

Office Leasing



Market softness continues

The quarterly rental adjustment has continued, but is still at manageable levels for the time being.

- In the central five wards (C5W), cracks have deepened in the office market with all submarkets seeing rents contract and increased vacancy rates for a second consecutive quarter. However, the declines were modest outside Shibuya.
- Average Grade A office market rents in the C5W fell 2.6% quarter-on-quarter (QoQ) and 2.4% year-on-year (YoY) and now stand at JPY36,460 per tsubo¹ per month.
- The average Grade A office vacancy rate in the C5W increased slightly to 1.0% in Q4/2020.
- Average large-scale Grade B office rents declined to JPY27,866 per tsubo per month – a contraction of 2.3% QoQ and 1.1% YoY.
- The average vacancy rate in the Grade B market lies at 1.6% following a loosening of 0.6 percentage points (ppts) QoQ and 1.5ppts YoY.
- As many companies adopt remote work policies, shared office providers are moving to rapidly expand offices outside the C5W to accommodate the increase in demand. These remote offices are likely to serve as a complement to central offices and as one solution for issues surrounding working from home.
- Remote work policies may see some companies downsizing their central offices. However, this may also create an opening in the traditionally air-tight prime office market for companies that had been interested.

“While rents have adjusted slightly this quarter, the moderations were mostly found in Shibuya as the rest of the market remains fairly resilient. Prevalent work-from-home arrangements may also change some of the dynamics of the office market.”

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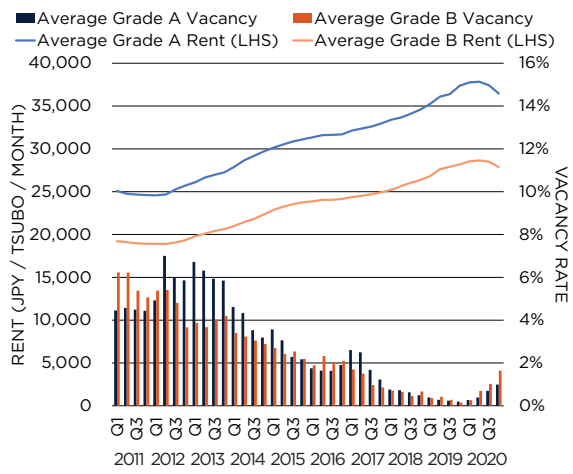
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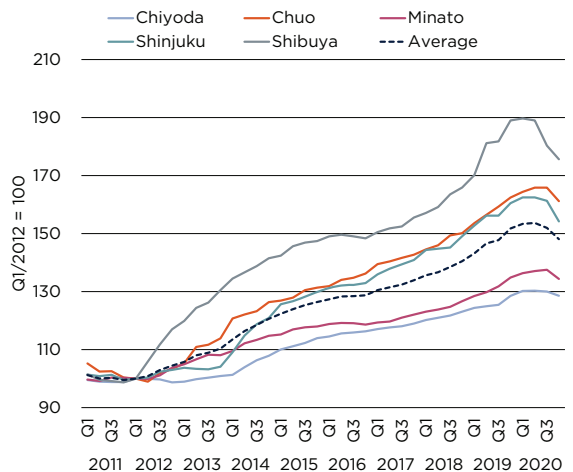
¹ 1 tsubo = 3.306 sq m or 35.583 sq ft.

GRAPH 1: Office Rents And Vacancy In Tokyo's C5W*, 2011 to Q4/2020



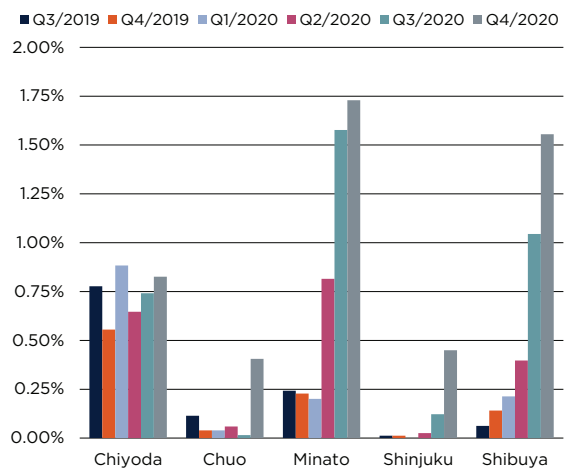
Source Savills Research & Consultancy
*Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index By Ward, 2011 to Q4/2020



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy By Ward, Q3/2019 to Q4/2020



Source Savills Research & Consultancy

GRADE A OFFICES

The Grade A² market is still experiencing the impact of the global pandemic and subsequent economic slowdown. Indeed, rents saw their first yearly decline since 2011, falling 2.4% YoY and 2.6% QoQ to JPY36,460 per tsubo³. Moreover, vacancy rates have inched 0.3ppts higher to 1.0% – the highest level in about three years. However, Japan’s economy is gradually recovering, as illustrated by a 5.3% increase in GDP QoQ in Q3/2020. Footfall at Tokyo stations, meanwhile, has improved to about 60-70% of the pre-pandemic level from 35% in May, indicating some return of office workers. These might be early signs of a recovery and although some new supply came to the market not fully leased, the overall market fundamentals are still sound.

At the ward level, Shibuya is once again in the spotlight as the black sheep of the family, with a -7.1% YoY decrease in rents; significantly higher than its counterparts, and the primary contributor to the overall 2.4% decrease in YoY rents. Leading up to 2020, Shibuya largely benefited from the concentration of IT companies located in the submarket and had achieved the largest rental increase since 2012. However, after COVID-19 hit, these IT companies were the first to embrace the transition towards remote work. This turn of events effectively counterbalanced what was previously a rapidly growing market.

The rest of the C5W have all experienced softening QoQ growth, ranging 1.1% to 4.4%. However, on a YoY basis, most markets have remained flattish. In addition, while all of the C5W have seen an increase in vacancies, they are relatively small increases from record-low levels. As such, while pure QoQ figures might paint a somewhat bleak future for the market, the overall YoY may simply reflect a natural correction for a market that saw relatively high growth rates in the past few years.

LARGE-SCALE GRADE B OFFICES

Elsewhere, the Grade B⁴ market faced similar circumstances to that of the Grade A market. For instance, rents declined 2.3% QoQ to JPY 27,866 per tsubo. Consequentially, the market has also declined 1.1% YoY, marking the first annual contraction this year. Furthermore, Grade B vacancies have increased 0.6ppts to 1.6%, in line with the upward trend that began in Q1/2020.

However, looking at each individual submarket diverts the attention to one major submarket. As in the Grade A office market, Shibuya is accountable for a large proportion of the submarket’s overall

slump with a 5.6% decrease in rents over the quarter. Furthermore, vacancies in the ward have also increased by 3.5ppts YoY to 3.7%. While the other areas in the C5W have not been as impacted as Shibuya, tenants in general now appear to have possibly greater negotiating power, and with landlords keen to maintain occupancy, rents could see a further adjustment in the near future.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

Amongst the C5W, Chiyoda is still the most expensive, with rents standing at JPY43,233 per tsubo. Although rents slightly declined by 1.1% QoQ, they are on par with rents recorded in Q4/2019. In fact, they currently sit at a 19% premium over the average Grade A C5W rent levels, compared to 16% in Q4/2019. Therefore, it can be seen that rent levels in the premium submarket have remained strong despite the economic downturn.

Examining the ward’s vacancy rates, Chiyoda’s performance appears sound: seeing an increase of 0.1ppts QoQ and 0.3ppts YoY to 0.8%. As such, Chiyoda remains resilient. Within the ward, trading conglomerate Mitsui & Co. have reportedly moved out of the JA building, where they previously occupied 11 floors, and into the newly constructed Mitsui & Co. building in the Otemachi district, and as such is likely to see vacancy rates rise above 1% in the next quarter.

Chuo

In Q4/2020, Chuo saw a quarterly drop of 2.8%. Average rents are JPY34,919 per tsubo: a decrease of 0.8% YoY. Despite this quarterly setback, when compared with data before the pandemic, Chuo has outperformed its peers with an annualised growth rate of 3.6% since 2018, besting the C5W average of 2.7%. With no additional supply forecasted for 2021, and supported by the comparatively large tenant pool of Japanese company headquarters, supply should remain tight. Although its vacancy levels have seen an inched up 0.4ppts this quarter due to an increase in vacancy in the Harumi area, they are still extremely low, and lie at 0.4% compared to the C5W average of 1.0%. Indeed, it is unlikely that Chuo will see any further sudden changes imminently given that its vacancy levels have held steady even amidst this pandemic.

Minato

The rents in Minato are currently at JPY34,041 per tsubo having fallen QoQ by 2.3%, and have seen a slight decrease of 0.4% YoY. Lying 7% below the submarket average, it is a far cry from its glory days as the second most expensive submarket in the C5W. Moreover, its vacancy rates are the second highest in the C5W, standing

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.
3 Throughout the report, "per tsubo" is shorthand for "per tsubo per month".
4 "Large-scale Grade B office" refers to buildings with a GFA of 4,500 tsubo (15,000 sq m) and a building age of less than 25 years. Some buildings are included that do not fit this definition.

TABLE 1: Tenant Relocations, Announced In Q4/2020

| ORIGIN | | | | | | DESTINATION | |
|---------|------|--------|---------|----------|-------|-------------|----------|
| Chiyoda | Chuo | Minato | Shibuya | Shinjuku | Other | | |
| 2 | 5 | 9 | 2 | 2 | 12 | | |
| ↓ | ↓ | ↓ | ↓ | ↓ | ↓ | | |
| 1 | 1 | 2 | | | 1 | → | 5 |
| 1 | 3 | 1 | | | | → | 5 |
| | 1 | 3 | | | | → | 5 |
| | | 1 | 1 | | | → | 2 |
| | | | 1 | 1 | | → | 2 |
| | | 2 | | 1 | 10 | → | 13 |
| | | | | | | | Chiyoda |
| | | | | | | | Chuo |
| | | | | | | | Minato |
| | | | | | | | Shibuya |
| | | | | | | | Shinjuku |
| | | | | | | | Other |

Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Announced In Q4/2020

| COMPANY | BUSINESS SECTOR | TYPE | FORMER/CURRENT LOCATION | | NEW LOCATION | APPROXIMATE SPACE | |
|-------------------------------------|---------------------|----------------------|---|---|---|-------------------|---------------|
| | | | | | | TSUBO | SQ M |
| Fujitsu | Technology | Office Consolidation | Multiple Minato, Shinagawa, Yokosuka | → | JR Kawasaki Tower Office Building Kawasaki | Not disclosed | Not disclosed |
| Hitachi Social Information Services | Systems Integration | HQ Relocation | Multiple Minato & Shinagawa | → | Omori Bellport D Shinagawa | 1,440 | 4,700 |
| Mitsui Direct General Insurance | Insurance | HQ Relocation | Koraku Kokusai Building Bunkyo | → | Sumitomo Fudosan Iidabashi First Building Bunkyo | 1,092 | 3,600 |
| Furukawa | Machinery | Relocation | Nihombashi Nishikawa Building Chuo | → | Tokiwabashi Tower Chuo | 1,092 | 3,600 |
| Bridgestone Sports | Sporting Goods | Office Consolidation | World Trade Center Building Minato | → | Tokyo Square Garden Chuo | 816 | 2,600 |

Source Nikkei RE, Savills Research & Consultancy

at 1.7%, a 1.5ppts YoY uptick. Although still very low, its comparatively higher vacancy rates can be explained by a few large relocations, and the fact that Minato hosts a large number of SMEs that have greater mobility, meaning that potential vacancy is more likely to materialise than in other wards.

Minato takes centre stage with regard to relocation affairs. For instance, in mid-2021, Fuji Xerox will reportedly move from Roppongi T Cube to Toyosu Bayside Cross, located outside the C5W to consolidate its national salesforce. As a result, this will create approximately 5,000 tsubo of vacant office space, and therefore have a significant impact on vacancy rates when the time comes.

Furthermore, with increasing supply in the coming years from large developments such as the Shinbashi Tamuracho Project in 2021 and the Toranomom Azabudai Project in 2023, it remains to be seen if the demand for office space can keep up with the supply.

Shibuya

Shibuya has been the bearer of bad news throughout 2020, and unfortunately, this remains the case in the final quarter of the year. Rents have fallen 2.6% QoQ and 7.0% YoY to JPY37,524 per tsubo, which is the lowest it has been since Q1/2019. Furthermore, vacancies have also been on the rise, now at 1.6% after a 0.5ppt YoY expansion. Indeed, the technology and start-up hub of Tokyo has lived up to its stereotype of being quick to adapt to change, in this case through negotiating rents, as seen by the rent reductions of many individual buildings in the ward compared to Q4/2019. Indeed, rent levels have seen a disproportionate decrease when compared to the increase in vacancies in Shibuya.

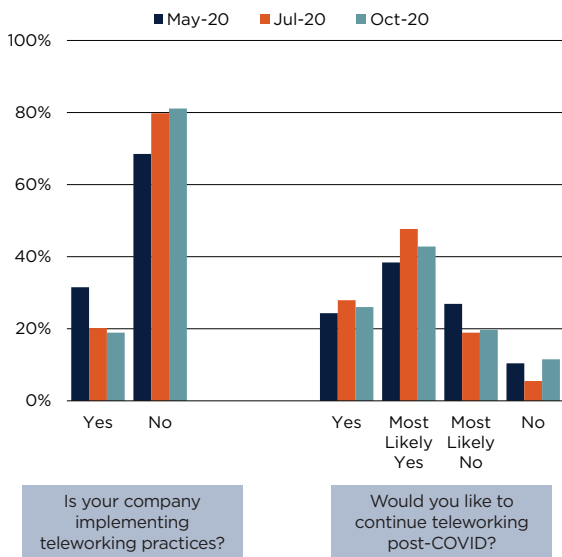
However, solely comparing Shibuya's 2020 performance to its 2019 results might lead one to judge the submarket too hastily. Looking back to 2019, it can be seen that new buildings were significant contributors to the ward's spectacular double digit YoY growth, fuelled further by demand

from technology and start-up firms eager to establish themselves in the location. With demand having waned in 2020 due to the pandemic, rent levels fell accordingly. Despite the drastic decrease in 2020, one must remember that Shibuya also grew over 20% from 2018 to the end of 2019, where in comparison, the rest of C5W average managed less than 12%. As such, while not the superstar it was a year ago, Shibuya's longer-term performance is still solid; a sign that it could have simply been a submarket that was previously overheated and has now seen a necessary adjustment. With the heavy correction that Shibuya has already seen this year, it could show more upcoming resilience as companies may find Shibuya more attractive due to its adjusted rents.

Shinjuku

Shinjuku's rents remain the cheapest in the C5W at JPY32,583 per tsubo. In terms of rent performance, it has been somewhat lacklustre, with its rents declining by 4.4% QoQ and 3.9% YoY, which is

GRAPH 4: Survey Responses Regarding Current And Future Teleworking Practices, October 2020



Source Japan Productivity Center, Savills Research & Consultancy

below the C5W average. With its scarcity of new developments, unlike its other C5W counterparts, it is hard to see significant increases in rent going forward.

On the other hand, its stability amongst the C5W is something to be noted. Vacancy rates have increased by 0.3ppts QoQ to 0.5%, which is the second lowest, next to Chuo. The affordability of Shinjuku rents combined with the access that the namesake station provides, makes it a comfortable location. The fact that Shinjuku is the only member of the C5W to have consistently maintained a vacancy rate of less than 1% since Q3/2016 is case in point.

SHIFTING WORKSTYLES: THE HUB AND SPOKE MODEL

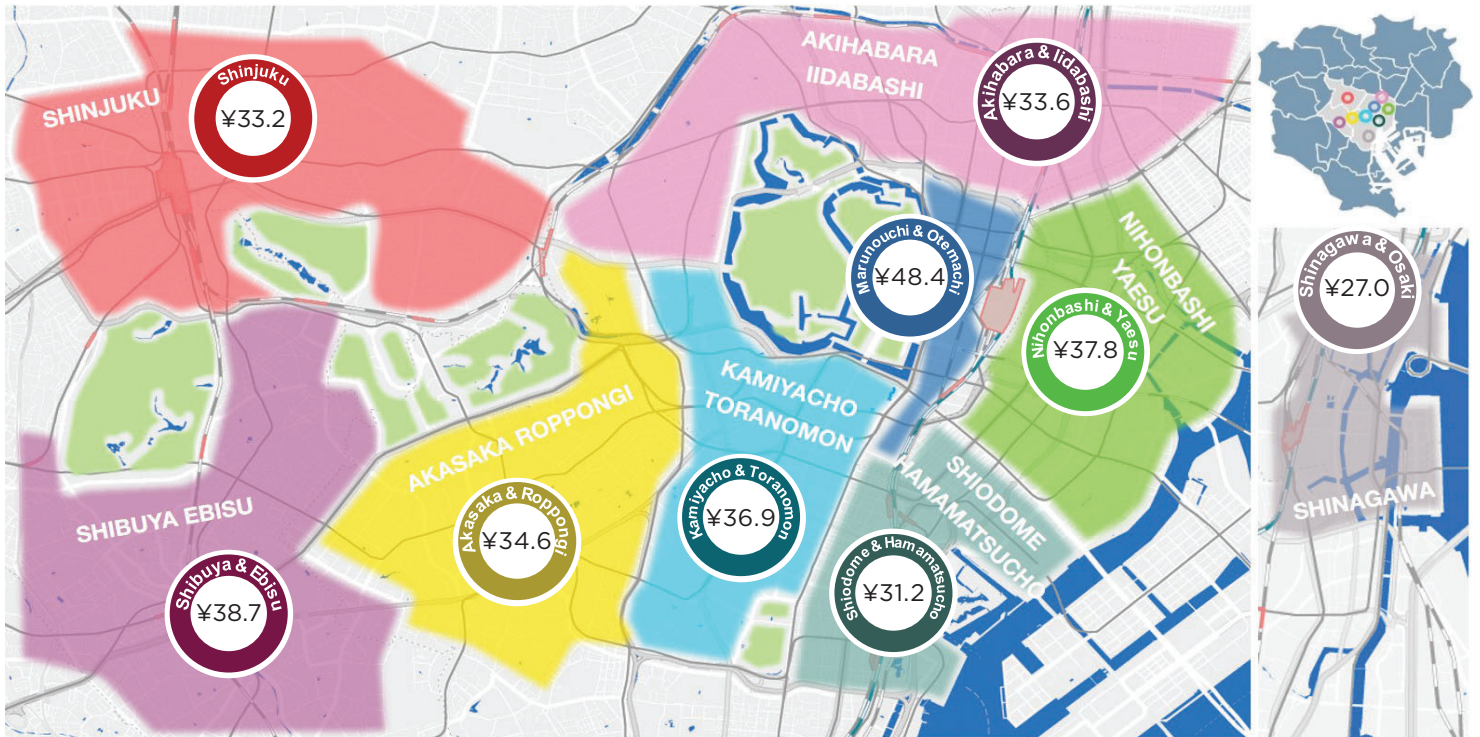
The COVID-19 pandemic prompted many Japanese companies to introduce work-from-home measures, and, despite many hiccups, these policies would now have been in place for almost a year. Even now, footfall at major stations remains about 30% below the pre-pandemic level, indicating that many still remotely. Indeed, a survey conducted in October by Japan Productivity Centre indicated that nearly 70% of respondents

were keen to continue with some form of remote work even once the pandemic is under control. That said, since most Japanese companies have solid balance sheets and imminent financial prospects are not desperate, most of them should keep their existing office spaces while maintaining this hybrid model with regular/occasional work-from-home arrangements.

In this new landscape, the era when everyone commutes to the central office together is over. Small cash-strapped or start-up companies are likely to embrace remote work, and some have already reduced office space, resulting in a loosening in vacancy, especially in Shibuya and Minato. Meanwhile, even major companies, especially in hard-hit industries, such as Idemitsu and Mitsubishi Chemical, have also announced plans to maintain remote work options while consolidating office space in Tokyo.

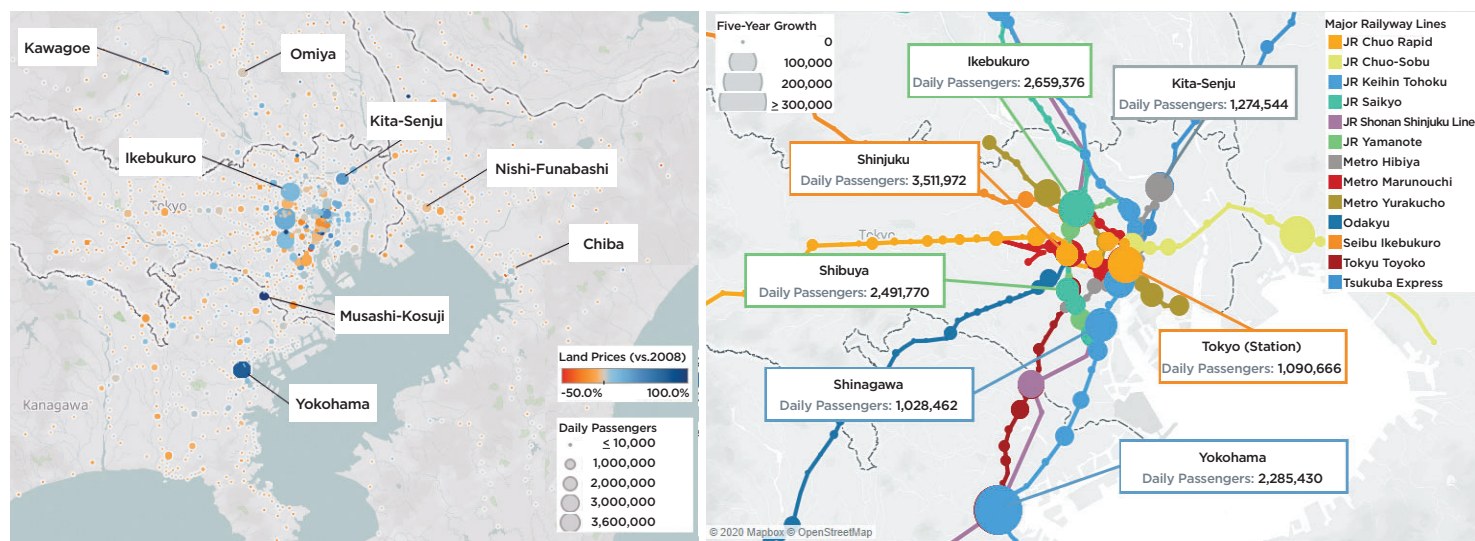
One avenue to facilitate work-from-home is the utilisation of shared office providers. According to the National Census, 3.7 million people commute to the C5W, of which just under a half come from within the 23W, and with 1.7 million coming from the outskirts

MAP 1: Average Rents Per Tsubo In Selected Submarkets, Q4/2020



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

Map 2: Tokyo Train Lines By Traffic Density



Source Savills Research & Consultancy

of Tokyo and neighbouring prefectures. As residences in Tokyo are generally too small to be ideal workplaces, especially for employees with young children, conveniently located, station-front shared offices close to residential hubs are gaining traction. While this business model is nothing new, many players have continued to expand and accelerate their footprint outside of the C5W on the back of growing remote work demand. This creates new opportunities, even for small-to-medium size offices in areas that were previously not popular for offices.

For large companies one key element of satellite shared offices may be the range of coverage it has, as people commute to Tokyo from various areas, and therefore these firms would prefer to use operators with large numbers of locations. Natural targets would be stations with large passenger traffic (Map 2).

The office still retains its importance as a meaningful place of collaboration and productivity, and also creates a sense of belonging for employees. Many companies implementing remote work are likely to adopt a hybrid model where these remote offices complement their central office. One plausible scenario after the pandemic ends would be employees working remotely occasionally, and mainly being present at the central office. This could mean that the office market could see a slight increase in vacancy levels due to companies downsizing their central offices. However prime areas should remain popular with other companies that would like to relocate to prime areas when available, while new demand appears in aforementioned new areas.

This also means even in the C5W, less convenient areas are likely to run out of steam. Being located within the C5W alone will no longer suffice as a feature to attract new tenants, and only offices

that can more holistically satisfy company needs will exhibit greater demand as the polarization of office demand continues. In fact, vacancy increases are currently observed to be concentrated in these areas. Furthermore, office demand should demonstrate correlation with overall economic conditions. Indeed, with significant inroads made in the production of a viable vaccine, this trend may slow down or even eventually somewhat reverse, subject to the economic recovery. Conversely, if the economy goes south, for instance in a scenario where the vaccination plan is a failure, we may see skyrocketing work-from-home arrangements, in the form of effective cost reduction.

OUTLOOK

The Grade A office sector has so far somewhat managed the worst of the global pandemic storm. While average rents have declined over the year, these changes can mostly be attributed to the steep cooling-down in Shibuya, which has been exacerbated by the concentration of technology companies that tend to be more mobile and quick to adapt to change by nature. Average vacancies are still very low, although somewhat more pronounced in Shibuya and Minato than in other wards. Therefore, while average rents should not see impending significant changes in more stable wards like Chuo and Chiyoda, there may be slight declines in other areas with higher vacancies as landlords become more flexible in order to attract new tenants.

Japan is currently in the midst of its third and largest wave of COVID-19 new cases, thus making it unlikely that we will see an imminent return to the office. Indeed, as of late Q4/2020, train usage during peak hours at major stations is still 70% of pre-

COVID levels. This number should go up once the pandemic calms down, but probably not to 100%, and this will create new demand and opportunities. Also, with this cloud of uncertainty looming over future prospects of the office market, views on leasing show stark differences from player to player, which should generate some office investment opportunities.

We expect some form of work-from-home arrangements to remain, but these will function as a supplement to offices themselves. Most people will still either go to the main office or nearby satellite offices because most apartments in Tokyo are small and sub-optimal as a workplace. Work-from-home arrangements should remain to give employees the flexibility to stay at home occasionally based on personal preference and lifestyle. Though, if economic hardship materialises and corporations look to reduce office space as an avenue to cut costs, work-from-home should become more prevalent in the form of effective restructuring. Nonetheless, the amount of office space required is ultimately dependant on industry and job function; while some administrative jobs may function normally with remote work, certain context-based jobs would still require employees to come regularly to the office.

Looking ahead, the advent of a viable vaccine looks to smoothen the existing friction in domestic and overseas movement and should provide greater stimulus to the Japanese economy as a whole. Hopefully, if economic conditions start to revert back to normal more quickly than anticipated, this emerging office trend could end up being transient, and we may eventually observe some reversal of the trend.

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.