

Japan - October 2022

Q
SPOTLIGHT
Savills Research

A Deep Dive into Tokyo Office



Recovery is underway, albeit gradually and unevenly

Summary

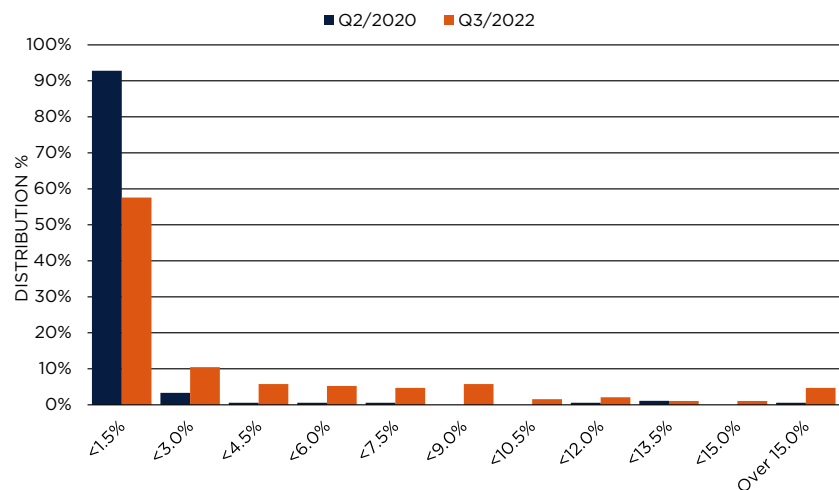
- The pandemic has slowed the Tokyo office market overall, but the impact was felt differently in different submarkets.
- Although multiple forces are at play, building age and accessibility have largely elucidated different performances among different submarkets.
- At the property level, walkability to stations seems to have influenced property performances during the pandemic as well.
- The market has seen signs of slowing corrections with vacancy rates stabilising and rental decreases moderating.
- The primary cause of market average rents weakening more slowly in recent quarters was a smaller number of properties that were prompted to reduce rents.
- Although we expect rental growth gaining some momentum in 2024 after a supply wave in 2023, a slowdown of the global economy could delay recovery.
- Recovery is likely to be uneven considering how the pandemic has affected different submarkets and properties differently.
- Investor appetite for office assets remains large as indicated by the substantial transactions in recent quarters and the strong investor interest they garnered.

INTRODUCTION

Looking at the Tokyo Grade A office market in the central five wards (C5W) as a whole, the market has continued to see moderate corrections, with vacancy rates increasing and rents on a downward trend. As of Q3/2022, the average vacancy rate rose from virtually 0% in the pre-pandemic period to 4.1%. Meanwhile, the average market rent has decreased by 13.2% from the pre-pandemic peak of JPY37,800 per tsubo achieved in Q2/2020 - a complete reversal of the accelerated growth that was seen leading up to 2020.

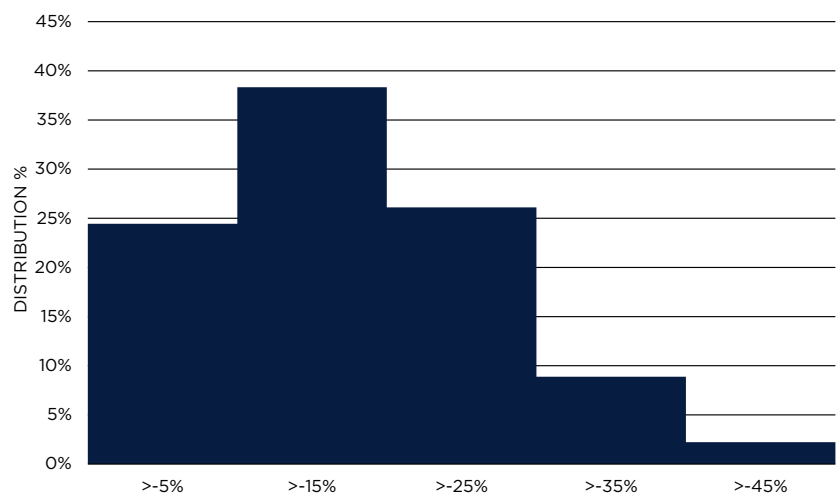
Nonetheless, the adverse impact from the pandemic has been felt unevenly across the market. While a number of office buildings have performed poorly, many other properties have in fact demonstrated resilience and have been doing well throughout the pandemic. For instance, Graph 1 illustrates that although there are more properties with higher vacancy rates in Q3/2022 compared to Q2/2020, an overwhelming majority have maintained low vacancy rates. Furthermore, the scale of rental corrections varies across the market, with some buildings seeing more significant changes in rent than others (Graph 2).

GRAPH 1: C5W Grade A Office Vacancy Rate Distribution, Q2/2020 vs Q3/2022



Source Savills Research & Consultancy

GRAPH 2: C5W Grade A Office Rental Change Distribution, Q2/2020 vs Q3/2022



Source Savills Research & Consultancy

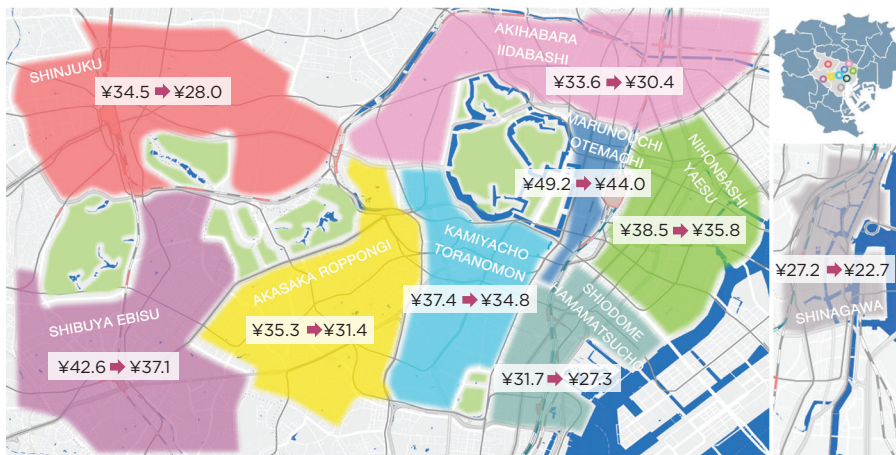
Diverging trends are also apparent at the submarket level, as we have shown in our past quarterly office briefings. In order to gain a better understanding of the underlying cause, we have carefully analysed each submarket to draw insight. Although different factors are at play in different areas, the two factors that seem to have significantly contributed to diverging performances are building age and accessibility. In this report, we have attempted to quantitatively validate this assertion using linear regression models.

The findings are summarised in Graph 3. Overall, the reasonably high R² values¹ show that the models can explain performance variance to a reasonable extent, though many other factors seem to have affected individual property performances. While this indicates the limitations of the models' explanatory power, at the same time, we believe that these results indicate that value-add opportunities are present. Essentially, if individual

While the Tokyo office market as a whole continues to see modest corrections, submarket and property-level performance varies, and the divergence between overperformers and underperformers has become increasingly clear. Going forward, we expect a gradual improvement of overall market conditions, although a slowdown of the global economy could delay recovery.

¹ An R² of 1 would mean that the variables of the model perfectly explain rents.

MAP 1: Grade A Office Rent by Submarket, Q2/2020 vs Q3/2022

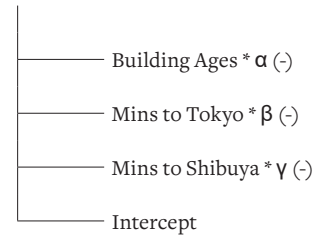


Source Savills Research & Consultancy

properties' performances were dictated by unchangeable factors such as building age and accessibility, there would be little room for investors to add value. Indeed, there are successful examples of offices that have observed rental increments due to bold strategic initiatives and capital expenditure plans.

GRAPH 3: Linear Regression Analysis Results

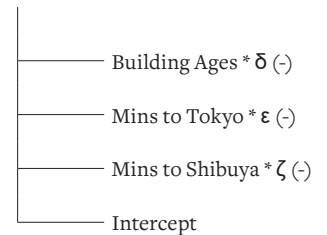
Office Rent (JPY)



R-squared = 0.66 (property level)

R-squared = 0.89 (submarket level)

Rental Correction by Submarket (%)



R-squared = 0.83

Source Savills Research & Consultancy
 Note: Greek letters represent coefficients calculated for variables. Minus signs following Greek letters indicate these variables have negative impact on office rents and rental corrections by submarket.

TABLE 1: Submarket Rental Change, Q2/2020 vs Q3/2022

SUBMARKET	Q2/2020	Q3/2022	CHANGE
Toranomon & Kamiyacho	37,400	34,800	-6.8%
Nihonbashi & Yaesu	38,500	35,800	-7.0%
Akihabara & Iidabashi	33,600	30,400	-9.6%
Marunouchi & Otemachi	49,200	44,000	-10.7%
Akasaka & Roppongi	35,300	31,400	-10.9%
Shibuya & Ebisu	42,600	37,100	-12.8%
Hamamatsucho & Shiodome	31,700	27,300	-13.6%
Shinjuku & Osaki	27,200	22,700	-16.4%
Shinjuku	34,500	28,000	-18.8%
C5W	37,800	32,800	-13.2%

Source Savills Research & Consultancy

Overall, Tokyo is expected to remain a popular target market for international investors due to its market size and stability. Indeed, some large transactions recorded in recent quarters highlight strong investor appetite for office assets in the Tokyo market. Specifically, a large interest in Otemachi Place West Tower that was transacted recently is a noticeable example. Although it was eventually acquired by domestic investors, it has been reported that several overseas investors joined the bidding process with keen interest. Even outside of prime submarkets, quality properties with value-add opportunities are also receiving sound interest from investors with large capital to deploy. As investor interest is expected to increase once recovery starts in earnest, our discussions in this report are intended to provide a framework for thinking through about what is to come next.

PANDEMIC IMPACT

As explained in the introduction, the impact from the pandemic varied for different submarkets and properties. As illustrated in Table 1, average rental changes range between -6.8% in Toranomon & Kamiyacho and -18.8% in Shinjuku, while the C5W on average experienced a rental decline of -13.2%. While multiple factors, including area characteristics such as average rental levels, neighbourhood amenities, commutability, submarket reputations, supply, as well as individual office characteristics such as building specifications, tenant profiles, management strategies and so on, are deemed

to have affected the results, our statistical analysis has identified two factors that seem to have significant impact on submarket performances: building age and accessibility.

Indeed, these two factors are expected to retain their importance going forward as office needs will be affected by the behavioural changes seen during the pandemic. Specifically, unlike the pre-pandemic times when everyone was required to go to the office daily, hybrid work styles that were implemented amidst the pandemic have made people discover that more work can be done remotely than initially expected. With this new realisation, the primary reasons people would need to go to the office will likely be for collaboration and company cohesion, and newer office buildings with good accessibility are better suited to meet these needs. Furthermore, newer buildings with advanced features are desirable from the ESG perspective as well.

As such, we focus our attention mainly on these two factors and attempt to evaluate how much of the performance difference can be explained by them in this section. Admittedly, an analysis emphasising a small number of specific variables entails risk of possible oversimplification, but there are certain merits to fully evaluating the impact of building age and accessibility. Firstly, they are relatively easy to quantify, so we can draw objective conclusions. Secondly, by evaluating how much performance variance can be explained by these two factors, we can at the same time gain a sense of how much of this variance cannot be explained by them.

The latter reason has implications for value-

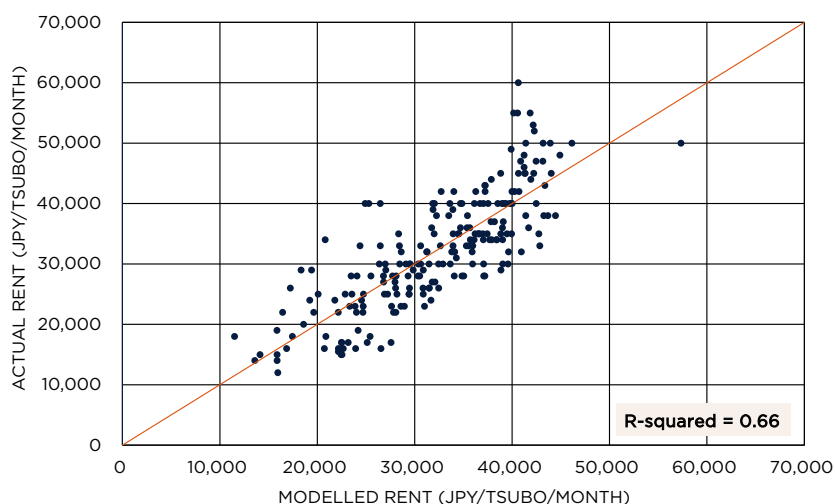
add investments because if building age and accessibility could fully explain how each property performs, it suggests that there is little room left for value-add opportunities because these factors are unchangeable. Overall, the model results indicate that a considerable proportion of performance variance is left to be explained by other factors than building age and accessibility, and this implies that there is room for investors to increase value by changing things that they have control over.

To see how much performance variance can be explained by these two factors, we have run a linear regression analysis of their impact on rental levels. Graph 4 compares the actual rents for the Grade A properties in Tokyo’s central 6 wards (C6W)² on the y-axis with their modelled rents derived from our regression analysis using building age and travel time³ to Tokyo station and Shibuya station as variables on the x-axis. The reason for using distance to Tokyo station and Shibuya station as a proxy for accessibility is that Marunouchi and Shibuya are the two most expensive submarkets, and it appears to reasonable to assume that rents are affected by how easily people can access these two areas from each property location.

The results appear to reasonably support the use of these variables to measure rental performance. As shown in Graph 4, the dots are generally gathering along the the 45-degree line, indicating that the model has a reasonable explanatory power (the dots will line up perfectly on the diagonal line if modelled rents fully match actual rents). As expected, the results indicate that building age and the distance to Tokyo station and Shibuya station have a negative impact on office rents. In other words, the older the buildings are and the further the properties are from those two stations, the lower their rents will become.

Although the results are encouraging, the model’s R² (0.66) value also implies that there is still much that cannot be explained by this simple model. Indeed, there are some examples of properties that have rental premiums, presumably owing to factors such as their high specifications and the large renovations conducted over the years. Specifically, one noticeable trend is that some properties toward the higher end of the rental spectrum had substantially higher actual rents than modelled rents. This is likely because some of these properties are trophy assets in prime areas and have a rental premium for the prestige associated with the building. Overall, the

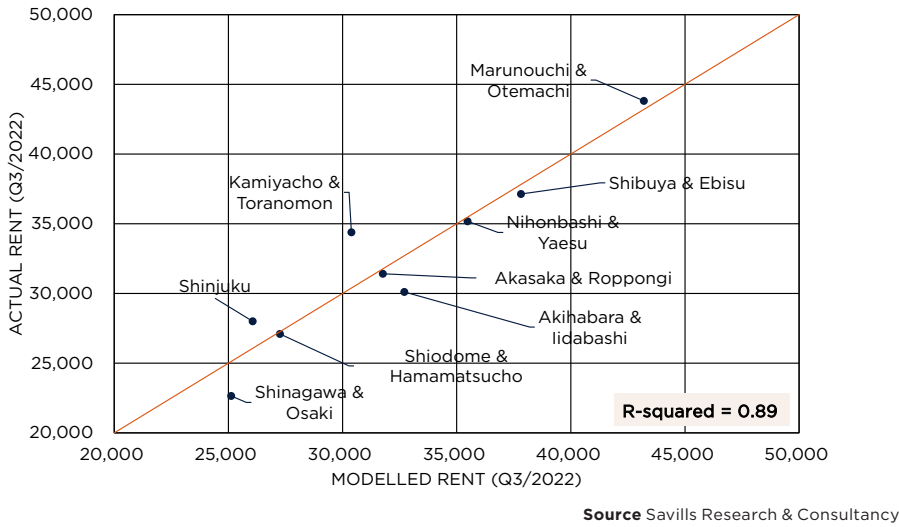
GRAPH 4: Actual and Modelled Rent Comparison, Q3/2022



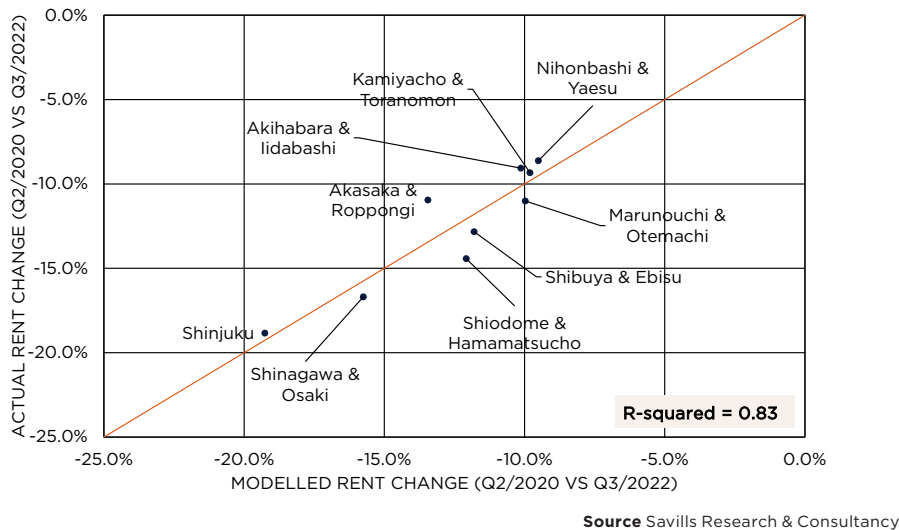
Source Savills Research & Consultancy

² The C6W is the C5W plus Shinagawa ward.
³ Here, we have defined it as travel time from each property to Tokyo station and Shibuya station using public transportation (i.e. trains and buses).

GRAPH 5: Actual and Modelled Rent Comparison by Submarket, Q3/2022



GRAPH 6: Actual and Modelled Rental Change Comparison by Submarket, Q2/2020 vs Q3/2022



model’s results indicate that building age and accessibility are indisputable key factors. However, they are not sufficient in themselves to fully explain performance differences of individual properties. Savvy investors who can derive the cause of deviation and spot rent mismatches could thus theoretically identify potential value-add opportunities.

Separately, we have tested how the same two factors can explain rental differences at the submarket level. The hypothesis is that the model should prove more reliable for submarket-level analysis since the deviance of individual properties is averaged out after being aggregated. As evident in Graph 5, the model results are in fact much more significant than the previous regression analysis on individual properties (R^2 of 0.89).

At the submarket-level, we have also conducted another analysis. We have tested if building age and accessibility can explain different degrees of rental corrections experienced by different submarkets since the onset of the pandemic. Graph 6 and Table 2 show the results of the linear regression analysis, and they seem to suggest the decent explanatory power of the two variables here as well.

Table 2 illustrates variables used in the model and its results. Reviewing the table, it is clear that the older the average age of the office buildings in one submarket, the larger the rental corrections the submarket saw between Q2/2020 and Q3/2022. As expected, the regression analysis results also indicate that building ages have influenced submarket performances the most with its coefficient being the largest in absolute figures.

Another implication of the model results is how the distances to Tokyo station

TABLE 2: Actual and Modelled Rental Change Comparison by Submarket, Q2/2020 vs Q3/2022

SUBMARKET	AVERAGE AGE	DISTANCE TO TOKYO	DISTANCE TO SHIBUYA	ACTUAL RENT CHANGE	MODELLED RENT CHANGE
Nihonbashi & Yaesu	11	10	27	-8.6%	-9.5%
Akihabara & Iidabashi	11	13	26	-9.1%	-10.1%
Toranomon & Kamiyacho	11	19	23	-9.3%	-9.8%
Akasaka & Roppongi	15	21	19	-10.9%	-13.4%
Marunouchi & Otemachi	12	3	26	-11.0%	-10.0%
Shibuya & Ebisu	13	29	5	-12.8%	-11.8%
Shiodome & Hamamatsucho	13	17	28	-14.4%	-12.1%
Shinagawa & Osaki	18	25	22	-16.7%	-15.7%
Shinjuku	22	27	19	-18.8%	-19.3%

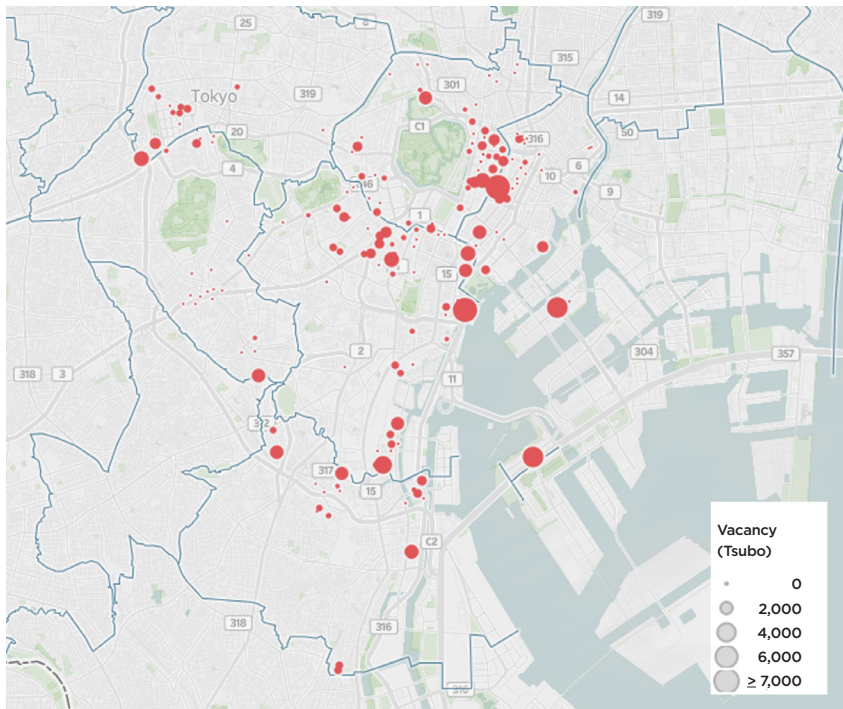
Source Savills Research & Consultancy

Note 1: In this table, actual rent changes are based on the data of properties for which the comparison of two periods is possible.

As such, the figures differ from the ones in Table 1.

Note 2: Average ages are based on building ages as of the base year (i.e. Q2/2020).

MAP 2: Vacant Space of Grade A Offices in the C6W, Q3/2022



Source Savills Research & Consultancy

and Shibuya station work negatively in the model. In other words, the model indicates that properties proximate to Tokyo station and Shibuya station have benefited from their locations. This may be interesting considering that Shibuya saw large rental corrections at the beginning of the pandemic because IT companies were quick to adopt remote work, and Shibuya's stronger rental growth leading up to the pandemic had also caused its large correction.

However, recent data indeed shows that rents for properties in Shibuya have started showing signs of bottoming out earlier than rents in other areas, and vacancy in the submarket remains tight (Map 2). After all, Shibuya maintains its strong popularity as an IT hub, and a series of development projects around Shibuya station has significantly improved its status as a business hub. As such, proximity to Shibuya is expected to be beneficial going forward.

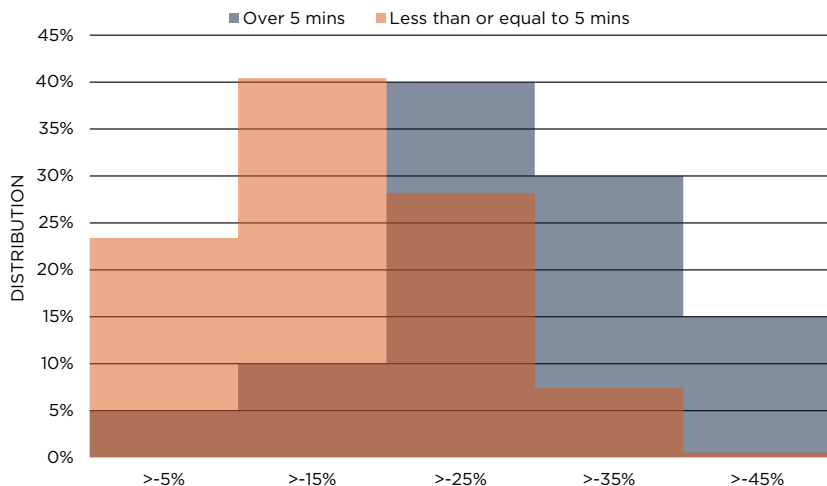
Another point to highlight on accessibility is how the distance from stations appears to have affected property level performances. Graph 7 aggregates data on a histogram, and it shows that offices that require longer than a five-minute walk generally have had larger rental corrections. These office properties have seen around a 20% rental decline on average while the average was about 10% for the ones closer to their nearest stations. To be sure, a majority of Grade A offices are located within a five-minute walk from stations. However, some properties in certain areas are further than five minutes away and are disadvantaged by their locations. It also appears that some offices within a five-minute walk still would have suffered disproportionately if their nearest stations have unfavourable connectivity via Tokyo's train network.

To sum up our findings in this section, we have seen that the average building age and accessibility of submarkets are significant factors in determining rental corrections seen during the pandemic, which is in line with the arguments we have made in our previous reports. In particular, building age was a good variable to explain the differing performances among submarkets during the pandemic. With these findings in mind, we will discuss the prospects for the Tokyo office market in the next section.

PROSPECTS FOR THE TOKYO OFFICE LEASING MARKET

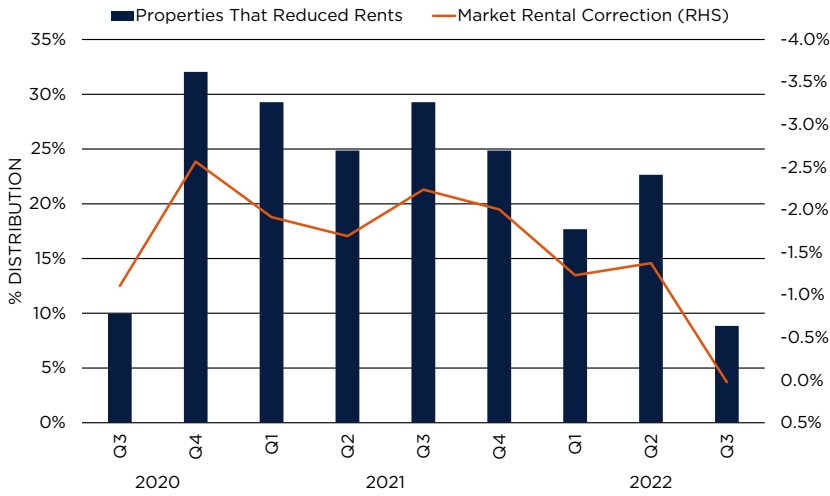
In recent quarters, prospects for the Tokyo office market have improved. As Japanese society is nearing normalcy, the Tokyo office market appears to have its bottom in sight with vacancy rates stabilising and rental corrections moderating. Indeed, the average market rent of Grade A offices stayed flat in Q3/2022 for the first time since Q2/2020 [Tokyo Office Leasing Q3/2022]. With the

GRAPH 7: Impact of Walkability on Rental Change of Grade A Office in the C6W, Q2/2020 vs Q3/2022



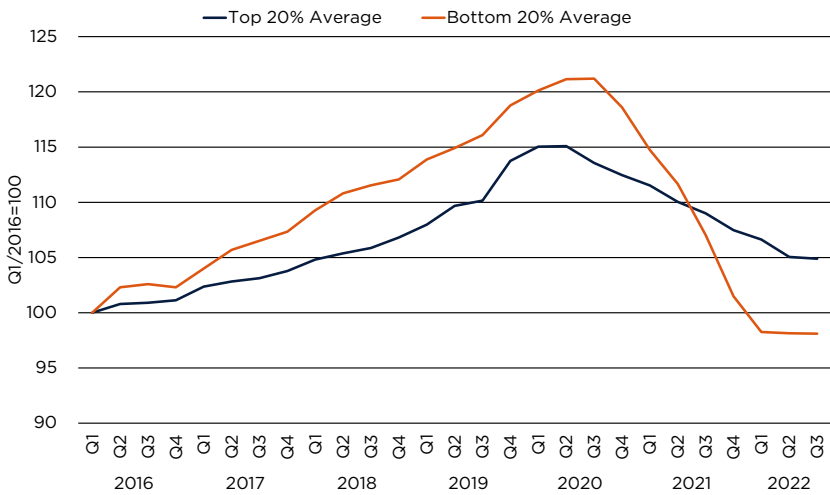
Source Savills Research & Consultancy

GRAPH 8: Grade A Offices that Reduced Rents and Market Average Rental Correction, Q3/2020 to Q3/2022



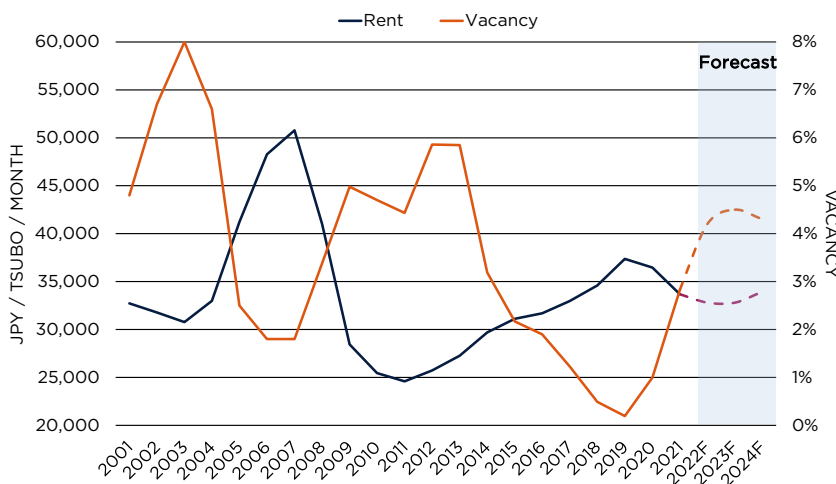
Source Savills Research & Consultancy

GRAPH 9: C5W Grade A Office Rental Index (Top 20% Average vs. Bottom 20% Average), Q1/2016 to Q3/2022



Source Savills Research & Consultancy

GRAPH 10: Grade A Office Vacancy and Rent Forecast through 2024F



Source Savills Research & Consultancy

market average rent having reversed back to the levels seen in 2017, tenants seem to be finding current rents reasonable.

Nonetheless, considering the discussions in the previous section, we expect future recovery to be uneven across the market. One indicative chart is Graph 9, which suggests that properties in the bottom 20% in terms of rental levels have suffered disproportionately more than the top 20%. It is especially interesting to see that the former is now below 2016 levels while the latter has maintained 2018 levels. This might indicate that some lower-rent properties have been caught in price competition.

Going forward, we believe that submarkets and properties that saw larger corrections will continue to have hard times ahead. In fact, while good quality properties with convenient access have been able to attract tenants who find their current rental levels reasonable, other properties with relatively low rents are struggling to fill space even with aggressive discounts and prolonged free rental periods. These properties were able to attract tenants when the market was extremely tight, but their allure of affordability has faded in the current market environment where quality offices can be secured at reasonable rents. This explains how the rental level of the bottom 20% plunged much more than the top 20% in Graph 9.

At the submarket level, this suggests that prime submarkets such as Marunouchi and Shibuya are likely to exhibit steady recovery as the demand for highly regarded office towers in these areas will likely continue to be strong. This is particularly true for Grade A offices around Shibuya station, which have very tight vacancy rates and are likely to lead the recovery. Indeed, many office towers around the station have not reduced rents for over a year, and pre-leasing for the Sakuragaoka Project appears to be going smoothly.

On the other hand, the submarkets with older office buildings will likely lag others in recovery. Specifically, the submarkets such as Shinjuku and Shinagawa & Osaki have seen larger rental corrections primarily due to their older office stock, and might take more time to return to the pre-pandemic level. As we discussed in previous reports, Shinjuku's redevelopment has lagged other submarkets, as many office towers in the submarket were built between the 1970s and 1990s. While they go through regular renovations, Shinjuku's relative competitiveness appears to have dwindled with other submarkets seeing new, state-of-the-art towers built in recent years.

Shinagawa & Osaki also has a relatively aged stock with many built in the 1990s

and early 2000s. To be sure, these office buildings are not necessarily old. However, the difference for Shinagawa & Osaki is that the submarket was formed relatively recently, and there are no Grade A office towers that were built before the 1990s. As a result, the submarket has not seen as many new offices since its buildings are not aged enough to be redeveloped, making the average age relatively high. That said, several development projects are underway around Shinagawa station and Takanawa Gateway station. Those large-scale mixed-use projects could provide a boost for the area's long-term growth.

Putting everything together, we continue to expect a gradual recovery for the overall Tokyo market over the next few years. As discussed above, while stronger properties should see faster recovery, weaker ones will likely drag the market down, which together will likely result in mild recovery for the Tokyo office market as a whole. Although there were no substantial changes from our previous forecast in June, we have made some downward adjustments reflecting more recent figures (Graph 10).

Specifically, actual vacancy rates have been higher than we expected partially because pre-leasing for new office towers completed this year was slower than our initial assumption. Additionally, recent developments in the global economy including the prolonged war in Ukraine, persistent inflation, and global quantitative tightening have prompted us to lower

the rental growth expectation in 2024. Nonetheless, Japan's economy is faring relatively better than its global peers with inflation remaining at manageable levels. Furthermore, corporate performances are still improving albeit at a modest level, and active pre-leasing for supply in 2023 also bodes well for next year.

CAPITAL MARKET

Although the Tokyo office market is not out of the woods, investor appetite in this sector remains strong. Most noticeably, it has been announced that a consortium led by Hulic will acquire the Japanese government's portion in Otemachi Place for about JPY400 billion, which is said to be the highest price paid for a single commercial real estate property in Japan. The property reportedly saw strong interest from various buyers, including overseas institutional investors. Based on the price and the quality of the property, the cap rate is likely closer to the lower end of the 2 to 3% range.

Elsewhere, while investment opportunities remain scarce in prime submarkets, properties outside of prime submarkets also attract strong interest especially if they are considered to have room for value-add. For instance, some properties transacted in 1H/2022 appear to have received strong interest as potential buyers were able to underwrite lease-up strategies, although their locations were not ideal.

One reason for Japan's continuing allure is

its attractive yield spread compared to global peers. Although there is mounting pressure on the BOJ to tighten its monetary policy, the bank has adamantly kept its current stance unchanged. A further weakening of the yen could urge the BOJ to adjust policies more quickly, but increases in interest rates are nonetheless expected to be moderate. As such, Japan's real estate market, especially Tokyo, should maintain its relative attractiveness over its global peers. Indeed, some investors such as Gaw Capital Partners see the current weak yen as an opportunity to leverage and reap higher returns.

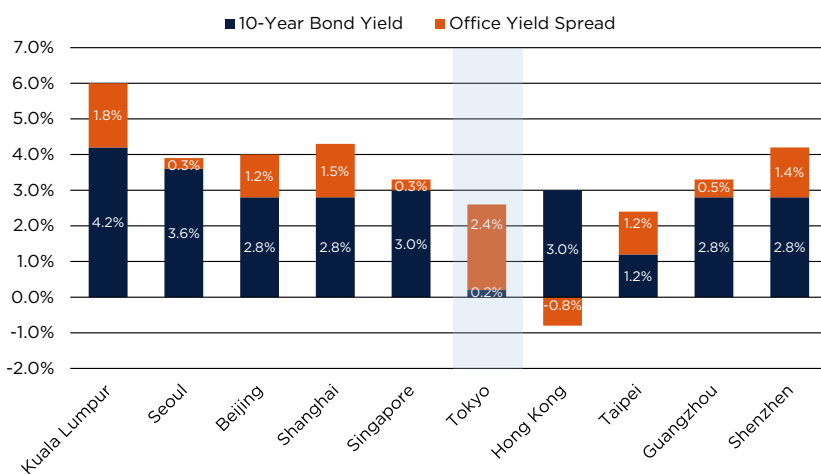
OUTLOOK

The Tokyo office market has continued to see moderate corrections, as several offices have still been prompted to lower rents to retain tenants. Downward pressure is likely to stay considering that vacancy rates are still loosening. However, there are signs of bottoming out, with some properties seeing rents stabilise or even edge up in recent quarters.

Considering that the pandemic impacted different submarkets differently, their recovery is also likely to be uneven across the market. While the submarkets with older office stock appear to have experienced larger rental corrections, the ones that have seen recent redevelopment have been weathering the pandemic better. The connectivity of submarkets and accessibility of individual properties appear to have influenced performances throughout the pandemic as well. When recovery starts in earnest, the submarkets and properties that have exhibited resilience and maintained low vacancy thus far are likely to bounce back first. Furthermore, this pattern will likely be pronounced due to the implementation of hybrid work styles. Relatively new properties with good accessibility are more suitable to meet new needs created by alternative work styles.

That being said, it is worth noting that these only represent average patterns that manifested in the aggregated data, and there is large variance that cannot be explained by our simple regression models. This indicates that it is possible for underperforming properties to break free from general market trends with the right strategies. Specifically, shrewd investors should be able to identify properties with opportunities and increase value with the right strategies and capital expenditures in place. In this process, the framework we have presented in this report should become a useful guide as it provides

GRAPH 11: Grade A Office Spreads, Q2/2022



Source Savills Research & Consultancy

rough estimates of expected rents accounting for hard factors such as building age and accessibility.

Overall, the recovery of the Tokyo office market is likely to be gradual on average. Although vacancy rates are likely to be slightly higher than we expected earlier this year, the active pre-leasing for supply in 2023 bodes well for the market. The decreasing number of properties that are prompted to lower rents indicates that rents have come

down to levels which tenants find reasonable.

Additionally, considering that Japanese companies have seen improvements in profitability in recent quarters, rental levels have become relatively more affordable, and Japan's progression towards a post-pandemic society should also prop up office demand going forward.

That said, if economic conditions sour, our current base scenario might prove optimistic.

Indeed, as central banks grapple with inflation and in turn continue to tighten their monetary policy, another global economic recession is becoming likely. Although Japan is faring better in terms of inflation, a potential slowdown of the global economy is likely to delay the office market recovery in Tokyo. If this happens, the divergence between overperformers and underperformers may deepen further.



For more information about this report, please contact us

Savills Japan

Christian Mancini
CEO, Asia Pacific
(Ex. Greater China)
+81 3 6777 5150
cmancini@savills.co.jp

Savills Research

Tetsuya Kaneko
Managing Director, Head of
Research & Consultancy, Japan
+81 3 6777 5192
tkaneko@savills.co.jp

Yoshihiro Kanno
Senior Manager, Research
& Consultancy, Japan
+81 3 6777 5275
ykanno@savills.co.jp

Simon Smith
Regional Head of Research
& Consultancy, Asia Pacific
+852 2842 4573
ssmith@savills.com.hk
