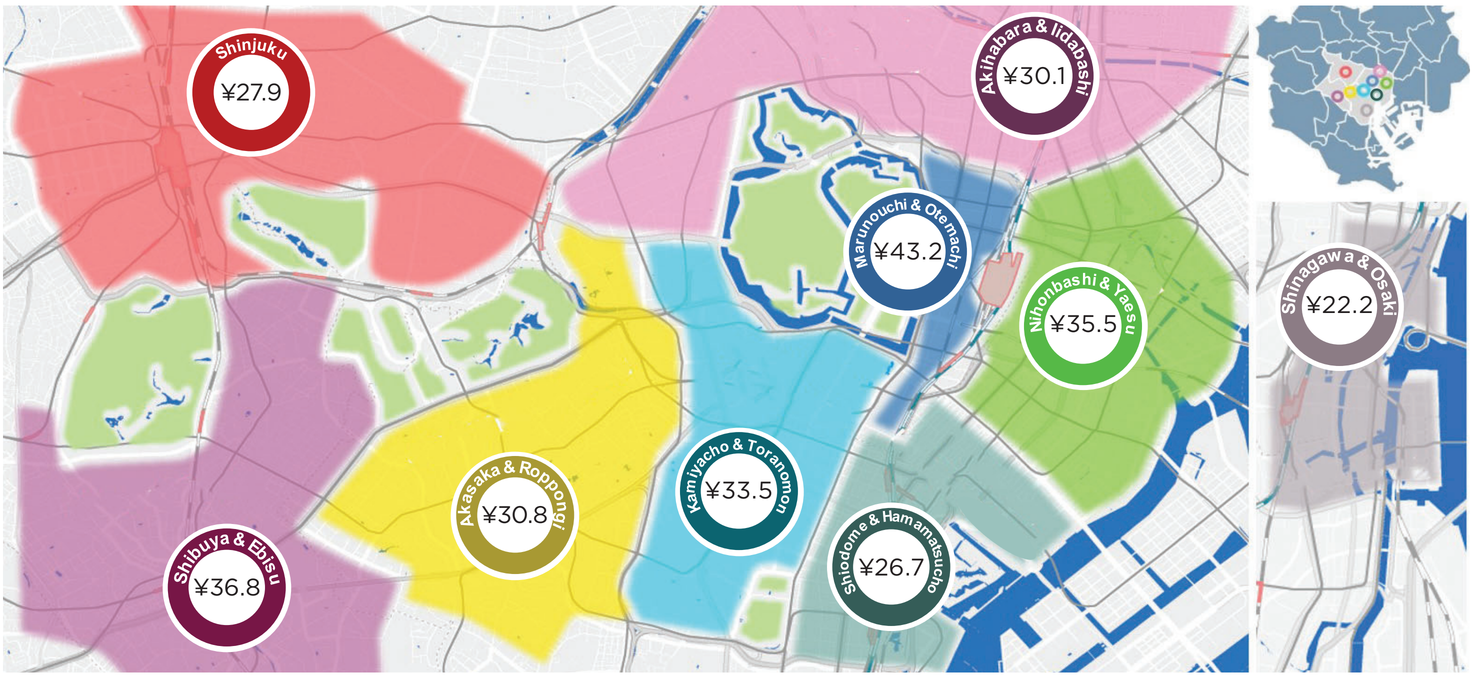
Leasing activity was moderate in Chuo over the quarter. The largest recently reported relocation was by Fukuoka Financial Group, which will relocate their headquarters and branch offices from the Fukuoka Building in Chuo to Tokyo Square Garden, and lease a total of 800 tsubo in the building. Meanwhile, Ogis-RI will relocate its Tokyo head office to Tokyo Nihombashi Tower, leasing around 670 tsubo in the building, which amounts to a moderate downsizing from its current premises.

Minato

Rents increased marginally in Minato by 0.1% QoQ to JPY30,188 per tsubo, which translated to an annual decline of 2.0%. Meanwhile, vacancy loosened by a notable 3.4ppts over the quarter to 6.1%, and was the only ward to experience an annual vacancy increment at 1.7ppts. An outsized proportion of this change was contributed by the completion of Azabudai Hills Mori JP Tower and Toranomon Hills Station Tower, both of which arrived to the market with elevated levels of vacancy and above-average rents. That said, market rumours indicate that Toranomon Hills Station Tower is receiving firm interest and is nearing a high level of occupancy, while Azabudai Hills Mori JP Tower is likely to take more time. Overall, expansions by Japanese companies have been notable this quarter.

Minato ward welcomed an outsized proportion of large office relocations, and the most notable reported tenant movement in Q3/2023 took place in the submarket by Mitsubishi Heavy Industries. The company will retain its current headquarters in Chiyoda, but will lease nearly 10,800 tsubo

MAP 1: Average Rents Per Tsubo in Selected Submarkets, Q3/2023



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 1: Tenant Relocations, Q3/2023

ORIGIN							DESTINATION
Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other		
12	11	21	8	1	22		
8	1				4	13	Chiyoda
2	6	2			3	13	Chuo
	2	16	1		2	21	Minato
			5			5	Shibuya
1				1	2	4	Shinjuku
1	2	3	2		11	19	Other

Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Q3/2023

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION	NEW LOCATION	APPROXIMATE SPACE	
					TSUBO	SQ M
Mitsubishi Heavy Industries	Technology and Electronics	Office Consolidation	N/A N/A	Tamachi Tower Minato	10,800	35,600
Fujitsu	Technology and Electronics	HQ Relocation	Shiodome City Center Minato	Kawasaki Plant, Fujitsu Uvance Kawasaki Tower Kawasaki	10,000	33,100
Sansan	Financial Services	HQ Relocation	Aoyama Oval Building Shibuya	Shibuya Sakura Stage Shibuya Tower Shibuya	4,200	13,800
Denso	Automotive	Office Consolidation	N/A N/A	Shintora Yasuda Building Minato	2,800	9,200
Master Trust Bank of Japan	Financial Services	HQ Relocation	MTBJ Building Minato	Akasaka Intercity Air Minato	2,400	7,800

Source Nikkei RE, Savills Research & Consultancy

across 14 floors in Tamachi Tower, which is slated for completion in September 2023. The company plans to consolidate a number of dispersed offices, including those of its group companies with the move.

Denso will reportedly open a new office in the Shintora Yasuda Building, which is due for completion in 2024, consolidating dispersed offices across a 2,800 tsubo footprint. Master Trust Bank of Japan will relocate from its current headquarters in MTBJ Building, which it leases in its entirety, to Akasaka Intercity Air, both in Minato, and is reportedly set to lease nearly 2,400 tsubo. Meanwhile, both Mitsubishi Electric Information Systems and Exeo Digital Solutions will take up space in the newly completed Sumitomo Fudosan Tokyo Mita Garden Tower, reportedly leasing 1,200 tsubo and 1,000 tsubo, respectively. In particular, Mitsubishi Electric Information Systems is planning to continue its hybrid work arrangements, and is actively seeking to implement work style reform by introducing new office layouts following the relocation.

On the other hand, Fujitsu will reportedly relocate its headquarters away from Shiodome City Center to both its Kawasaki City Plant, which will be renamed as Fujitsu Technology Park in 2024, and to Fujitsu Uvance Kawasaki Tower, and will return an estimated 10,000 tsubo of space during the move. Fujitsu has been reorganising its office space since the pandemic, having terminated offices leases of over 15,000 tsubo in Tokyo, and the relocation of its headquarters appears to be a cost-saving measure. Overall, it appears that it will take some time for Minato to fill its floors to the pre-pandemic level.

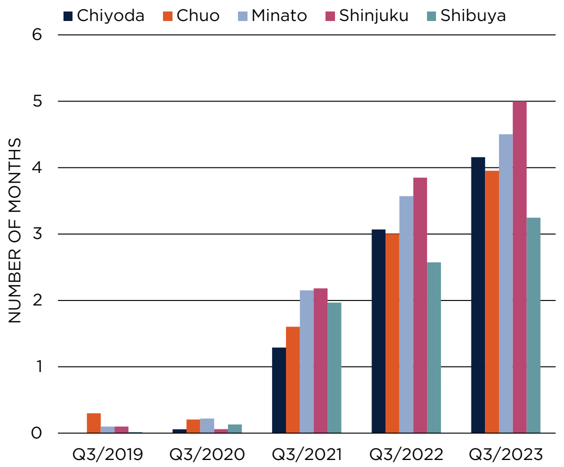
Shibuya

Stability continues in the Shibuya market, with average rents increasing by 0.4% on a quarterly basis to JPY35,000 per tsubo, amounting to a moderate YoY contraction of 0.7%. Meanwhile, vacancy tightened by 0.7ppts QoQ to 1.1%, which is the lowest figure in the C5W, and points to the robust demand in the ward. Little new Grade A supply has come to the market recently, and the scarcity of premium office space has contributed to the ward maintaining the second highest average rents in the C5W.

Looking ahead, Sakura Stage Shibuya Tower is a major addition scheduled for completion in November 2023, and is rumoured to have a very high pre-leasing rate. Redevelopment activity in recent years has elevated the image of the submarket, and has contributed to its heightened popularity among tenants. Indeed, nearly half of reported relocations to the Shibuya submarket between August 2022 and 2023 were to newly built office developments, according to Mitsubishi Real Estate Services, which is an indication of the red-hot appetite for modern office space in Shibuya. As such, there are limited concerns regarding the leasing performance of major upcoming developments in the ward.

Among the companies that have pre-leased space in Sakura Stage Shibuya Tower, Sansan will reportedly lease the largest footprint. The company

GRAPH 4: Average Free Rent Period by Submarket, Q3/2019 - Q3/2023



Source Savills Research & Consultancy

plans to relocate its headquarters, leasing an estimated 4,200 tsubo across five floors, and consolidating scattered offices in order to improve productivity. The company also plans to continue its hybrid working arrangements, and use its office in Sakura Stage Shibuya Tower as a central hub. Appirits will also move its headquarters to the development, reportedly leasing an estimated 840 tsubo of space.

Shinjuku

The situation in Shinjuku appears to be largely positive. Shinjuku's rents increased moderately by 0.3% QoQ to JPY26,583 per tsubo, while average vacancy tightened by 1.0ppt QoQ to 1.3%. Large-scale vacancies are scarce, and a number of office expansions took place in the submarket, with demand particularly high among Japanese companies. Given the dearth of new major developments recently, this encouraging situation will likely continue, with the strong performance of Japanese corporations likely to be a major contributing factor.

Although leasing activity was relatively quiet in Shinjuku in Q3/2023, the current tight levels of vacancy and overall rental growth trajectory indicate that there should be limited concerns among observers. Nippon Game Card will reportedly relocate its headquarters to Sumitomo Fudosan Shinjuku Central Park Tower, leasing around 450 tsubo in the building. Meanwhile, Imagica Geeq will lease an estimated 300 tsubo over multiple floors in Acropolis Tokyo, although further details regarding their current premises and the timing of the relocation are undisclosed.

TENANT RELOCATION TRENDS

The equilibrium between supply and demand for office space has shifted since the pandemic, and the office leasing market appears to have taken on some new characteristics in the post-pandemic era. Hybrid work arrangements look to continue as a corporate perk and office vacancy levels are not as tight as in pre-pandemic times, which has led to some properties with less desirable features struggling disproportionately. The balance of negotiating power between building owners and tenants has shifted notably in favour of the latter, especially as over 400,000 tsubo of new office space is scheduled for completion in the Greater Tokyo market in 2023 and 2025, and potential tenants have been able to be pickier when choosing new offices. On the other hand, as relocation activity has been recovering with tenants reassessing and confirming their office needs, landlords may currently be feeling a greater sense of certainty and stability.

Tenant movement has recently picked up in earnest, and a large proportion of relocations appear to be office consolidations. Vacancy levels were so tight in the pre-pandemic era that tenants did not have much choice when it came to leasing office space, which led to inconvenient and inefficient configurations of offices scattered across the city in some cases. Presently, vacancy levels are a little looser by comparison, and tenants have an opportunity to consolidate disparate offices. Furthermore, due to rental adjustments, tenants can enjoy a greater sense of affordability among new offices. While some companies are downsizing their office space due to lingering remote work, many are not, and are instead redefining the roles of central offices in the post-pandemic environment. This has led to a growing number of tenants installing dedicated communication space and private booths for video conferences and focused work, among other amenities. Moreover, office consolidations allow for the creation of more efficient office layouts, boosting the synergy between related departments and improving productivity overall.

Looking closer at tenant preferences, newer office buildings have received an outsized proportion of interest from prospective tenants. According to a Mizuho Trust & Banking Co. survey of office relocations in the C5W and Shinagawa in FY2022, over 50% of surveyed companies moved to offices that were over 10 years newer than their current premises, and over 30% of the total were to those over 20 years newer. Meanwhile, the same survey revealed that over 15% of relocations were to buildings completed within the last five years, while over 15% were to newly constructed buildings. Access is also an important factor, and offices located within close proximity to metro stations have been especially popular among tenants. The same study indicates that almost half of relocations were to office buildings that are either directly connected to, or located within a minutes' walk from the nearest metro or train station.

While modern buildings with good proximity have been popular, and have had little trouble filling space, a number of buildings lacking such characteristics have struggled notably, and some bifurcation has materialised in the Tokyo C5W market. In addition, the amount of free rent being offered by landlords has increased significantly across the C5W since the pandemic (Graph 4), as the era of ultra-low vacancy rates ended abruptly, and landlords were forced to offer greater incentives to attract and retain tenants. A large proportion of this appears to be concentrated among underperforming properties in undesirable locations amidst the heightened competition for tenants. The Harumi area in Chuo ward is one example. The overall average free rent period for grade A and grade B offices was four months across Chuo ward in Q3/2023, while that of offices in Harumi specifically was around nine months. Furthermore, properties located in Daiba in Minato ward recorded free rent periods of between 10 and 12 months over the same period, while the ward average was between four and five months.

Nonetheless, it should be noted that a handful of new large-scale grade A and grade B developments that arrived to the market in 2022 and 2023 had relatively long free rent periods of over six months - even those in central locations. Although few of these buildings have struggled with vacancies given the strong appetite for modern office space, this is a sign that landlords are operating with caution. Indeed, the market still has room for recovery and vacancy rates remain relatively loose. They are also aware that the new upcoming supply may destabilise the market further, and are hence looking to create greater incentives to quickly secure tenants.

Overall, the current landscape for office leasing and tenant relocations suggests that the demand for office space has recovered to a certain extent since the pandemic. Indeed, because the market has overall seen some loosening, many tenants have utilised opportunities in the recovering market to carry out overdue relocations and consolidations, and reassess their office needs, especially as hybrid work arrangements look to remain commonplace. Given the relatively high level of choice and attractively adjusted rents, tenants appear to be keen on leveraging this opportunity and would like to secure modern offices in central locations with good transport access. On the other hand, poorly located and older offices have been largely overlooked, and some landlords will increasingly be required to offer additional incentives to attract and retain tenants, especially since large amounts of new office supply will arrive to the market over the coming years. However, the recovery trend in the office market and overall strong performance by Japanese corporations is likely to reassure building owners that the demand for office space should remain sound.

OUTLOOK

Cautious optimism continues in the Tokyo grade A and large-scale grade B office market in 2023. Average rents for grade A offices increased modestly, while rental contractions for grade B offices were marginal over the quarter. Vacancy rates are low and look to remain stable across the C5W, despite some major additions in 2023 contributing to some moderate loosening in the market. Indeed, the Tokyo office market has been supported by tailwinds in the form of strong Japanese corporate performance, particularly in export and some service industries, which should provide landlords with some certainty moving forward.

The Tokyo office market has yet to recover from the shock of the pandemic, which has given tenants more choices at attractive rental levels when looking to relocate from their current premises. Average vacancy rates are still relatively loose, given that hybrid work arrangements remain a common company benefit, and the upcoming large new office supply will present more opportunities for tenants going forward. Indeed, many companies have recently carried out office consolidations, due to the greater choice of offices and more attractive leasing options, such as longer periods of free rent. While the rate of relocations appears to have largely recovered, modern offices in central areas with good transport access were the primary beneficiaries. On the other hand, prospective tenants have increasingly soured on opening offices in older buildings with poor access, given their difficulties in attracting talent in the current tight labour market. As such, some bifurcation persists in the market and such offices continue to struggle with high levels of vacancy.

Nevertheless, we predict that the office market will continue on its present stable trajectory overall. The absorption of new major office supply across the C5W appears to have proceeded with limited issues given the sound demand for modern office space in Tokyo, which should be a silver lining for upcoming projects later in the year. That said, the poor performance of older properties is somewhat concerning, and some vacancies and secondary vacancies will likely materialise in 2023, particularly in areas with poor access. As such, observers may see some rental corrections and loosening of vacancy in these areas, which may affect respective submarket averages. That said, the lull in new supply in 2024 will likely ease this situation somewhat, which, in conjunction with strong corporate performance, will help the market absorb the large amount of new supply from this year.

Savills monitors rents and vacancy levels of 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 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, our benchmark figures, particularly vacancy rates, tend to be lower than other market indices.