

Japan - June 2021

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**SPOTLIGHT**  
Savills Research

# Tokyo Office Supply



# Whilst the worst appears to be over, concerns linger over secondary vacancy and future supply

## Summary

- The large influx of supply that 2020 brought to the Grade A office market has been mostly absorbed. With limited supply expected in 2021 and 2022, the Tokyo office market should have time to cope with the secondary vacancy that is likely to emerge later this year.
- The next milestone for supply in the central five wards (C5W) will be in 2023, with nearly 350,000 tsubo of GFA estimated to come online. Thereafter, 2025 will be in focus with an estimated 500,000 tsubo of GFA coming online.
- Toranomom, Minato will lead the next supply influx in 2023 and 2024 with the completion of the Toranomom-Azabudai project. Other submarkets such as Shibaura & Hamamatsucho and Shibuya will also be seeing large supply.
- Various economic indicators are showing that the economy is undergoing recovery, although the delayed start of vaccinations in Japan may slow the recovery of the overall economy, including the Tokyo office market.
- As the post-pandemic world comes into view, the office market has started to show its ability to adapt by addressing diversifying tenant needs. Location, and to a lesser extent flexibility in leasing, now matter more than ever in order to attract tenants.
- Mixed-use office developments will have features and amenities that meet the diverse demand of tenants, including a flexible work style that is expected to stay post-pandemic.

## SUPPLY PIPELINE

Until recently, competition for new office space was so fierce that buildings would often be fully leased long before completion. For this reason, the office market had fared better than expected, despite looming concerns over the significant levels of supply in 2018 and 2020. Needless to say, the COVID-19 outbreak in early 2020 has clouded the sector's previously optimistic prospects, and this is reflected in both Grade A office vacancy rates and rents in the C5W. For instance, the former saw a marked loosening from near zero to 1.2% as of Q1/2021. Meanwhile, rents have declined 5.3% year-on-year (YoY) to JPY35,800 per tsubo per month over the same period. At the ward level, having notably outperformed its peers pre-pandemic, Shibuya bore the brunt of the pandemic as a result of its larger tenant

pool of technology companies. Looking ahead, with office demand weakening, secondary vacancy derived from last year's supply is likely to materialise later this year and may exacerbate the current situation. That said, the limited supply in 2021 and 2022 should provide a much-needed respite for the market, with both years expecting to see less than 30% of the supply in 2020 (Graph 1).

Turning to specific developments expected in 2021, notable projects include Tokiwabashi Tower<sup>1</sup>, the first phase of an even larger project which includes Torch Tower – expected to be Japan's tallest office tower in 2027, and Hibiya Fort Tower<sup>2</sup>. Somewhat impressively, these two projects alone will account for around 50% of the 130,000 tsubo of GFA that the C5W will see this

<sup>1</sup> Formerly Tokiwabashi Project Building A  
<sup>2</sup> Formerly Shinbashi Tamuracho Project

TABLE 1: Major Development Projects in Tokyo, 2021 to 2025

BUILDING NAME	SUBMARKET	FLOORS	GFA (TSUBO)	YEAR
Tokyo Torch Tokiwabashi Tower	Marunouchi & Otemachi	37	44,000	2021
Hibiya Fort Tower	Toranomon & Kamiyacho	27	32,000	
Tokyo Midtown Yaesu	Nihonbashi & Yaesu	45	86,000	2022
Toranomon · Azabudai A	Toranomon & Kamiyacho	65	140,000	2023
Toranomon · Azabudai B1	Toranomon & Kamiyacho	63	51,000	
TTM Project	Shibaura & Hamamatsucho	29	34,000	
Toranomon Hills Station Tower (Formally 1&2 Chome A)	Toranomon & Kamiyacho	49	77,000	
Park Tower Kachi Doki Mid	Nihonbashi & Yaesu	45	42,000	
Shibuya Sakuragaoka A	Shibuya & Ebisu	39	56,000	
Toranomon 2-Chome Centre Redevelopment (Business Tower)	Toranomon & Kamiyacho	38	55,000	2024
Mita 3-4 Chome A1	Shibaura & Hamamatsucho	42	60,000	
Shin-Toda Building	Nihonbashi & Yaesu	28	31,000	
Akasaka 2 Chome Project	Akasaka & Roppongi	43	63,000	
Shibaura 1 Chome Project S	Shibaura & Hamamatsucho	45	68,000	2025
Nihonbashi 1 Chome C	Nihonbashi & Yaesu	51	112,000	
Nishi Azabu 3 Chome NE	Akasaka & Roppongi	55	30,000	
Yaesu 1 chome East B	Nihonbashi & Yaesu	54	68,000	
Shinagawa Redevelopment Project 1st Phase 3rd Block	Shinagawa & Osaki	31	64,000	
Shinagawa Redevelopment Project 1st Phase 4th Block	Shinagawa & Osaki	30	139,000	
Higashi Ikebukuro 1-Chome Project	Ikebukuro	30	44,000	
Hamamatsucho 2-Chome A-1 Tower	Shibaura & Hamamatsucho	37	44,000	
Toranomon 1-Chome East Redevelopment	Toranomon & Kamiyacho	30	38,000	

<sup>1</sup>Projects with total GFA of over 30,000 tsubo  
Source Savills Research & Consultancy

year. Next year, the largest project will be Tokyo Midtown Yaesu, the third Midtown project following Tokyo Midtown and Tokyo Midtown Hibiya (Table 1). In fact, the Yaesu area is undergoing a complete overhaul, with multiple large-scale projects scheduled to be completed by 2030.

Following these two relatively quiet years, the next wave of large supply is expected in 2023. Interestingly, one notable characteristic of this influx is the high concentration of a small number of large-scale projects within the Toranomon submarket. Namely, the Toranomon Azabudai project and the tentatively named Toranomon Hills Station Tower by Mori Building, which will bring approximately 100,000 tsubo of NRA to the market in total. Whilst sizeable, there is plenty of appeal for these projects, especially given the past success of the redevelopment of Roppongi. Indeed, the attraction of being in a city within a city and the immaculate local infrastructure that underpins the area are certainly some of the factors that may steal some of the limelight from other developments slated for 2023. In the same submarket, the business tower of the Toranomon 2-chome redevelopment project, which is being carried out by a consortium of six companies<sup>3</sup>, will provide another 30,000 tsubo of NRA.

Considering that all these projects in Toranomon represent well over 10% of the ward's overall office stock on an NRA basis, it clearly provides a sense of the scale of what is to come that year. As such, absorbing such a high level of office space in the same submarket simultaneously will not be an easy task, and the likely result will be a temporary softening of the market. Unsurprisingly, the reaction to this new supply has the potential to change the direction

<sup>3</sup> Nippon Steel Kowa Real Estate, Dai-ichi Life Group, Kanden Realty & Development, Tokyo Gas Real Estate, Kyushu Railway Company, and Taisei Corporation.

## The shift towards teleworking appears manageable for the Tokyo Grade A office market for now. Even so, looming concerns remain over the emergence of secondary vacancy from offices newly supplied during 2020, as well as the elevated supply levels expected in 2023. For the time being, the market has paused, while the acceleration of the vaccine rollout should act as a tailwind for an eventual economic recovery, and by proxy, a revival of office demand.

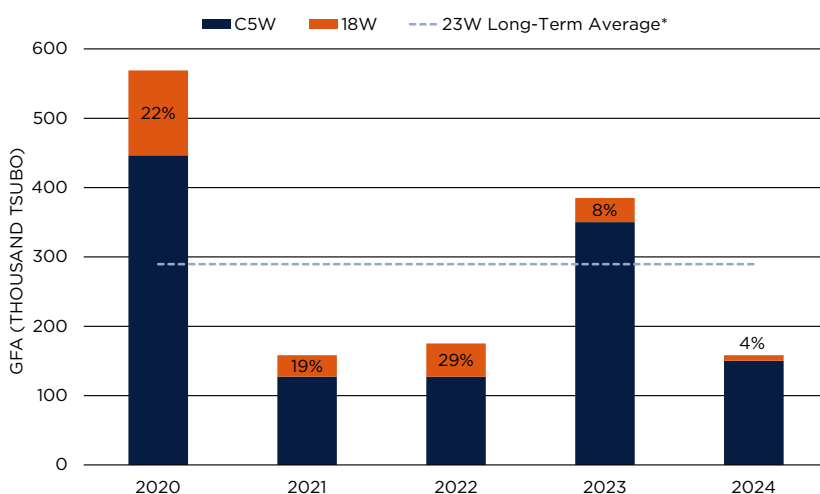
of the overall Tokyo office market moving forward. On top of Toranomon, Minato appears to have a packed schedule with other large single-building developments. Some of these may struggle especially when compared to the comprehensive developments in Toranomon.

Not wanting to be left out, another ward that will also see a large influx of supply in 2023 is Shibuya. However, it is not all good news with the ward at a delicate juncture. Looking at Shibuya before the onset of COVID-19, for instance, the ward seemed to have it all: vacancy levels were at rock-bottom, and rental growth comfortably outpaced its peers thanks to its newfound status as a hub for technology

firms and start-ups. Thus, any additional supply appeared welcome, and even necessary to relax its air-tight office vacancy. When the pandemic hit, however, these tenants were quick to adopt remote work arrangements, and the submarket quickly saw a notable weakening in demand. Against this backdrop, large-scale projects such as the Sakuragaoka District redevelopment – adding over 20,000 tsubo of NRA to the market, approximately 10% of Shibuya's Grade A office stock – have the potential to disturb the delicate equilibrium between supply and demand at present. Even so, over the longer term, the area maintains its strong appeal as a hub for the technology sector. And with the ever-growing calls for digital transformation (DX) in Japan acting as a tailwind for the sector, demand for office space should strengthen as a result. At the same time, there are also positives on the supply side. Here, Tokyu Land – a driving force behind Shibuya's redevelopment – has been experimenting with flexible lease terms which should be particularly appealing to the fast-moving start-ups that the ward is trying to attract. Nonetheless, with plenty of uncertainties lingering, the sudden supply spike in 2023 could be worrisome.

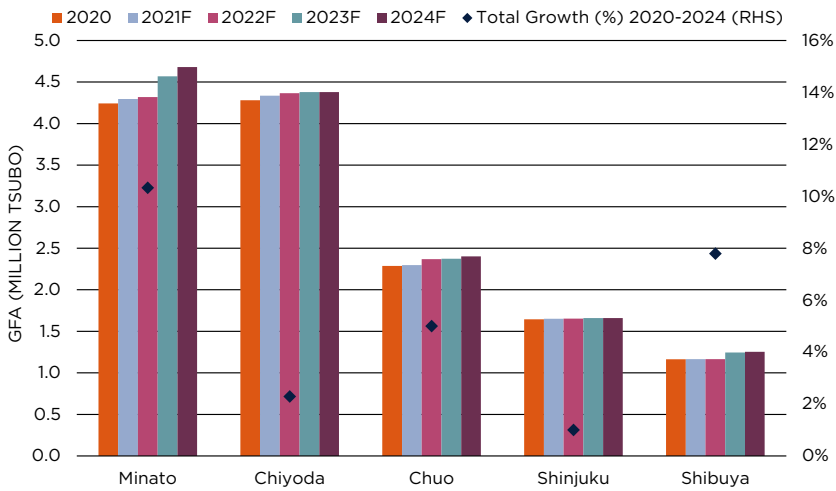
Not only has there been an adjustment in the supply of offices over the past few years, but change is also afoot in the buildings themselves. Specifically, the increase in mixed-use developments has brought additional foot traffic to the area, whilst also providing landlords with diversified streams of revenue. A prime example of this is Tokyo Hibiya Midtown – completed in March 2018 – which welcomed around 22 million visitors, and with it, brought in nearly 16 billion yen in profits within its first year of opening. Elsewhere, another new development: Shibuya Scramble Square,

**GRAPH 1: Combined Office Supply (GFA) Estimates for the C5W and the 18W, 2020 to 2024**



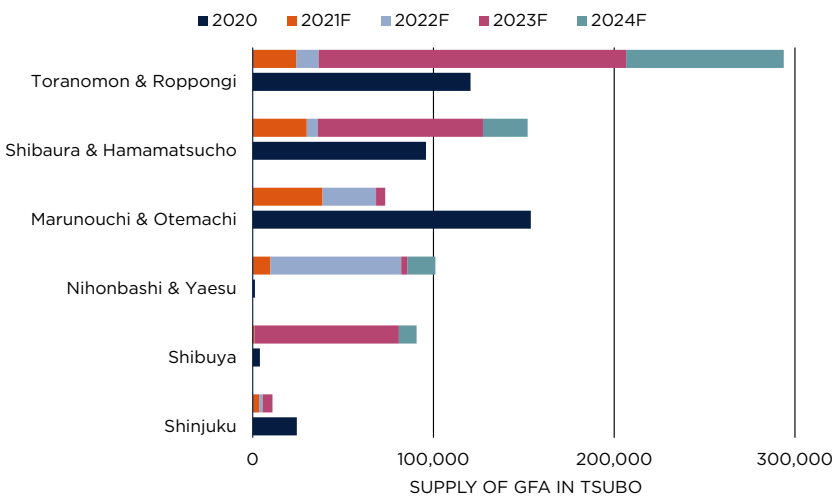
Source Savills Research & Consultancy  
\*From 2020 to 2024

**GRAPH 2: Total Office Stock by Ward and Percentage Increase, 2020 to 2024**



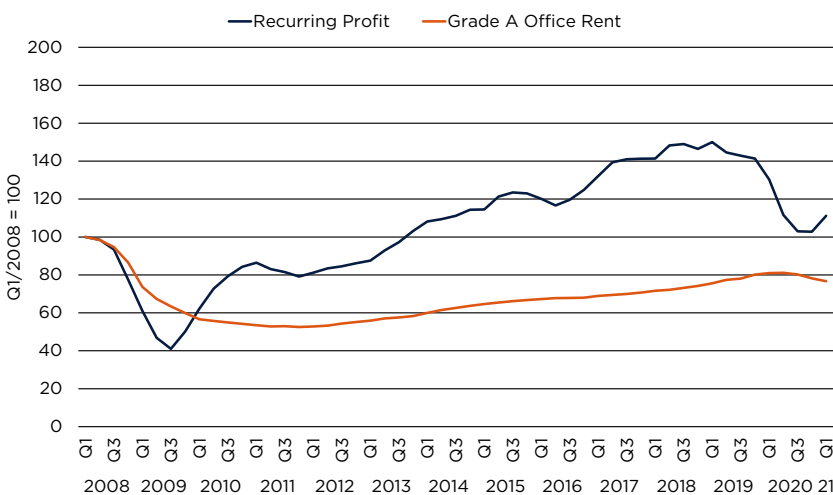
Source Miki Shoji, Savills Research & Consultancy

**GRAPH 3: Supply by Submarket, 2020 vs 2021 to 2024**



Source Savills Research & Consultancy

**GRAPH 4: Grade A Rent vs Corporate Profits Index, 2008 to Q1/2021**



Source Ministry of Finance, Savills Research & Consultancy

welcomed nearly 6 million visitors in the first four months of its opening in November 2019.

With the appeal of these mixed-use offices clear to see, their adaptable and diverse tenant demand, where a flexible work style is more common, should be particularly well-suited in the post-pandemic environment. Further emphasising this view is the fact that residential units in these areas have remained popular due to their prime urban locations. Impressively, according to the Real Estate Economic Institute, the average 23W Tokyo condominium price per sq m increased by 11% YoY in 2020. Furthermore, this trend is unlikely to wane any time soon considering that the C5W has experienced some of the highest population growth over the last decade, whilst simultaneously boasting a greater ratio of workers working and living in the same ward compared to the other 18W. Indeed, the vibrancy that these mini communities could bring to the local area will certainly be of benefit to tenants and landlords alike, potentially boosting the value of the surrounding amenities.

To sum up, these major projects expected in 2023 should attract strong interest due to their favourable locations, state-of-the-art facilities and the mixed-use components that will supplement these developments. At rental levels that are reasonable enough to attract tenants to fill large floor plates, we believe these projects could capture expansion and relocation demand from tenants in older office buildings. That said, concerns remain. In particular, the concentration of large supply in a certain area at the same time is likely to soften the market temporarily at the very least. A more imminent challenge for the Tokyo market could be the secondary vacancy derived from the large 2020 supply. As discussed in the later section, whether there will be sufficient demand to fill the gap should depend on how fast the economy is able to recover.

**ECONOMIC CONDITIONS**

2020 was clearly a troubled year for the Tokyo office market, with vacancy rates and rents weakening considerably in concert with a contracting domestic economy. Some green shoots have emerged, however. For starters, according to the March 2021 Tankan<sup>4</sup>, confidence is slowly returning to a majority of companies, irrespective of size. Moreover, Japanese corporate performance has rebounded strongly from the sharp declines during the second and third quarters of 2020 – posting a 20% YoY gain in recurring profits as of Q1/2021. Further, a third of listed companies in Japan have announced plans to increase dividends in this fiscal period. Of course, whilst cost-cutting can partly explain this improvement, a sharp uptick in exports of products such as cars and electric equipment to the U.S. and China has also been a major boon. To be sure, the recent restrictions on business hours and

<sup>4</sup> Tankan is a short-term economic survey of nearly 10,000 enterprises in Japan conducted by the Bank of Japan.

the delayed start of the vaccine rollout will undoubtedly slow the return of employment and discretionary in-store spending to pre-pandemic levels. Overall, however, with some momentum building, a moderate recovery is still expected in 2021, and this is backed up by respondents of the Tankan indicating a general optimism for growth during the rest of the year.

In truth, economic activity is likely to recover in earnest in 2022, and this includes the much-maligned hospitality sector. By mid-2022, domestic demand should be back in full swing, driving the country's GDP back to pre-COVID levels – something that is vital if there is any hope for the large office supply in 2023 to be absorbed. Indeed, the successful economic recovery is likely to rekindle concerns of a labour shortage, which is expected to support

Grade A office demand as attracting talent becomes more difficult. Specifically, high-end modern buildings are especially likely to have a competitive advantage in such an environment. Indeed, amid the proliferation of teleworking environments, these offices will surely reinvent themselves as a place of collaboration and in-person social interaction. Moreover, further emphasis will be placed on central locations and convenient access to maximize the number of staff who can easily commute to the office, now that commuting for some is viewed as a productivity drain. Tenant movements toward these offices in convenient locations will keep prime areas sound over the mid-term.

Whilst an overall recovery in the office sector may become more apparent, it is doubtful that this will be the case for all grades and locations.

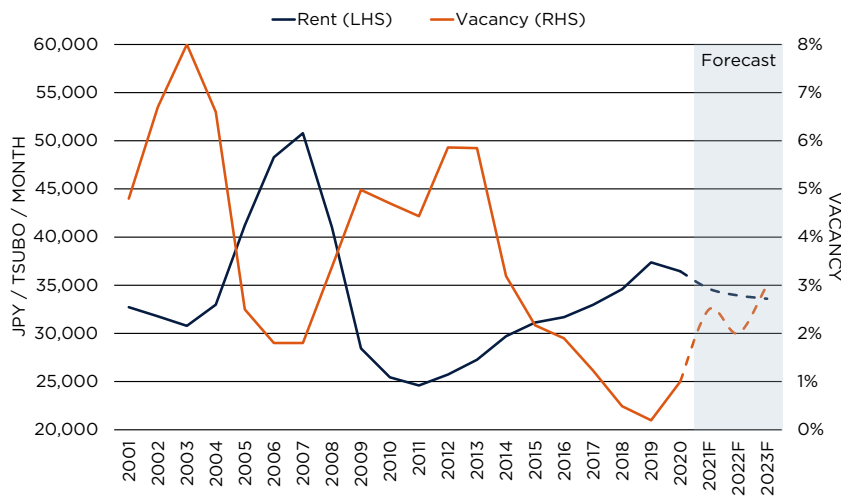
Understandably, with some flexible work arrangements now a permanent fixture of daily life, it will be a challenge for office utilisation rates to return to previous highs. Also, the fact that office interior design companies have seen strong performance may be an indicator of what will come next. Indeed, some companies may return extra office space and have a free-address layout instead, while other financially weaker tenants may continue to vacate permanently to reduce costs.

**FORECAST OF RENT AND VACANCY**

Given the discussions thus far, we expect vacancy rates to loosen and rents to see further corrections during 2021. Clearly, the delayed start of the vaccine rollout will stall any chance of bringing workers back to the office, and the manifestation of secondary vacancy from the large supply in 2020 will impede Tokyo's office market recovery. This will be especially apparent in office buildings that are less accessible. On the plus side, 2022 should serve as a buffer and provide enough time for the economy to fully open.

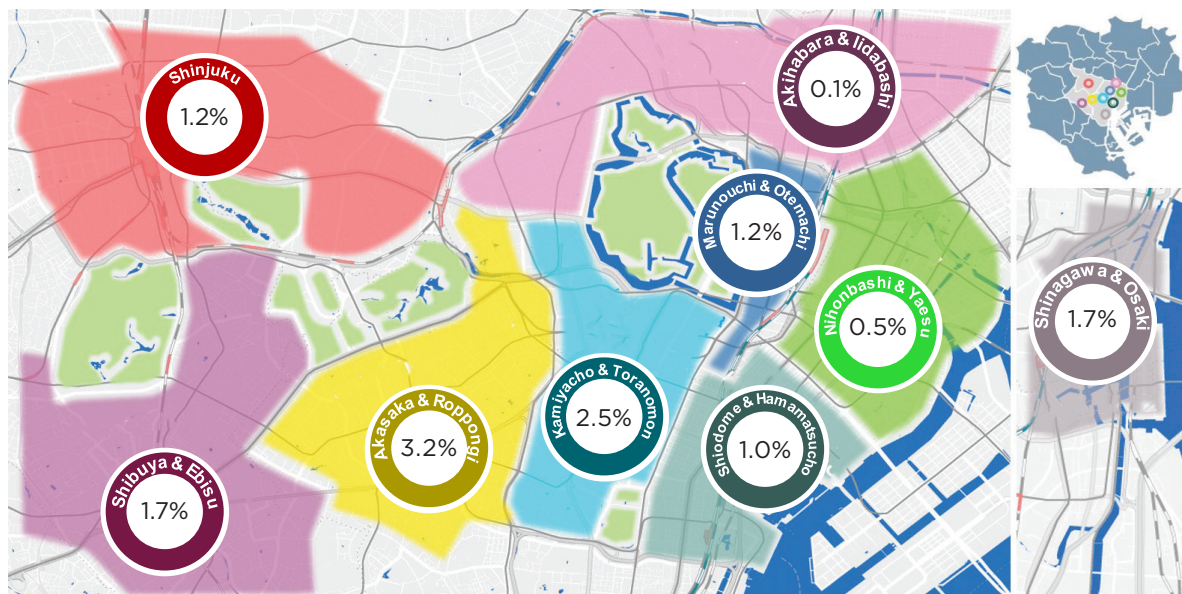
Further down the line, the aforementioned supply influx in 2023 remains a headache. Any pain will be soothed, however, with the full recovery of the Japanese economy and subsequent rekindling of office demand helping push rents higher once more. Moreover, not only is 2023 a significant year for office supply, but it is also likely to have ramifications for the next wave slated for 2025 – where supply is currently forecasted to be more than 40% larger than the supply in 2023. Whilst concerns regarding vacancy are too early to assess, it is worth noting that a large proportion of the total supply, most of which is Grade A, is attributed to a few developers. As such, they may shift their focus towards tenants with

**GRAPH 5: Grade A Vacancy Rate and Rent Forecasts, 2001 to 2023F**



Source Miki Shoji, Sanko Real Estate, Savills Research & Consultancy

**MAP 1: Vacancy within each submarket as of May 2021**



Source Savills Research & Consultancy

better creditworthiness and building long-term relationships with prospective tenants, rather than achieving higher rents. Not only would this help alleviate some concerns over vacancy, but it should also positively impact market sentiment during the influx of new supply. 2023, therefore, looks set to be pivotal for the longer-term health of the market.

When looking at the ward-level, some are expected to outperform others. Here, Chiyoda and Chuo should remain stable given their concentration of large Japanese corporations, ease of access, and central locations. In fact, Chiyoda is the only ward that has managed to hold vacancy levels flat since the onset of COVID-19. Elsewhere, Minato, which witnessed a similar amount of GFA expansion in 2020 as Chiyoda, has been dealt the double whammy of loosening vacancy rates and rents falling by double in comparison. Perhaps the fact that two of Minato's main submarkets have almost double the vacancy of other submarkets within the C5W (Map 1) is partly to blame. Meanwhile, Shibuya's rents and vacancy have stabilised after a sharp correction, maybe suggesting that a liking for more central offices near major transit hubs still rings true.

To sum up, due to a somewhat frail economy, combined with the effects of flexible working practices reducing the need of office space, we predict that rents will continue to weaken heading into 2023 (Graph 4). At the same time, while vacancy levels in less convenient parts of the city rise, rates in prime areas and superior buildings should remain sound. As a result, we expect a slight loosening over the same period, although some tightening may emerge in 2022 as rents adjust to attract tenants.

### OUTLOOK

Whilst the COVID-19 outbreak has dampened any previous optimism, there are some signs of stability when looking at certain sections of the market. On one hand, the pandemic has inadvertently cancelled many plans to expand, with some tenants now looking to downsize. Yet, the two largest developments this year, Tokiwabashi Tower and Hibiya Fort Tower, are almost entirely pre-leased. Even more impressive is the fact that office supply planned for 2021 is over 80% pre-leased or filled. Indeed, it would seem that newer developments within the Grade A office market should be able to demonstrate stability, whilst ill-located offices may be on course to struggle.

Meanwhile, the market's reaction to the proliferation of remote work continues to add to the uncertainty. At the same time, efforts to accelerate DX could further change working practices and possibly the high-context work culture in Japan – a potential headwind to the mid-term prospects for the sector.

Fundamentally, however, the office is necessary as a place for collaboration, nurturing corporate culture, and creating a sense of belonging. Hence, we predict that a hybrid model will gain more ground, as it has in the past months, with free-address layouts increasing dramatically. Landlords who find themselves leaning towards this style may find it advantageous to offer flexible lease contracts and pre-established office spaces. In such a model, employees will generally go to the main office but occasionally utilise a satellite office closer to residential hubs or work from home, even post-pandemic. Also, a hybrid model on a large

scale will make commuting to central offices easier with less crowded trains, as well as increase the space and comfort at central offices. It is not surprise, therefore, to see a rapid expansion of such services in response. Whilst demand for these satellite offices is strong, it is likely to be limited to convenient locations such as station fronts where employees can easily commute to. In contrast, in the case of lower grade offices, employees are more likely to commute every day as a result of the inadequacies in the IT infrastructure of a typical tenant.

Looking ahead, whilst the sharp uptick in supply slated for 2025 remains far off, the current plans for expansion are worth keeping in mind. Even so, with major market participants in that year suffering financially as a consequence of the pandemic, plans may change and/or be delayed. The much-discussed Maglev Line project, meanwhile, is set to be delayed and there does not appear to be much impetus to accelerate the development in Shinagawa, where the terminal station is planned.

All things considered, therefore, the largest concerns for the market in the short-term are twofold: secondary vacancy deriving from last year's supply, and the next surge in 2023. With plenty of uncertainties in between, including the timescale for a vaccine rollout-induced economic recovery, market participants will keep a keen eye on the sector's preparedness heading into 2023 during these quieter years. For now, the market is likely to demonstrate some stability, with any adjustments being manageable, particularly concerning the normalisation of teleworking practices.



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