Japan - June 2022

SPOTLIGHT
Savills Research

# Tokyo Office Supply

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# Total office demand remains stable


**Summary**

- Supply volumes in recent years have affected submarket performances during the pandemic, especially in Minato and Chuo.
- While the supply wave in 2023 is a concern for some submarkets, market fundamentals are expected to gradually recover, supported by improving economic conditions.
- Shinjuku has been slow regarding new developments, but now has several major redevelopment plans in the pipeline. Meanwhile, Shibuya's multiple development plans will transform the district.
- In the long term, continuous redevelopment could be an increasingly important differentiator among submarkets as workers may need stronger incentives to commute to the office.
- Pre-leasing for major projects slated to open in 2023 is picking up.
- Vacancy rates may edge up through 2022 and 2023 as more new offices open, but rents are expected to stabilise as many prime offices are reasonably priced now.
- Demand for satellite offices is expected to grow as telework becomes an essential part of office strategies, creating new office demand.


**INTRODUCTION**

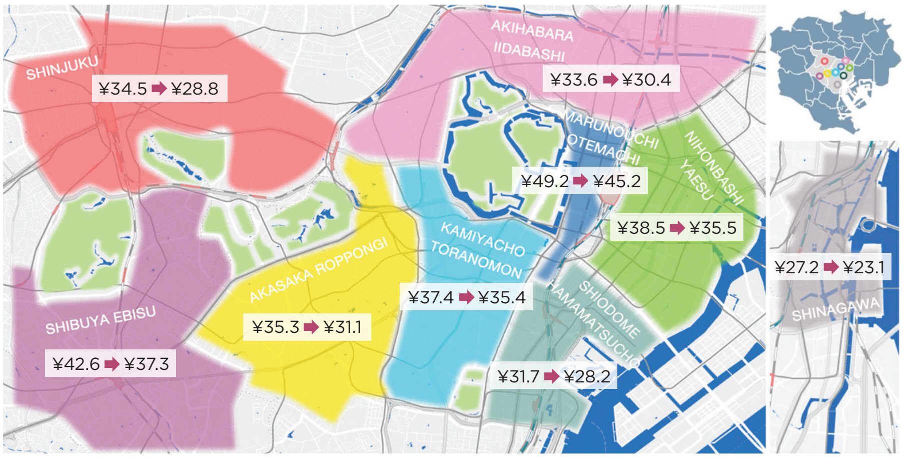
Prior to the pandemic, Tokyo's office market exhibited resilience with extremely tight vacancy and rental growth. Although there were some concerns about the large supply leading up to the 2020 Olympics, the growing office demand appeared to have filled any additional space that entered the market. Indeed, pre-leasing was so strong that a majority of new offices opened fully leased or close to it.

However, the pandemic has abruptly halted this trend. Even after two full years, gradual corrections have persisted, and the average rent of Grade A offices in the central five wards (C5W) was JPY33,266 per tsubo as of Q1/2022 - a 12% decline from its peak in Q2/2020, effectively reversing back to levels seen in Q1/2018.

The negative impact has been felt across Tokyo, although the degree of correction varies depending on the submarket in question (Map 1). Submarkets in the west of Tokyo, particularly Shibuya/Ebisu and Shinjuku, have experienced large declines. On the other hand, more central submarkets such as Marunouchi/Otemachi and Toranomon/Kamiyacho have performed comparatively well thus far. While there are several factors that have contributed to the diverging performances, one notable factor could be the different levels of supply in recent years.

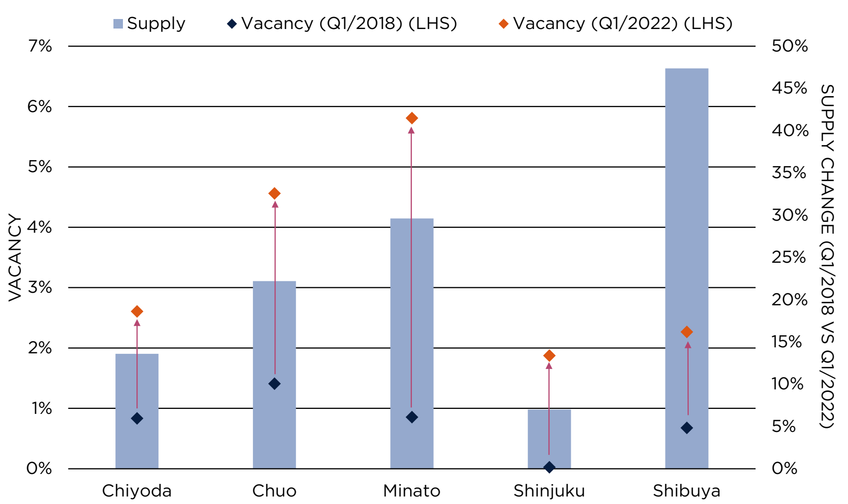
As mentioned above, the current rental level for Grade A offices is approximately in line with the level in Q1/2018. However, current vacancy rates are higher than those in

**MAP 1: Grade A Office Rent by Submarket, Q2/2020 vs Q1/2022**




**Source** Savills Research & Consultancy

**GRAPH 1: Grade A Office Vacancy vs Office Stock Growth, Q1/2018 vs Q1/2022**




**Source** Savills Research & Consultancy

Q1/2018, and wards where larger amounts of supply have been introduced have generally seen larger vacancy increments (Graph 1). Specifically, Chiyoda experienced a relatively small increase in supply during this period, and its vacancy increment is milder when compared to Minato and Chuo, which have both seen larger amounts of supply. In addition, the lower level of supply is also thought to have helped rental stability in submarkets such as Marunouchi/Otemachi.

At the same time, Shibuya had the largest supply, but its vacancy increment was the smallest. However, Shibuya still has the smallest office stock in the C5W by far. Also, the smaller loosening in vacancy was likely aided by the large corrections in rent considering that Shibuya substantially lowered rents during the pandemic. In fact, with more reasonable rental levels, Shibuya has started seeing more leasing activity.

Although the emergence of telework as a new threat to office demand has shifted the focus of recent discussions away from office supply, it remains important to have a good understanding of future supply and its implications. Although the supply over the next five years will be smaller than what was seen in the past, the large supply expected in 2023 and 2025 could further weaken some submarkets given that the market remains fragile. This is especially true for older offices, because while new offices tend to have an easier time filling empty space, the secondary vacancies that arise in older offices put them in a more vulnerable position. In this report, we will summarise future office supply trends and major projects that investors should look out for. Furthermore, we will discuss how teleworking will likely shape the future of the office market.

**The Tokyo office market remains stable, although submarkets that have seen large amounts of supply have shown signs of weakness during the pandemic. Market fundamentals are gradually improving, and this has alleviated some concerns over the supply wave in 2023. In general, quality offices at the right price remain sought after. While hybrid work styles have transformed some office needs, total office demand appears stable.**

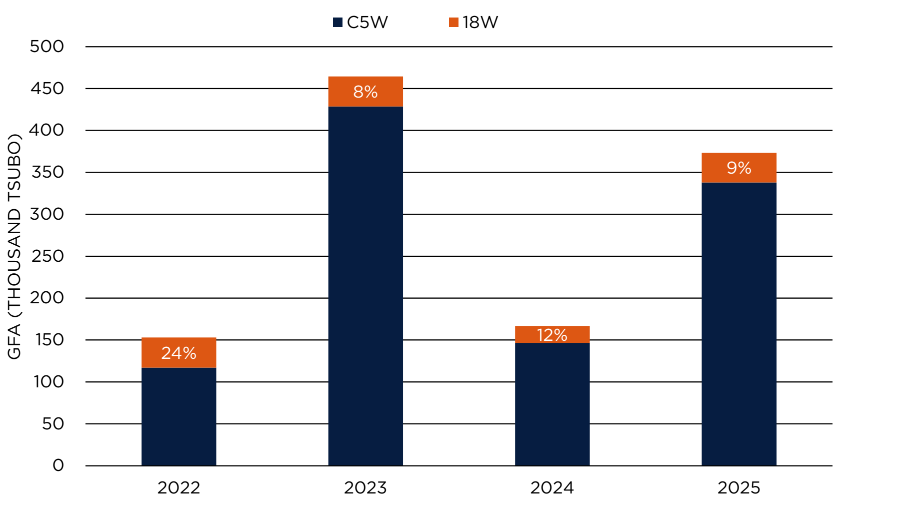
## SUPPLY PIPELINE

In 2021, several new large-scale office towers were completed and have become new landmarks in Tokyo. Although pre-leasing was not as robust as what was seen during pre-pandemic times, they managed to fill most floors, and their impact on the market vacancy rates was mild. Specifically, Tokiwabashi Tower, the first phase of a larger project with Torch Tower, was completed in June and added 22,800 tsubo of NRA. While it experienced hiccups such as when Mitsubishi Tanabe Pharma cancelled its plan to lease three floors in the building, Tokiwabashi Tower managed to secure tenants including Tokio Marine Holdings, Kuraray, and Furukawa Corporation. In the same month, Hibiya Fort Tower was also completed and added 13,000 tsubo of NRA. The 26F tower has some vacant floors, but has attracted entities such as Japan Racing Association, Tokyu Agency, and WeWork.

2022 is a slow year in terms of supply, but the largest project this year, Yaesu Central Tower (Tokyo Midtown Yaesu), appears to have had a lacklustre start before its opening this summer. Although it is in a prime location and directly connected to Tokyo Station, the tower has reportedly only pre-leased about 50% of its 38,000 tsubo of NRA in office space thus far. While it has managed to secure major tenants such as Sumitomo Life, Mitsui Chemicals, Daikin, and M&A Capital Partners, the asking rent appears high given the current market conditions.

In 2023, the Toranomon submarket in particular is expected to see large supply, led by the Toranomon Azabudai project by Mori Building. Although there was concern over the project due to its sheer size (65,000 tsubo of NRA), it is rumoured that the project is fully pre-leased. One reason for its sound pre-leasing could be its pricing - the Toranomon Azabudai Project is reportedly offering mid JPY30,000 per tsubo. In fact, as the overall market momentum remains lukewarm, reasonably priced offices seem to be gaining popularity.

**GRAPH 2: Combined Office Supply (GFA) Estimates for the C5W and the 18W, 2022 to 2025**



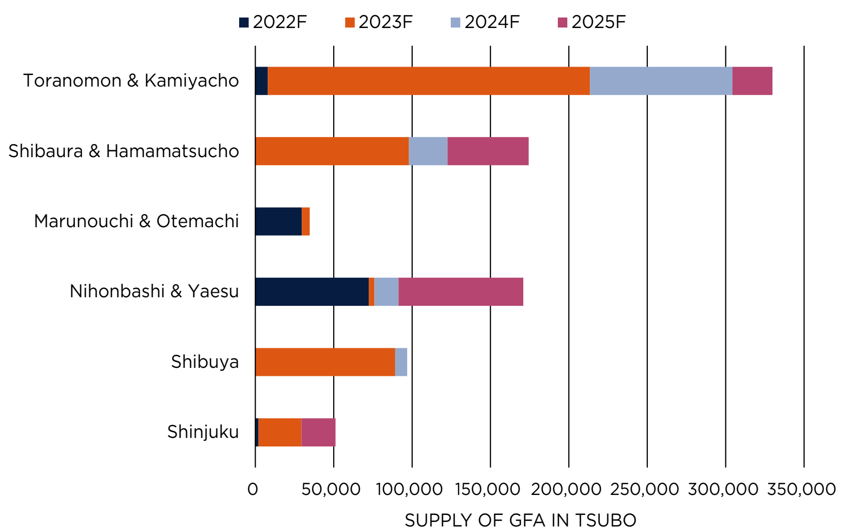

**Source** Savills Research & Consultancy
*Adjusted GFA figures based on estimate office floor space.

**TABLE 1: Major Development Projects in Tokyo, 2022 to 2026**

| BUILDING NAME | SUBMARKET | FLOORS | GFA (TSUBO) | YEAR |
|---|---|---|---|---|
| Yaesu Central Tower (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 | |
| Tamachi Tower | Shibaura & Hamamatsucho | 29 | 34,000 | |
| Toranomon Hills Station Tower | Toranomon & Kamiyacho | 49 | 77,000 | |
| Shibuya Sakuragaoka A | Shibuya & Ebisu | 39 | 56,000 | |
| Toranomon 2-Chome Centre Redevelopment (Businness Tower) | Toranomon & Kamiyacho | 38 | 55,000 | |
| Tokyo Mita Redevelopment Project | Shibaura & Hamamatsucho | 42 | 60,000 | |
| Shin-Toda Building | Nihonbashi & Yaesu | 28 | 31,000 | 2024 |
| Akasaka Trust Tower | Akasaka & Roppongi | 43 | 63,000 | |
| Shibaura 1 Chome Project S | Shibaura & Hamamatsucho | 45 | 68,000 | 2025 |
| Yaesu 1 Chome East B | Nihonbashi & Yaesu | 54 | 68,000 | |
| Toyosu 4-2 District Redevelopment Project Tower A & B | Toyosu | 18/15 | 41,000 | |
| Hiromachi District Redevelopment A-1 | Shinagawa & Osaki | 23 | 76,000 | |
| Takanawa Gateway City Tower I | Shinagawa & Osaki | 30 | 139,000 | |
| Takanawa Gateway City Tower II | Shinagawa & Osaki | 31 | 64,000 | |
| Higashi Ikebukuro 1-Chome Project | Ikebukuro | 30 | 44,000 | 2026 |
| Toranomon 1-Chome East Redevelopment | Toranomon & Kamiyacho | 30 | 38,000 | |
| Nihonbashi 1 Chome C | Nihonbashi & Yaesu | 51 | 112,000 | |

**Source** Savills Research & Consultancy

**GRAPH 3: Supply by Submarket, 2022 to 2025**

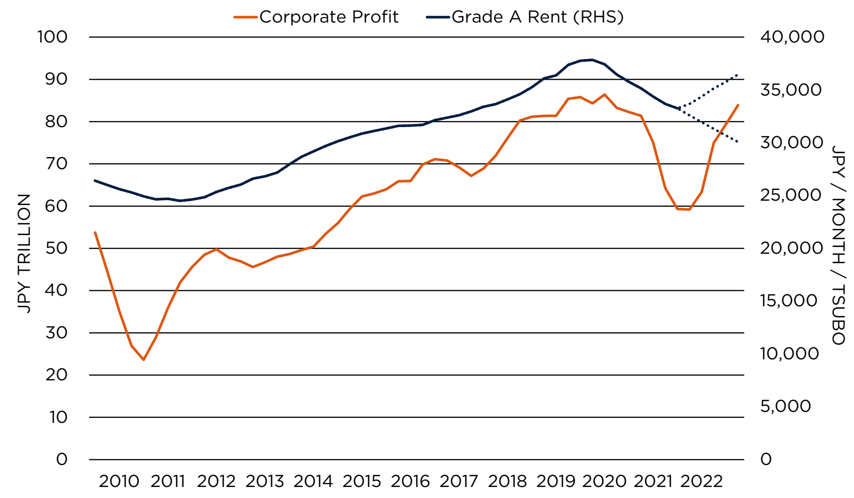



**Source** Savills Research & Consultancy
*Adjusted GFA figures based on estimate office floor space.

Since the project almost accounts for half of the supply in the Toranomon/Kamiyacho submarket in 2023, its promising pre-leasing alleviates concerns over the large supply. Elsewhere, another large project in the submarket, Toranomon Hills Station Tower, will reportedly house Goldman Sachs. Given its unparalleled location with direct access from the new Toranomon Hills Station, the office tower should not struggle to find tenants.

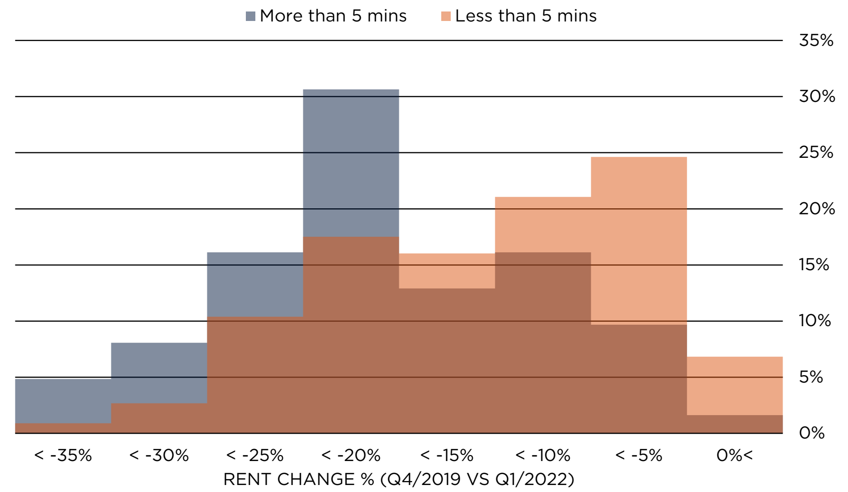
Shibuya, which was also a concern in our previous Tokyo Office Supply report in 2021, appears better set for the future. As mentioned earlier, leasing seems more active, and vacancy rates have started to stabilise. Additionally, the Shibuya Sakuragaoka project, which is slated for completion in 2023, is rumoured to have already secured anchor tenants. While Shibuya will continue to add large supply such as the Dogenzaka Ni-Chome South project in 2026 and Shibuya Scramble Square West in 2027, the area's popularity should continue to increase with

**GRAPH 4: Grade A Office Rent vs Corporate Profit with 1.5 year lag, Q1/2010 to Q1/2022**



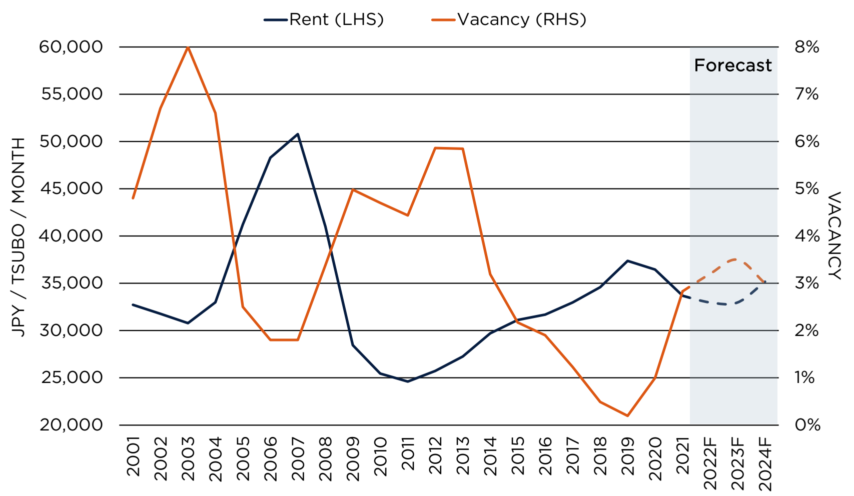

**Source** Ministry of Finance, Savills Research & Consultancy

**GRAPH 5: Grade A & B Office Rent Change by Walking Distance from Nearest Station, Q4/2019 vs Q1/2022**




**Source** Savills Research & Consultancy

**GRAPH 6: Grade A Office Vacancy Rate and Rent Forecasts, 2001 to 2024F**




**Source** Savills Research & Consultancy

the expected growth of the IT industry in the future.

On the other hand, some caution should be warranted for Shinagawa and Osaki because of the large supply expected in 2025. The new office space will be primarily derived from the enormous Takanawa Gateway City project, which will be directly connected to Takanawa Gateway City Station. The neighbouring bay areas have been noticeably affected during the pandemic. Indeed, the highly concentrated mid-and-back-office functions in the areas are more likely to have higher levels of teleworking, calling into question the level of office demand present.

Shinjuku is a latecomer in terms of redevelopment and has suffered the most since the pandemic began. However, the Shinjuku West Exit Redevelopment Project in 2029, spearheaded by large corporations including Odakyu and Tokyu, will add new high-quality office space next to the station and redevelop the Odakyu Department Store. This is a major project for the submarket and is expected to increase the popularity of the area. Preceding the development, the Meiji Yasuda Seimei Shinjuku Building will also be redeveloped in 2025 with Mori Building.

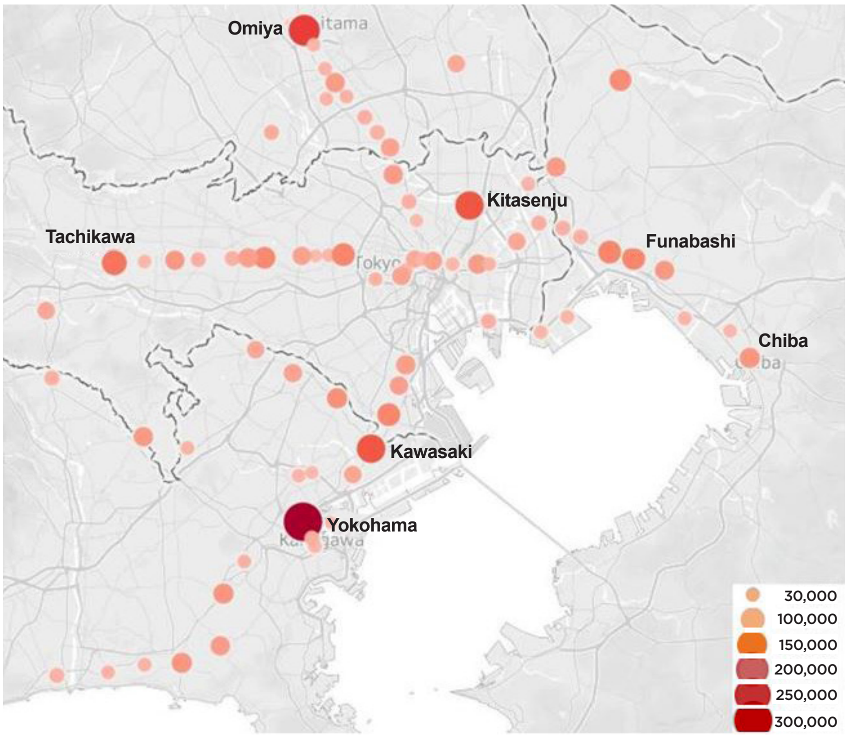
## ECONOMIC CONDITIONS AND RENTAL FORECASTS

With regard to market demand, the ongoing economic recovery should help office demand gradually return going forward. Historically, Grade A office rents have been loosely following corporate profits trends over the past decade with one- to- two-year lags. Considering that corporate profits started improving in Q4/2020, office rents could turn upward towards the end of this year or next year, especially after the pandemic transitions into an endemic state. In fact, the market has started showing some signs of bottoming out with stabilising vacancy rates and slowing rental declines.

At the property market level, performances have varied based on submarkets in Tokyo, and a K-shaped recovery is likely to continue going forward. Notably, areas with inconveniently located offices could continue to suffer. To this point, Graph 5 shows a diverging performance pattern based on the walking distance from the nearest station. While the majority of offices experienced rental declines between Q4/2019 and Q1/2022, offices more than five minutes away from stations exhibited larger rent declines. Considering that there remain large vacancies in some of these areas, this pattern is likely to continue in the near future.

Overall, economic conditions should continue to recover at a gradual pace with the country's GDP expected to exceed pre-pandemic levels very soon. As life slowly but steadily resumes normalcy and the country

**MAP 2: Top 100 JR East Stations by Volume of Passengers with a Commuter Pass*, 2020**




**Source** East Japan Railway Company, Savills Research & Consultancy
*Excluding Yamanote Line stations in order to make other hubs stand out.

proceeds with lifting various restrictions and border measures, market sentiment has also improved. However, considering that some submarkets are expected to continue struggling, the overall market recovery is unlikely to be strong. Vacancy rates may edge up through 2022 and 2023 as more new offices open, but rents are expected to stabilise as many prime offices are reasonably priced now.

## TELEWORK TRENDS

The impact that hybrid work styles will have on the office market is an essential point of discussion when considering the market's prospects. This issue is complex and is influenced by a multitude of variables, including the cultural and political slant of each respective company. As such, implications will need to be assessed continuously as the situation unfolds. However, based on currently available information, it appears safe to say that hybrid work styles are here to stay. Multiple studies over the past two years have shown that many corporate functions can perform as well remotely as in the office. In some cases, people have been shown to perform even better when they work remotely.

However, issues related to teleworking have also been widely shared, and the benefits of offices have also been re-affirmed. Specifically, people recognise that human interactions are necessary for workplaces, and offices will continue to play an essential part in facilitating communication and fostering corporate cultures. Indeed, in a post-pandemic world, office layouts and amenities are likely to become increasingly open and flexible to accommodate the evolving needs of tenants, which will effectively increase the required space per person.

Considering the above, we believe that the permanence of hybrid work will have a negative impact on office demand in Tokyo's CBD, but the damage is likely to be limited to a few percentage-point increments in vacancy compared with pre-pandemic times. The returning office demand in Shibuya where progressive IT companies are concentrated should be an early sign that supports this assessment.

Elsewhere, the demand for satellite offices is likely to continue growing as people seek an alternative to working at home. Currently, although close to 90% of telework is conducted from home, there are many challenges that people encounter while doing so, including limited workspace, productivity, security, as well as the difficulty of management. Satellite offices can provide solutions to these issues while maintaining some of the benefits of telework and could spark a new type of office demand.

Likely target locations for satellite offices are near major train stations that have large passenger flows. Map 2 illustrates the passenger traffic of the top 100 stations operated by East Japan Railway Company (JR East), excluding the Yamanote Line. In fact, an increasing proportion of flexible offices are being introduced outside of the C5W, and some satellite office brands of large developers have already opened in major transport hubs such as Kitasenju, Omiya, Kawasaki, and Tachikawa. As telework changes from an emergency measure to a longer-term office strategy, the need for satellite offices is expected to grow.

Overall, we believe that the total office demand will remain stable, given the increase in emerging office demand from satellite offices and layout changes in response to hybrid work arrangements. At the same time, the focal locations of demand appear to be somewhat different compared with pre-pandemic times.

## OUTLOOK

Overall, gradual recovery appears to be on the way in the Tokyo office market, supported by improving economic conditions. However, submarket performances have seen diverging trends during the pandemic, and recovery is therefore likely to be inconsistent. Given the precarious situation, the future supply could pose a threat to the stability of the market - new offices are likely to have an easier time filling vacant space, but older offices will be in a more vulnerable position.

Nevertheless, compared to a year ago, pre-leasing activity for supply in 2023 appears more active, alleviating some concerns. Major projects scheduled for completion next year are rumoured to have found anchor tenants. Another large wave of supply is forecast in 2025, but the market will have time to catch up by then.

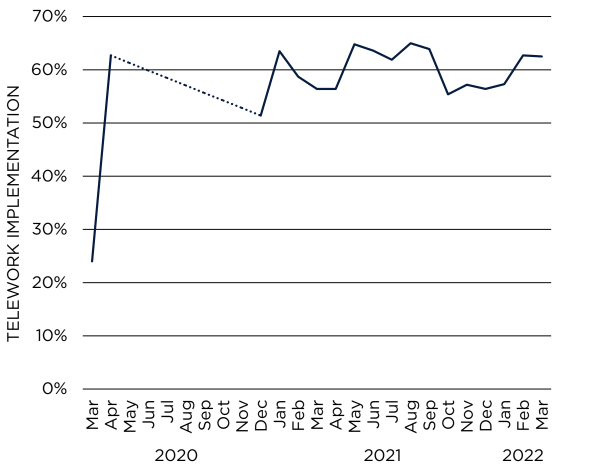
The prevalence of telework has certainly changed how we work, but its overall impact on office demand appears to be limited. While some companies that are pro-telework are likely to eliminate excess office space, other companies changing layouts and amenities should increase required space per worker. Although locationally inferior offices might struggle, those with good accessibility should continue to see sound demand.

Furthermore, as a solution to achieve a good balance of office and remote work, the hybrid work model that many companies were pressured to implement during the pandemic is expected to evolve going forward. Currently, most remote work is conducted from home, but many individuals face challenges in implementing this practice. With many developers and real estate operators eager to increase the number of flexible/satellite offices, leasing and utilising such spaces should become a realistic alternative.

Overall, we believe the total office demand in Tokyo will see little change. Emerging office demand such as satellite offices and layout changes in response to hybrid work arrangements are likely to create new spaces and compensate for the lost demand in Tokyo's CBD.

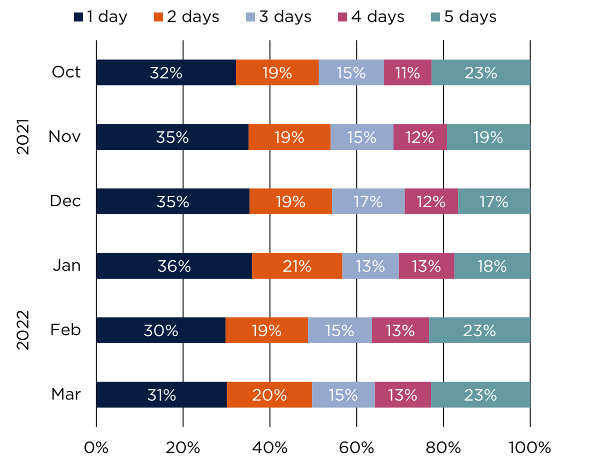
# Appendix - Development of Hybrid Work

**GRAPH 7: Monthly Telework Implementation Survey Results in Tokyo, March 2020 – March 2022**



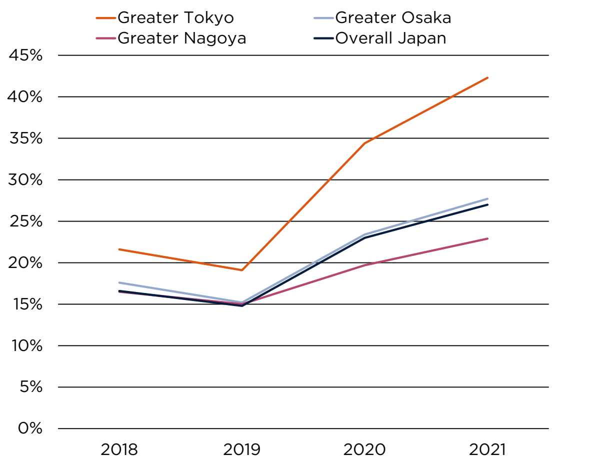

**Source** Tokyo Metropolitan Government, Savills Research & Consultancy

**GRAPH 8: Weekly Telework Percentage, October 2021 to March 2022**




**Source** Tokyo Metropolitan Government, Savills Research & Consultancy

**GRAPH 9: Telework Percentage by Region, 2018 to 2021**




**Source** Ministry of Land, Infrastructure, Transport and Tourism, Savills Research & Consultancy

After two full years since the pandemic has started, there is little doubt that many companies will continue hybrid work arrangements in a post-pandemic world. In Tokyo, the telework implementation rates have remained around 60% throughout the pandemic, and about 80% of companies who have telework arrangements typically have hybrid work styles where employees go to office one to four days a week. Indeed, many employees appreciated the benefits of telework, and managers have grown to learn that the same level of productivity can be maintained even if workers are not physically present the office.

The most obvious merit of telework is the reduction in commuting time. In Tokyo, people spend an average of about 40 minutes commuting - notably longer than other regions. Many agree that this is an unproductive and often unpleasant use of time, and removing the need to commute has freed up time for things that matter more. In fact, telework percentages in Greater Tokyo are higher than other regions, and they are also higher for people who have longer commutes.

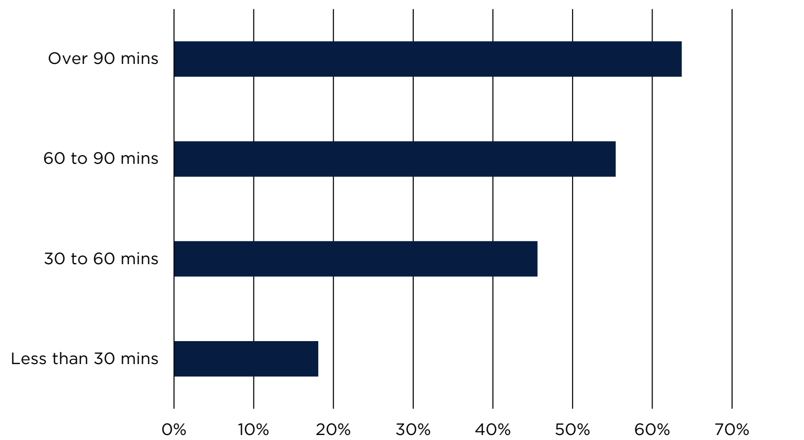
Even before the pandemic, the government had already started promoting telework from around 2013 in order to improve work-life balance and productivity through flexible work arrangements, aiming to triple the number of companies that implement telework by 2020 from 2012 figures. This trend accelerated especially after the promotion of work style reform in 2018. Indeed, companies such as Fujitsu and Yahoo that made headlines with their ambitious telework plans were already implementing hybrid work styles pre-COVID. As such, the underlying trend towards hybrid work was already in progress, and the pandemic has just expedited the process by effectively forcing the practice on most companies.

However, the demerits of telework have also become apparent and recognised during the pandemic. Smaller companies generally perceive more demerits than merits when it comes to teleworking whereas it is usually the opposite for larger companies, probably due to the fact that larger companies have more resources and capital to properly implement telework.

Commonly perceived demerits of telework are related to inefficiency of communication and a lack of human interaction – areas where offices are arguably considered superior to telework. For this reason, offices should continue playing an essential role in company workplace strategies.

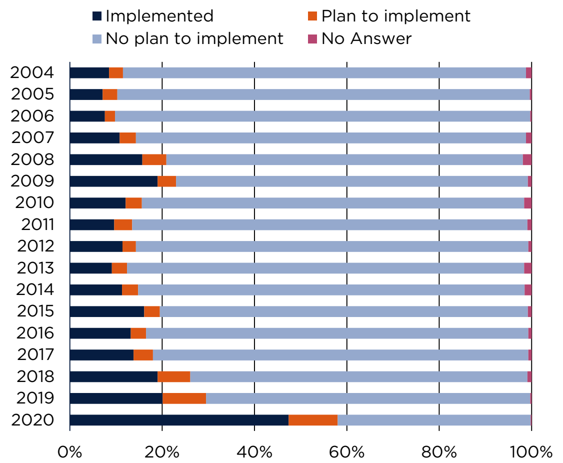
Furthermore, the pandemic has highlighted the importance of effective communications, and this has encouraged many companies to change office layouts to ones that better accommodate flexible work styles, which

**GRAPH 10: Telework Percentage by Commuting Time in Greater Tokyo, 2021**



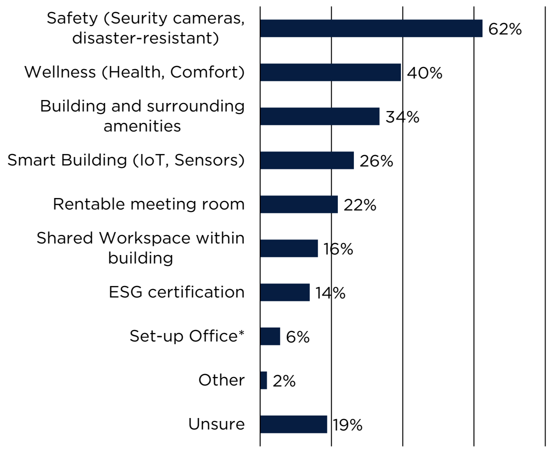

**Source** Ministry of Land, Infrastructure, Transport and Tourism, Savills Research & Consultancy

**GRAPH 11: Telework Implementation Percentage, 2004 to 2020**



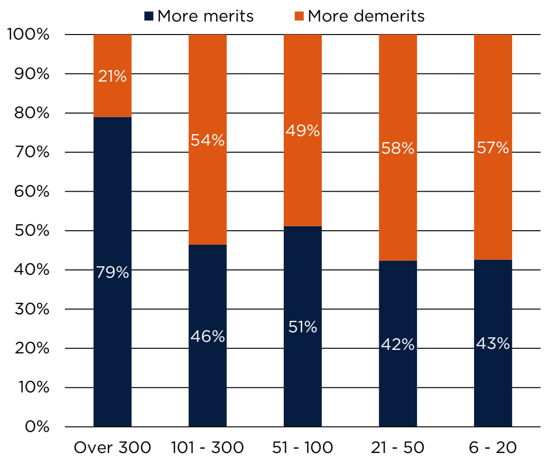

**Source** Ministry of Internal Affairs & Communications, Savills Research & Consultancy

**GRAPH 12: Key characteristics when Selecting Offices**




**Source** Xymax, Savills Research & Consultancy
* Set-up offices are pre-furnished by the landlord and leased to tenants.

**GRAPH 13: How Companies Perceive Telework by Company Size, February 2022**




**Source** Teikoku Databank, Savills Research & Consultancy

should in turn increase the required office space per seat. Growing preference for ESG conscious offices, including those that promote employee well-being, might also increase demand Grade A offices that already have favourable ESG features.

Given the above, we believe that the overall impact of the transition to more permanent hybrid work models on the Tokyo office market should be limited, at least in the short term. As mentioned in the main body of this report, the stabilising market conditions also indicate that demand is likely to return when rental levels are perceived to be acceptable and economic conditions recover.

## SATELLITE OFFICE

Based on the assumption that hybrid work will become more permanent, demand for satellite offices is expected to grow going forward. Currently, an overwhelming majority of telework is conducted from home, which imposes strain on some workers and poses potential security threats.

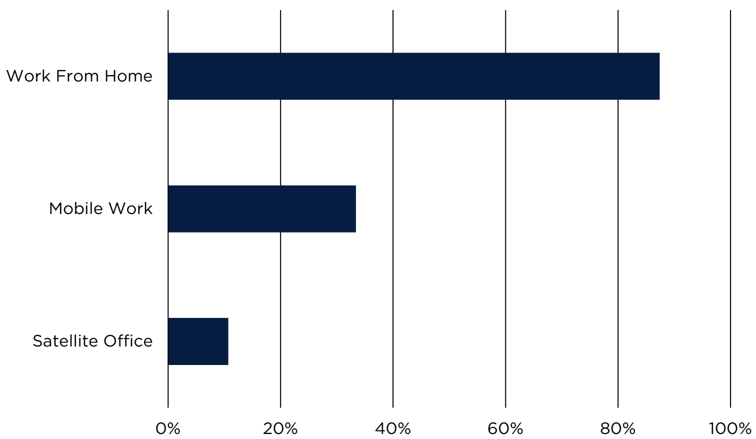
Some companies have been responding to this trend. For instance, Mitsui Fudosan, which operates its Work Styling brand from 2017, started Work Styling Solo in December 2020 to meet the increasing demand for remote workspace near workers' residences. As of March 2022, 33 Work Styling Solo locations existed in Tokyo and in train hubs of neighbouring prefectures. Unlike other flexible office types such as shared and co-working offices, these facilities mainly feature individual working spaces since the focus is more on convenience than collaboration.

As the use of satellite offices becomes more widespread as an alternative to work from home, the number of satellite office locations in suburban submarkets are expected to increase. In fact, Table 2 indicates that more flexible offices have opened outside of the C5W.

Investors searching for value-add opportunities in the office sector could bet on this trend and acquire small-to-middle-sized offices with the intention of renovating them for satellite office use. That said, the increasing competition in this sector could be a risk. Multiple flexible satellite offices near transportation hubs already exist. With flexible lease contracts, operators also need to take higher operational risk into account, although they could also enjoy higher rents and service fees.

Additionally, set-up offices should remain appealing especially for start-up companies since they prefer to use the money that would go to initial leasing costs to invest in their core businesses. Despite heightened costs related to furniture and equipment, as well as the increased risk related to flexible lease terms for tenants, owners could also benefit from premiums that they can charge for set-up offices.

**GRAPH 14: Telework Format, 2021**




**Source** Ministry of Internal Affairs & Communications, Savills Research & Consultancy
Note: Mobile work is a method of working that is not tied to a specific location.

**TABLE 2: Flexible Office Stock and Supply in Tokyo**

| TOTAL FLEXIBLE OFFICE STOCK IN TOKYO | | | | |
|---|---|---|---|---|
| AREA | LOCATION | % | TSUBO | % |
| C5W | 733 | 71% | 175,000 | 84% |
| 18W | 307 | 30% | 33,000 | 16% |
| 23W | 1,040 | 100% | 208,000 | 100% |

| FLEXIBLE OFFICE SUPPLY IN TOKYO, 2021 | | | | |
|---|---|---|---|---|
| AREA | LOCATIONS | % | TSUBO | % |
| C5W | 155 | 58% | 17,000 | 65% |
| 18W | 113 | 42% | 9,000 | 35% |
| 23W | 268 | 100% | 26,000 | 100% |

**Source** Xymax, Savills Research & Consultancy

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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

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