Japan - August 2020

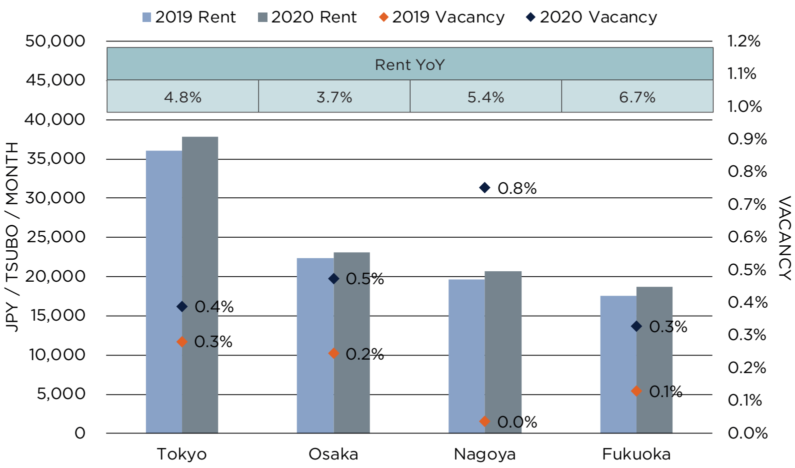
SPOTLIGHT
Savills Research

Regional Japanese Office Markets

savills

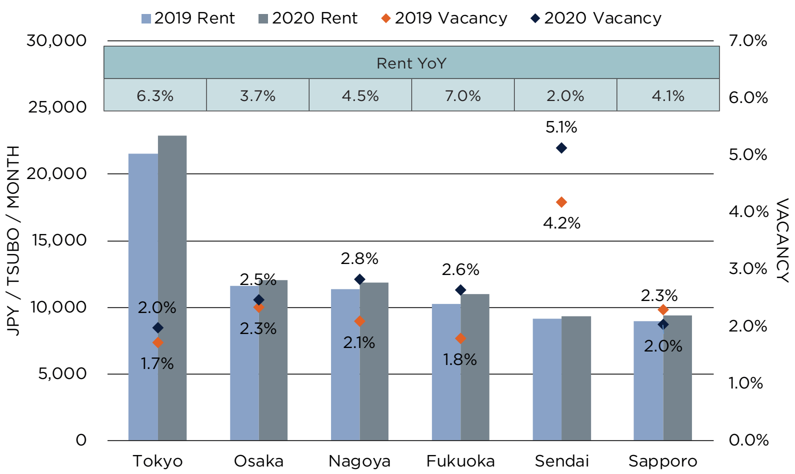
Regional rents to be tested

GRAPH 1: High-grade Office Performance, 1H/2020*



Source Savills Research & Consultancy
*Tokyo data represents Grade A office performance in the C5W.

GRAPH 2: All-grade Office Performance, 1H/2020*



Source Miki Shoji, Savills Research & Consultancy
*Market data as of June 2019 and 2020.

HIGH-GRADE OFFICES[1]

Amid the ongoing global pandemic, the pace of high-grade rental growth has expectedly slowed. Yet, the fact that growth is continuing at all provides some comfort, at least for now. Though the tenant profile found in this segment is better equipped to endure, the uncertainty surrounding the longevity of the outbreak remains a key concern.

To be sure, airtight vacancy rates across all major regions and sound office demand, backed by healthy corporate profits, have been significant factors behind the steady rental growth up to this point. That said, rates have unsurprisingly started to creep up lately, including in the capital.

Despite this slight uptick, the vacancy rate in Fukuoka remains extremely tight at 0.3% — the lowest amongst the major regions. Elsewhere, having had close to no vacancy last period, Nagoya saw the most change this time around, with rates rising to 0.8% (Graph 1).

As for rents, growth was strongest in Fukuoka in 1H/2020. Meanwhile, with growth in Osaka lagging behind its peers, the spread in high-grade rents compared to Tokyo widened. Office rents in the capital are now almost 64% higher following a 1.8 percentage point (ppts) expansion.

ALL-GRADE OFFICES[2]

Much like its high-grade counterpart, the all-grade market continues to be underpinned by tight supply, albeit not to the same extent. In contrast to the broader market, vacancy rates in Sapporo experienced a slight year-on-year (YoY) tightening of 0.3ppts and, as a result, the city has the lowest rate amongst the regions at 2.0%.

Likewise, the momentum in rental growth has continued this period. Unlike the higher-grade segment, however, the pace has quickened in all but Sapporo. Growth in Fukuoka was particularly impressive at 7.0% YoY. Sendai, however, lagged with rents rising by only 2.0% YoY.

The disparity in rents compared to the capital was more pronounced in the all-grade market in 1H/2020. Specifically, rents in Tokyo stand at a 90% premium to the next most expensive, Osaka.

REGIONAL INVESTMENT

According to the bi-annual investor survey conducted by the Japan Real Estate Institute (JREI) in April 2020, cap rates in most submarkets tightened slightly over the year. Sendai and Nagoya witnessed the most change, with both cities experiencing a

1 In each of Osaka, Nagoya, and Fukuoka, Savills monitors about 50 "high-grade" office buildings typically with a GFA of 15,000+ sq m (4,500 tsubo) and a building age of <25 years.
2 "All-grade" refers to offices typically over 1,000 sq m GFA, depending on the market. Data is sourced from Miki Shoji.

0.2% narrowing. Across the regions, rates continue to be around the 5% mark. In Tokyo, meanwhile, they are much tighter, lying closer to 4%. That said, considering the survey was conducted during the initial stages of COVID-19, when the extent of the crisis had yet to be fully understood, the market's outlook may be more pessimistic in reality.

Total real estate investment volumes for 1H/2020 totalled around JPY2.1 trillion, according to data from Real Capital Analytics (RCA) – a near 25% decline compared to the same period last year (Graph 3).

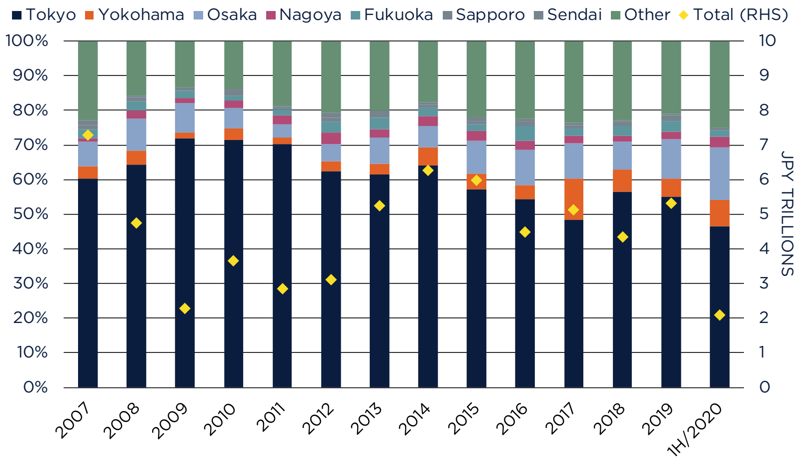
In terms of investment flows into specific regions, Fukuoka, Tokyo and Sendai, in that order, saw the greatest falls, with Fukuoka, for instance, experiencing a 50% drop. In contrast, both Sapporo and Nagoya saw a 25% uplift in inflows. AXA Investment Managers' JPY20 billion purchase of Royal Parks ER Sasashima – a large mixed-use apartment in Nagoya – no doubt contributed towards a significant share in the latter.

Other than Tokyo, Osaka attracted the largest volume of inflows in 1H/2020. Investment in the city rose by around 7% YoY to JPY320 billion, which includes the JPY32.8 billion purchase of Midosuji Front Tower by M&G Real Estate in April 2020.

Broadly speaking, the residential sector was the standout asset class during 1H/2020, with investments more than doubling YoY. Moreover, it was the only asset class to have experienced an increase in investment over the period.

Although rents are still rising, the impact of COVID-19 has started to weigh on vacancy rates. Looking ahead, some regions could feel the pain more than most, especially those burdened by a busy pipeline of projects.

GRAPH 3: Investment Volumes By Area For All Asset Types*, 2007 to 1H/2020



Source RCA, Savills Research & Consultancy
*Transactions where specific locations have not been identified are classified as other.

TABLE 1: BOJ Regional Economic Assessment, April 2020

REGION	TREND	CHANGE VS JANUARY 2020
Hokkaido (Sapporo)	"The economy has been facing strong downward pressure, due mainly to the impact of the outbreak of COVID-19."	↘
Tohoku (Sendai)	"The economy has been weak recently, due mainly to the impact of COVID-19."	↘
Kanto (Tokyo)	"The economy has been weak recently, due mainly to the impact of the outbreak of COVID-19."	↘
Tokai (Nagoya)	"The economy has been facing strong downward pressure, amid the ongoing spread of COVID-19."	↘
Kinki (Osaka)	"The economy has been weak due to the impact of the outbreak of COVID-19."	↘
Kyushu (Fukuoka)	"The economy has been weak recently, primarily in private consumption, exports, and production, due mainly to the impact of COVID-19."	↘

Source Bank of Japan, Savills Research & Consultancy

REGIONAL MACRO AND DEMOGRAPHICS

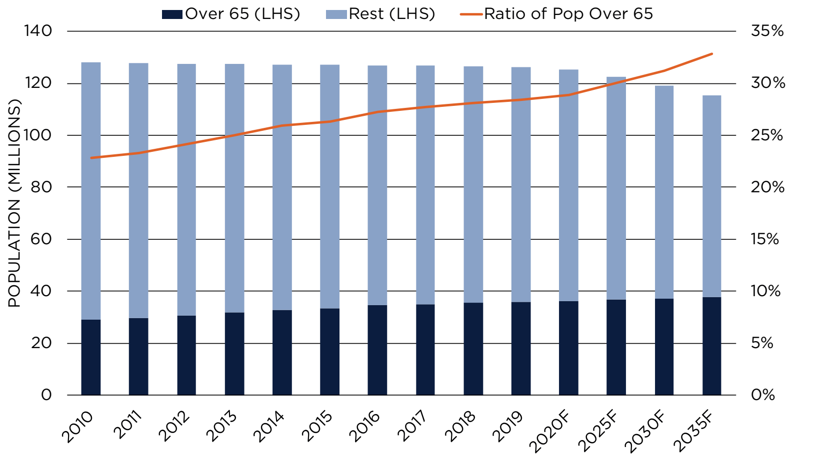
The Bank of Japan's (BOJ) Regional Economic Assessment in April 2020 rightfully paints a bleak picture for the Japanese economy (Table 1). No regions have been left unscathed from the debilitating impact of COVID-19, and economic prospects look dreary.

Meanwhile, Japan continues to grapple with demographic challenges, and this looks unlikely to change anytime soon. Indeed, faced with a double blow of a shrinking population and a greying labour force, these issues continue to dominate concerns over the nation's longer-term prospects.

Based on forecasts by the Ministry of Internal Affairs and Communications, for instance, the decline in the population was set to start in earnest in 2020, with the total figure eventually dropping below the 120 million mark by 2030 (Graph 4).

Although the longevity of Japan's population tends to be admired, this trait also means that the proportion of those over age 65 will continue to grow. In fact, this cohort is predicted to represent around a third of the total population by 2035, emphasising a potentially huge strain on Japan's economy and society.

GRAPH 4: Japanese Population Forecasts and Ratio of Those Over 65, 2010 to 2035F



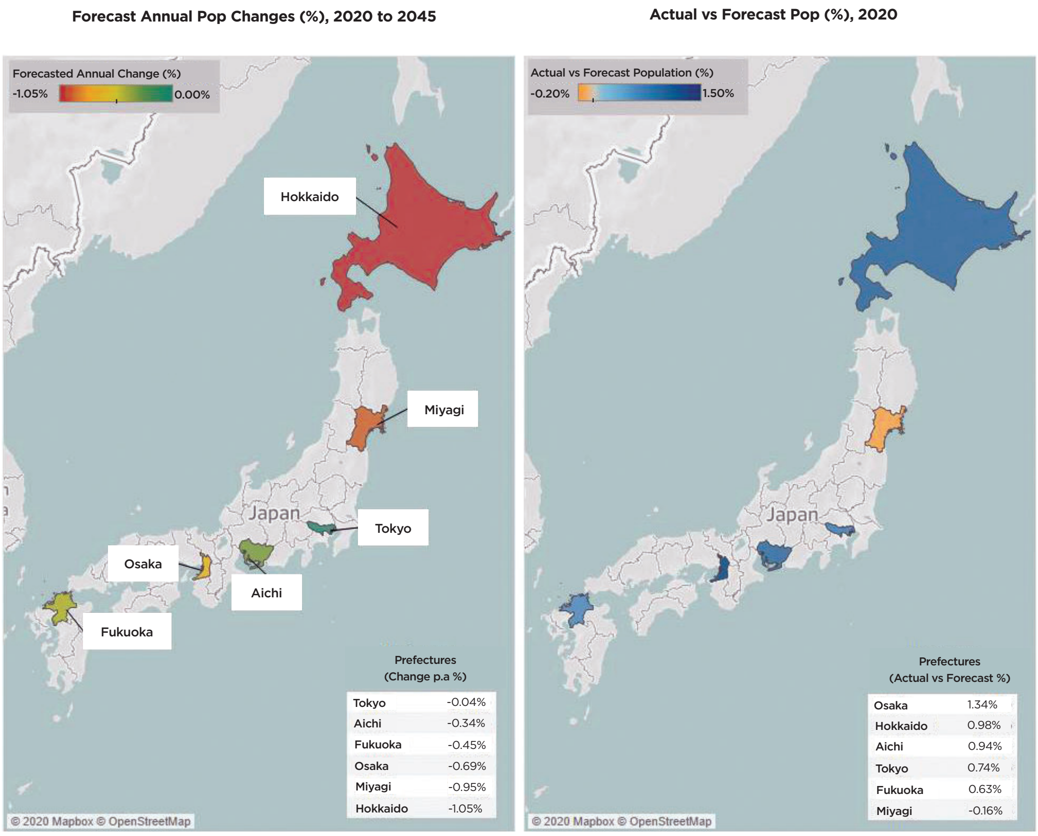
Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy

Unsurprisingly, major prefectures such as Tokyo and Aichi are forecast to shrink the slowest, with the former predicted to remain flattish between 2020 and 2045 (Map 1). In contrast, the destinies of northern prefectures such as Miyagi (Sendai) and Hokkaido (Sapporo) are less favourable.

That said, in reality it would appear that the population, though still in decline, is in somewhat better shape than forecast. For instance, comparing previous forecasts to actual population estimates for this year certainly paints a rosier picture, albeit not for Miyagi (Sendai) – the only prefecture where the current population is below predicted figures (Map 1). What's more, the forecasts do not take into account foreign residents, who, over the longer term, should act as a tailwind.

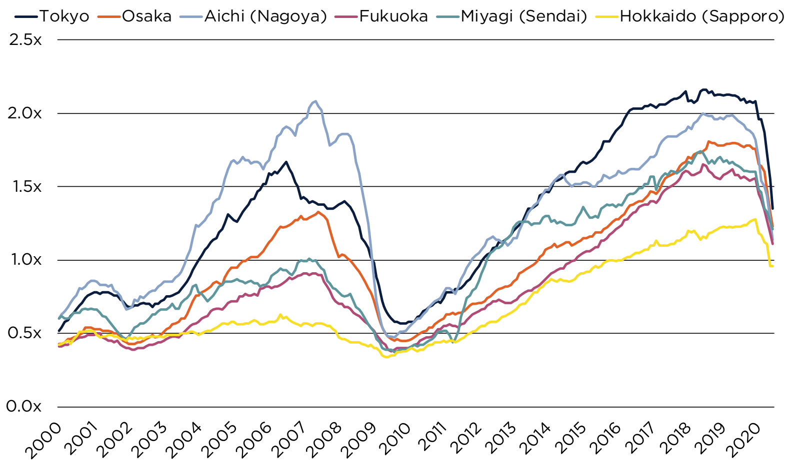
Indeed, despite the current inevitability of Japan's population decline, there appears to be more time than originally thought for progress to be made, at least for most of the major regions.

MAP 1: Forecast and Actual* Japanese Demographic Position



Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy
*The actual population is based on the Jyumin Kihon Daicho and is as of January.

GRAPH 5: Job-to-application Ratios, Selected Prefectures, 2000 to June 2020



Source Ministry of Health, Labour, and Welfare, Savills Research & Consultancy

EMPLOYMENT AND LABOUR DEMAND

Unsurprisingly, every major region has seen a worsening of its job-to-application ratio. The decline has been especially stark in Aichi (Nagoya) where it has fallen from close to 2.0x to 1.1x over the 12 months to June 2020. Yet, the fact that it remains above 1.0x is somewhat comforting. Likewise, this theme is present in the other major regions, other than Hokkaido. This most northern prefecture, despite seeing the smallest drop in the ratio, now appears to have more applicants than jobs available. Whilst a ratio of 0.96x is a concern, considering that during the financial crisis it plummeted to as low as 0.34x, this locality appears to be in better shape over a decade later.

OUTLOOK

The timing of the pandemic has been far from ideal for a Japanese economy already struggling with the consumption tax hike in October 2019.

Despite this, rents - underpinned by airtight vacancy - have continued to grow, albeit at a significantly slower pace. Meanwhile, given the lion's share of companies outside of the capital are much smaller in size, working from home is unlikely to be a big concern for regional markets. This is also true when considering the manageable population densities and the lower infection rates found in the regions.

Even so, while a major COVID-19-induced correction is yet to be observed as of June 2020, signs of change loom large. For instance, in all regions, vacancy rates have inched higher after several small floors were returned by those in the hardest hit industries, as well as small/medium companies in general.

That said, most tenants, especially larger ones with sound balance sheets, are taking a wait-and-see approach when it comes to decisions regarding office strategy. Yet, they cannot wait forever. A prolonged economic slowdown could lead to an increasing number of companies returning office space to reduce costs, and in this regard, regional economies may suffer more. Indeed, with Tokyo likely to continue being home to company HQs, regional branches will be first on the chopping block.

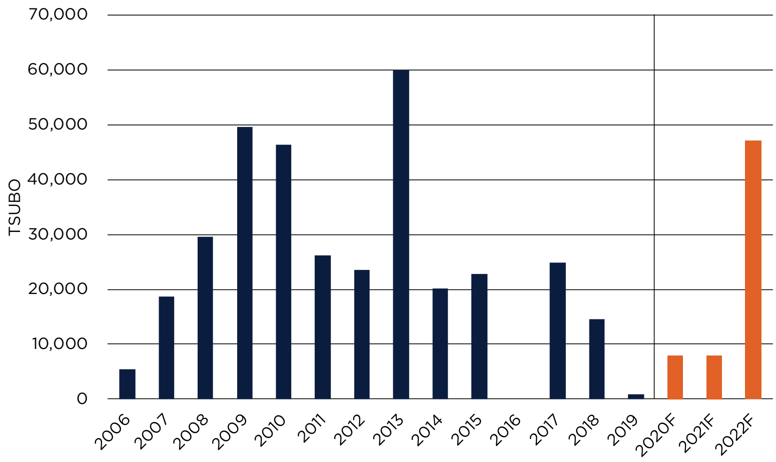
The ban on international travel remains a firm headwind. As this continues, cities that have up until recently been beneficiaries of the tourism boom should suffer disproportionally. As such, previously in-demand ground floor facilities are unlikely to find tenants willing to pay the lofty rents, thus remaining empty for the time being.

As for specific regions, supply pipelines significantly differ from city to city. For instance, in Nagoya, whilst the level of development anticipated is not immaterial, the area, rental levels and the timing of the new supply is varied. Therefore, with more diverse leasing targets, the expansion in supply would appear to be more manageable. Meanwhile, being less reliant on inbound tourism, for better or for worse, also means that the suspension of international travel is less impactful. In contrast, the manufacturing sector is extremely important to the city, and there may be concerns over tenant profiles in this industry. That said, these fears should be somewhat calmed for now given the relatively sound balance sheets found among industry participants.

On the other hand, Fukuoka and Osaka may not be so lucky. Here, large supply is concentrated in certain areas with a similar timing of completion. Indeed, pricing is likely to be less aggressive for these new offices with modern specifications considering weaker tenant demand. Consequently, this may lead to landlords rushing to offer discounts and free rent periods in order to fill space, and the result could be the start of a broader correction in rents.

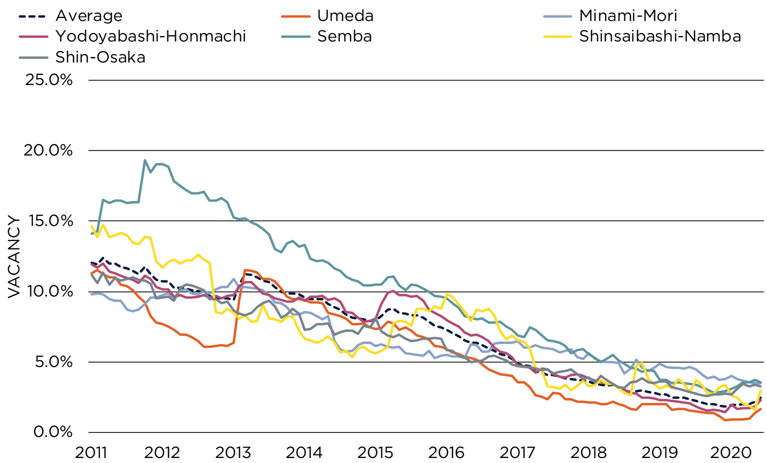
Considering the above, investors will need to closely analyse the characteristics of each city and its upcoming supply, all the while considering how they are primed to tackle the ongoing difficulty.

GRAPH 6: New NRA Office Supply In Osaka City, 2006 to 2022



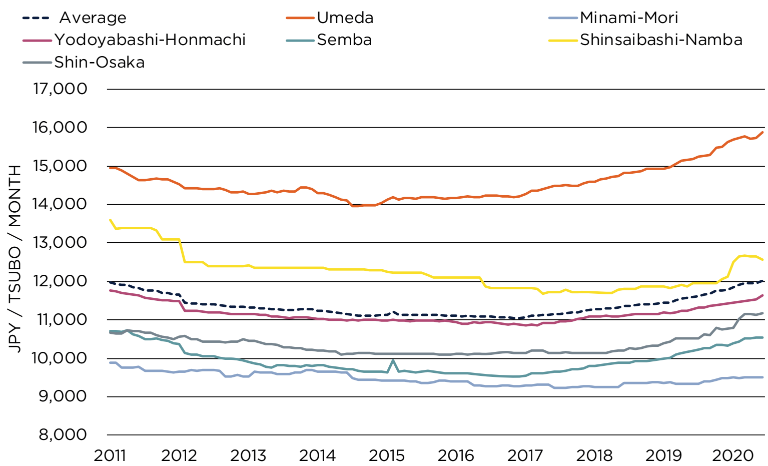
Source Sanko Estate, Building Group, Savills Research & Consultancy

GRAPH 7: Vacancy Rate In Osaka City By Area, 2011 to Q2/2020



Source Miki Shoji, Savills Research & Consultancy

GRAPH 8: Average Rent In Osaka City By Area, 2011 to Q2/2020



Source Miki Shoji, Savills Research & Consultancy

OSAKA CITY

Net Rentable Area (NRA)

As of June 2020, with demolitions exceeding completions, the total NRA in Osaka has maintained its gradual downtrend from a high of 2.2 million tsubo in February 2019. This trend should persist for the rest of the year given the moderate level of supply expected.

Things look set to be markedly different in 2022, however. The standout development will be the Umeda Twin-Towers South project – a mixed-use structure with around 28,000 tsubo of NRA. The Nihon Seimei Yodoyabashi Building, meanwhile, will add over 10,000 tsubo of NRA as well. Elsewhere, Shin-Osaka will likewise be active towards 2022, with several projects currently planned. Overall, more than 10,000 tsubo of NRA is set to be brought to the table.

Considering the above, therefore, supply in 2022 is anticipated to be at the highest level since 2013. Yet, it will quickly be overshadowed by 2024. As such, this trend is likely going to cause some concern during the lead-up if a large amount of supply is not absorbed beforehand.

Vacancy

High-grade vacancy rates in Osaka loosened slightly by 0.2ppts YoY to 0.5% this period, with some vacancy in the recently completed Obic Midosuji Building appearing to have contributed somewhat. At the submarket level, Namba witnessed the largest decline – contracting by around 1.5ppts YoY as remaining vacancy was absorbed.

Meanwhile, with the all-grade vacancy rate falling to as low as 1.8% in December, the momentum appeared to have legs heading into 2020. Yet, over the six months since, the figure has gradually increased to 2.5%. New supply will be limited until 2022, however, which should mitigate the impact of COVID-19 on the market.

Rent

Perhaps predictably, rents in Osaka were unable to avoid the slowdown in growth that has plagued the broader office market, with YoY rental growth falling to 3.7%. Nonetheless, average high-grade rents have manged to surpass JPY23,000 per tsubo per month.

In contrast, all-grade rental growth in Osaka has increased compared to the previous period. As a result, for the first time since October 2010, rents have exceeded JPY12,000 per tsubo[3]. Within the region,

3 Throughout the report, "per tsubo" is shorthand for "per tsubo per month".

TABLE 2: Osaka Prefecture Key Macro Indicators*

	JAPAN	TOKYO	OSAKA
Real GDP (JPY trillion)	485.2	103.6	38.6
Real GDP (YoY%)	-27.8	1.8	1.5
% of Japan (2015)	100%	20%	7%
Population (million)	125.9	14.0	8.8
Job to applicant ratio	1.1	1.4	1.2

Source Cabinet Office, Osaka Prefectural Government, Savills Research & Consultancy
*Real GDP for Japan is as of Q2/2020, for Tokyo, Osaka and % of Japan, 2015.

TABLE 3: Osaka High-grade Office

	1H/2020	HOH	YOY
Rent	23,100	2.2%	3.7%
Vacancy	0.5%	+0.3ppts	+0.2ppts
Top Rent	35,000+	0	0

Source Savills Research & Consultancy

Shin-Osaka was in the vanguard, with rents growing by over 6% YoY. In contrast, Minami-Mori again lagged as rents only saw a 1.9% YoY increase.

Umeda
The range of high-grade rents in the most expensive submarket remained unchanged at JPY20,000 to JPY35,000 per tsubo. Even so, there are offices in this submarket being newly marketed at almost JPY40,000, testing top rents. Average high-grade rents, meanwhile, continued their ascent, growing by 3.0% YoY to approximately JPY27,800 per tsubo. Indeed, undeterred by the submarket-leading rents, underlying fundamentals currently appear solid in Umeda, with vacancy holding firmly below 0.5% for around two years.

Yodoyabashi-Honmachi
Despite vacancy in this submarket remaining anchored around zero since 2H/2017, rents have stood unchanged since 2H/2018 - until now. With high-grade rents increasing by 4.7% YoY to around JPY22,300 per tsubo, not only was growth in this submarket the highest in the region, it was also the only one to have experienced more rental growth this period compared to the last. Perhaps as a result, the lower end of the range in rents saw a JPY1,000 uptick in Honmachi.

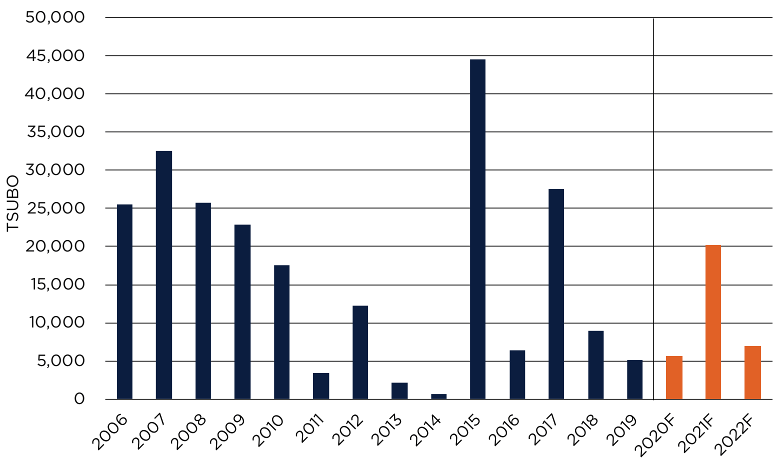
Shin-Osaka
Despite falling by 0.4ppts since the last report, Shin-Osaka still has one of the highest levels of vacancy in the region at 0.9%. Over the year, this figure increased by 0.3ppts – the third consecutive period of annual expansions.

In 1H/2020, high-grade rents in this submarket ranged between JPY16,000 and JPY27,000 – a decline of JPY1,000 at both ends. Whilst average rents grew 0.6% YoY to JPY21,500 per tsubo, it is a far cry from the four consecutive periods of double-digit annual rental growth experienced during 2018 and 2019. That said, since 2016, rents in Shin-Osaka have increased by 9.0% p.a, and as such, the Tokyo-like pricing appears to be squeezing out local businesses, unable to afford the rents.

Outlook
Whilst the underlying fundamentals still remain fairly firm in Osaka, the onset of the pandemic has seen the rate of rental growth in the high-grade market slow more than in other regions.

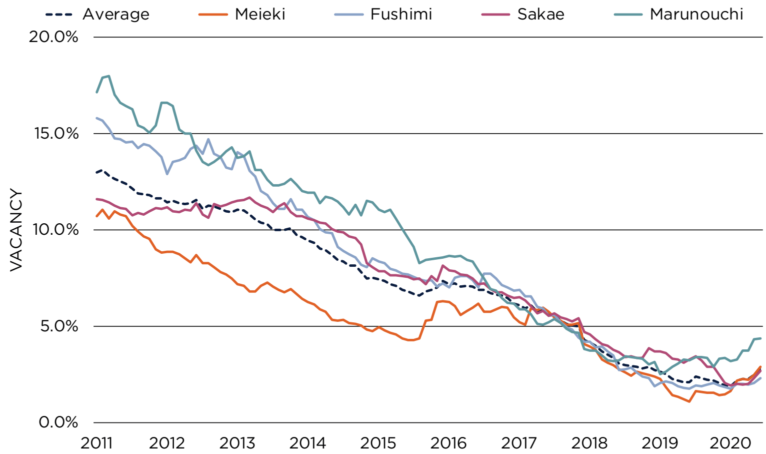
Looking ahead, the vacancy rate is likely to inch higher and rents should remain flattish or soften somewhat– at least until pre-leasing activity for the first wave of supply in 2022 becomes more visible. Moreover, given the continued uncertainty, pricing of this new supply is unlikely to be aggressive. Whilst a resulting price correction is not inevitable, it could spell trouble for the second wave in 2024, if much of it remains unabsorbed.

GRAPH 9: New NRA Office Supply In Nagoya City, 2006 to 2022



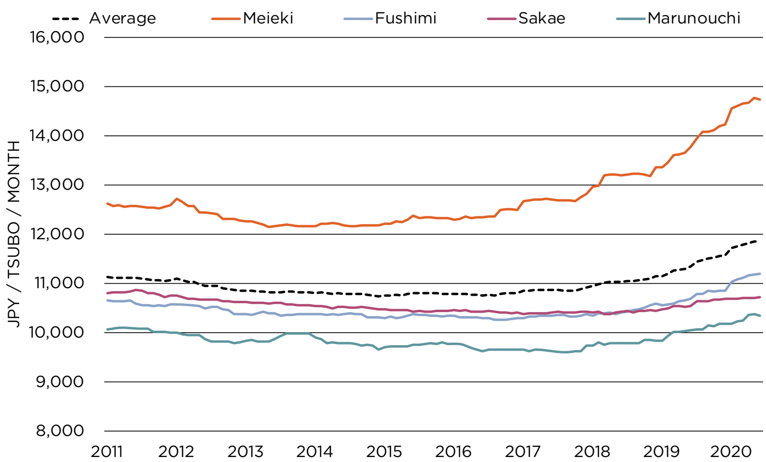
Source Sanko Estate, Biz Life Agent, Savills Research & Consultancy

GRAPH 10: Vacancy Rate In Nagoya City By Area, 2011 to Q2/2020



Source Miki Shoji, Savills Research & Consultancy

GRAPH 11: Average Rent In Nagoya City By Area, 2011 to Q2/2020



Source Miki Shoji, Savills Research & Consultancy

NAGOYA CITY

NRA

Though well short of the levels observed in 2015, supply anticipated for 2021 is notable. As well as the previously mentioned Noritake Forest Project, three other large-scale projects are expected. One of these is the Mitsui Building North Tower – a B2/20F multi-purpose structure located in the Meieki submarket with around 4,500 tsubo of NRA.

Thanks in part to its diverse nature, the moderate supply expected over the coming years should ensure some market stability. Even so, pre-leasing activity for the projects slated for 2021 will certainly be a bellwether for the region's mid-term prospects.

Vacancy

Despite high-grade vacancy rates slightly expanding this period, office supply remains tight in Nagoya. Rates now stand at 0.8% after a 0.7ppts expansion – the first in three years. The main source of this change appears to be large pockets of vacancy found in Global Gate West Tower, without which, the rate would be largely unchanged.

Since around 2017, the all-grade vacancy rate in Nagoya had been gradually tightening, falling to 1.9% as recently as January 2020. Yet, fast forward to June 2020, it lies at 2.8% – the highest level since the end of 2018. Over the year, meanwhile, a loosening of 0.7ppts was observed. This time around, marked rises in the Marunouchi and Meieki submarkets appear to be the culprits. The former, was home to a near 2% increase, whilst the latter, saw rates slacken by over 1%.

Rent

Average high-grade rents in Nagoya continue to grow, rising to JPY20,700 per tsubo this period. Yet, the rate of change has been noticeably slowing since peaking in 2H/2018. In fact, since then, average rental growth has halved to 5.4% YoY – the slowest since the end of 2017. In a reverse from the previous period, rents in Sakae saw the most growth in 1H/2020 – at around 10% YoY.

Looking at the all-grade market, you would not think that we were in the midst of a global pandemic. Having seen an uptick in rents of 3.7% YoY in December 2019, the pace of growth quickened to 4.5% YoY in June 2020. Average rents have increased to around JPY11,900 per tsubo as a result. Unlike the high-grade market, Sakae significantly lagged the broader average, with rents increasing by only 1.6% YoY.

TABLE 4: Aichi Prefecture Key Macro Indicators*

	JAPAN	TOKYO	AICHI
Real GDP (JPY trillion)	485.2	103.6	37.4
Real GDP (YoY%)	-27.8	1.8	0.7
% of Japan (2015)	100%	20%	7%
Population (million)	125.9	14.0	7.6
Job to applicant ratio	1.1	1.4	1.1

Source Cabinet Office, Aichi Prefectural Government, Savills Research & Consultancy
*Real GDP for Japan is as of Q2/2020, for Tokyo, Aichi and % of Japan, 2015.

TABLE 5: Nagoya High-grade Office

	1H/2020	HOH	YOY
Rent	20,700	2.8%	5.4%
Vacancy	0.8%	+0.7ppts	+0.7ppts
Top Rent	37,000+	+1,000	+1,000

Source Savills Research & Consultancy

Meieki

Given its convenient access to Nagoya Station, the Meieki submarket rightly commands the highest rents in Nagoya. Standing at JPY28,500 per tsubo, they represent a premium of over 50% compared to rents in the next highest submarket, Fushimi. In fact, since the last report, the range of rents for towers in proximity to the station has increased. Specifically, they now lie between JPY35,000 and JPY37,000 after a JPY1,000 rise at both ends. Given this level of rent, however, growth in this submarket was unsurprisingly the lowest in the region, coming in at 2.9% YoY.

Going some way in explaining this continued growth in rents is the submarket's vacancy rate. To wit, this has comfortably held below 1% for over two years. What's more, with the limited number of projects in the pipeline, this is unlikely to drastically change anytime soon.

Fushimi and Marunouchi

Annual rental growth in both submarkets slowed in 1H/2020. This dynamic was most evident in Fushimi this period, where the figure contracted from 17.0% to 5.0% YoY. Nonetheless, rents in this submarket have surpassed JPY18,000 for the first time in recent history – closing the gap with those in Meieki. Broadly speaking, the range of rents in these submarkets stands at JPY16,000 to JPY24,000 per tsubo following an increase of JPY1,000 at the lower end. As for vacancy rates, they remain close to nil in both submarkets.

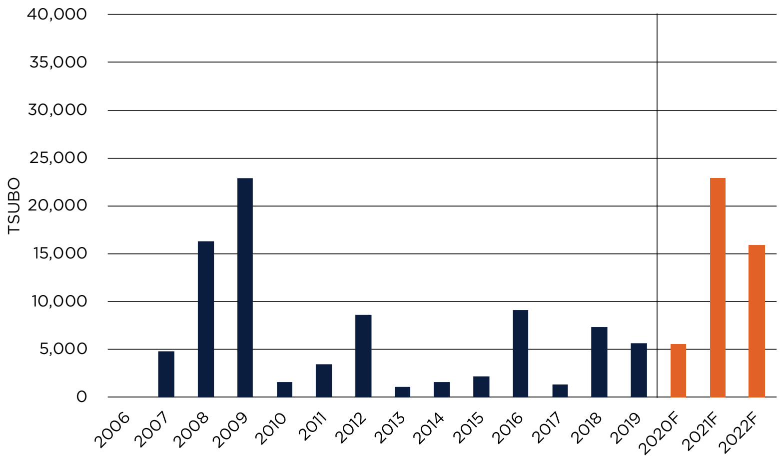
Outlook

Amid a global pandemic, what is providing some respite to the Nagoya office market is its tightness. Indeed, this is not only true right now, but also likely to be the case over the near future given the manageable level of new supply anticipated. Moreover, the projects that are expected over the next few years are spread across the various submarkets, adding another element of downside protection.

Of course, the office market is not completely shielded from the effects of COVID-19, and some instability is likely. Yet, this impact appears to have been somewhat limited thus far. For instance, despite some small office spaces being returned, noticeable downward adjustments in high-grade rents have yet to be observed.

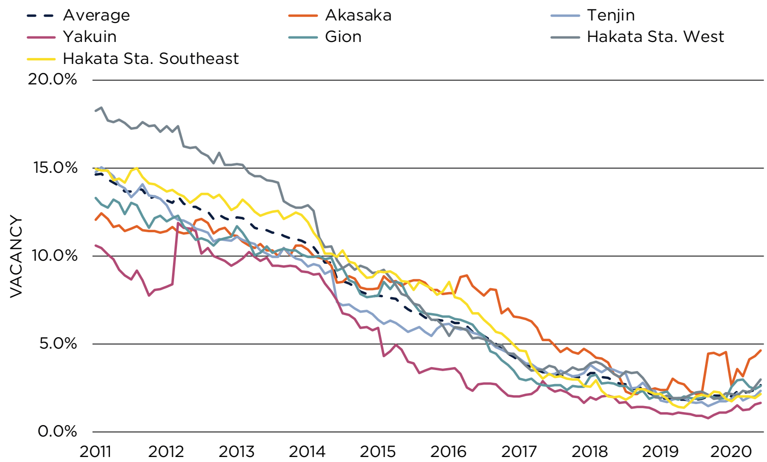
Whilst this region has an above-average exposure to the much-maligned manufacturing sector, tenants of high-grade properties tend to be financially sound. As such, many should be able to weather the ongoing storm for the time being. Still, vacancy will likely tick up and rents should remain somewhat flat for the foreseeable future.

GRAPH 12: New NRA Office Supply In Fukuoka City, 2006 to 2022



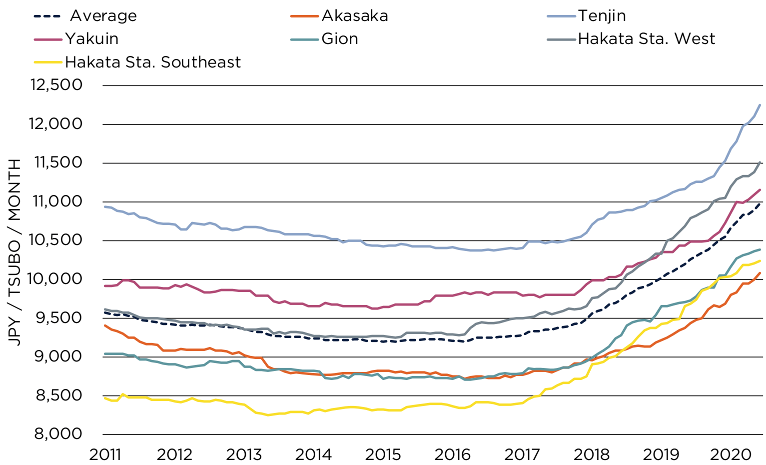
Source Sanko Estate, Building Group, Savills Research & Consultancy

GRAPH 13: Vacancy Rate In Fukuoka City By Area, 2011 to Q2/2020



Source Miki Shoji, Savills Research & Consultancy

GRAPH 14: Average Rent In Fukuoka City By Area, 2011 to Q2/2020



Source Miki Shoji, Savills Research & Consultancy

FUKUOKA CITY

NRA

Of the new supply expected this year in Fukuoka, the Kyukan Joutenji Dori Building is the largest. Specifically, completed in April, the B2/13F mixed-use structure, located near Hakata Station, added around 3,600 tsubo of NRA to the market.

Whilst supply added this year will be notable, the level of supply brought to the table in 2021 and 2022 will be significant. In fact, the former could see one of the highest levels of supply on record. Suffice to say, the dominating factor driving this marked expansion centres on the Tenjin Big Bang Project. Starting with the Tenjin Business Centre, scheduled for completion in 2021, 2022 will see the completion of the Former Daimyo Elementary School Site Redevelopment Project. Plans call for the huge multi-facility complex to house around 9,000 tsubo of NRA designated for office use. Thereafter, the next surge in supply is expected in 2024, with projects such as the Fukuoka Building – with around 13,000 tsubo of NRA – expected to come online.

With demand waning under the current circumstances, however, there is the feeling that the market may have peaked at the start of the year. As such, the landscape of the Fukuoka office sector currently looks vastly different. Aggressive pricing on new prime offices may therefore no longer be achievable.

Vacancy

The high-grade vacancy rate in Fukuoka has yet to reflect the obvious headwinds caused by COVID-19. Supply remains extremely tight at 0.3% – a mere 0.2ppts increase both YoY and half-on-half (HoH). The same cannot be said for Gion, however. Vacancy rates in this submarket have shown a marked change, rising over 1.0ppts to 1.3%, caused by relocations rather than supply expansion.

As for the all-grade market, vacancy rates have also started to gradually creep up of late. They now stand at 2.6% – a near 1.0ppts expansion over the year. This is perhaps understandable considering the wider spectrum of tenants attached to this sector, and by proxy, their weaker financial capacity overall. When looking at the submarket level, however, it is evident that most of this widening can be attributed to the 2.4ppts change in Akasaka.

Rent

Fukuoka experienced the highest rental appreciation in the high-grade office market this period, with growth of around 7%

TABLE 6: Fukuoka Prefecture Key Macro Indicators*

	JAPAN	TOKYO	FUKUOKA
Real GDP (JPY trillion)	485.2	103.6	18.2
Real GDP (YoY%)	-27.8	1.8	2.1
% of Japan (2015)	100%	20%	4%
Population (million)	125.9	14.0	5.1
Job to applicant ratio	1.1	1.4	1.1

Source Cabinet Office, Fukuoka Prefectural Government, Savills Research & Consultancy
*Real GDP for Japan is as of Q2/2020 and is preliminary, for Tokyo, Fukuoka and % of Japan, 2015.

TABLE 7: Fukuoka High-grade Office

	1H/2020	HOH	YOY
Rent	18,700	3.2%	6.7%
Vacancy	0.3%	+0.2ppts	+0.2ppts
Top Rent	25,000+	0	0

Source Savills Research & Consultancy

YoY. Rents are now over JPY18,700 per tsubo. Surprisingly, in contrast to the other regional high-grade markets, Fukuoka saw higher growth this period than the previous one, meaning that since 2016, annualised growth has been around 8% p.a – just exceeding the Osaka submarket.

At the all-grade level, rental growth was impressive, especially considering the current climate. Specifically, as of June 2020, growth over the year was 7.0% – by far the highest amongst the other regional markets. As a result, rents are at their highest level on record and within touching distance of JPY11,000 per tsubo.

Station Front

Despite the completion of two new office towers, which added around 10,000 tsubo of NRA, the vacancy rate in this submarket remained unchanged. Currently standing at 0.1ppts, it would appear that leasing activity over the period had been solid. Rents reacted accordingly, increasing by over 7% YoY. Looking ahead, the tentatively named Hakata 4-Chome Redevelopment project is expected to bring around 1,700 tsubo of NRA online next year.

Tenjin

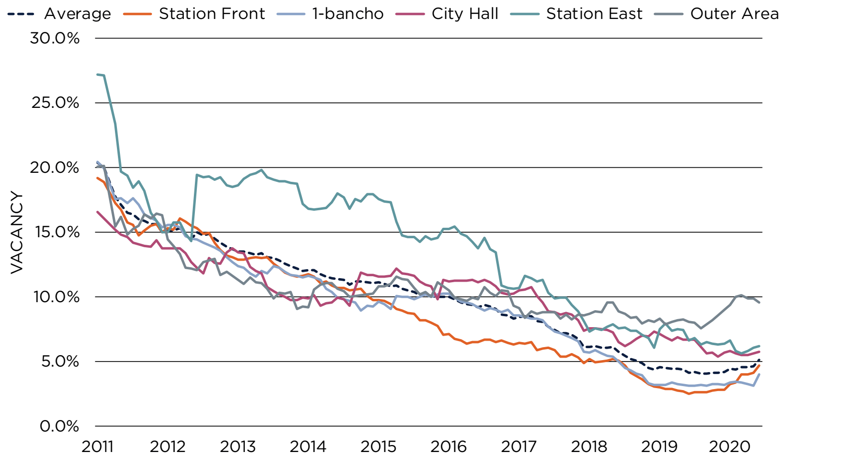
The range of high-grade rents in the Tenjin area have remained firm between JPY14,000 and JPY25,000 per tsubo. Even so, average rents saw a 5.4% YoY uptick, and now stand at around JPY20,800 per tsubo. Despite Tenjin experiencing the weakest annual growth amongst the submarkets, solid growth over the half-year has widened the gap between second placed Hakata. The premium now stands at around 4%.

Outlook

Previously, amid a buoyant market, rental growth in Fukuoka had been partly driven by tenants looking for alternatives after being evicted from their soon-to-be redeveloped offices. Yet, the market cannot rely on this dynamic to play out once more. Meanwhile, the region's disproportionate exposure to inbound tourism has also been a significant setback to the local economy, and as such, the prospects for the region appear downbeat.

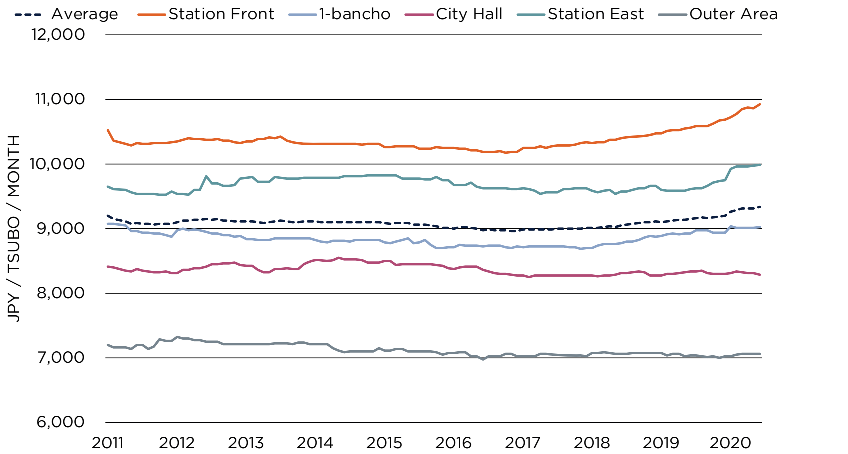
In truth, Fukuoka has been dealt a potential double blow of a global pandemic as well as a significant rise in upcoming supply. As a result of the outbreak stymieing pre-leasing activity, which had been ongoing in preparation for 2021 supply, there are now concerns over the market's short-term stability. Moreover, with 2022 assumed to also see a notable level of supply, the direction of future rents will likely depend on how pre-leasing for next year's supply progresses from here on out. Either way, for now, vacancy is likely to keep creeping up.

GRAPH 15: Vacancy Rate In Sendai City By Area, 2011 to Q2/2020



Source Miki Shoji, Savills Research & Consultancy

GRAPH 16: Average Rent In Sendai City By Area, 2011 to Q2/2020



Source Miki Shoji, Savills Research & Consultancy

SENDAI CITY

Supply

Of the five main regional office markets, Sendai has experienced the least change in supply recently. For instance, since 2010 – when the last meaningful phase of supply expansion was undertaken – Sendai's office NRA has declined by 0.4% as of June 2020. As such, supply remains comfortably below 0.5 million tsubo of NRA. All the while, driven by sound demand, much of the remaining supply has been absorbed over the period, contributing to rental growth – at least since mid-2017 – and the reduction of vacancy from as high as 20% during the start of 2011.

Whilst supply over the coming years is nothing to shout about, it will certainty make a change. In January this year, the city saw the completion of Sendai Kakyouin Terrace, a B1/9F office block with around 1,700 tsubo of GFA. In June, meanwhile, the mixed-use Sendai Miyagino Building was also completed adding around 4,200 tsubo of GFA.

New supply in 2021 will be even greater. Namely, coupled with the near 8,000 tsubo of GFA added from the tentatively named Sendai Station East Exit Office, the Milene T Sendai Building will also contribute approximately 3,000 tsubo of GFA.

Vacancy

Heading into 2020, the all-grade vacancy rate in Sendai was the highest among the main regional markets. As of June 2020, this remains the case. Specifically, unable

TABLE 8: Miyagi Prefecture Key Macro Indicators*

	JAPAN	TOKYO	MIYAGI
Real GDP (JPY trillion)	485.2	103.6	9.3
Real GDP (YoY%)	-27.8	1.8	1.8
% of Japan (2015)	100%	20%	2%
Population (million)	125.9	14.0	2.3
Job to applicant ratio	1.1	1.4	1.2

Source Cabinet Office, Miyagi Prefectural Government, Savills Research & Consultancy
*Real GDP for Japan is as of Q2/2020, for Tokyo, Miyagi and % of Japan, 2015.

to avoid the loosening of rates observed recently in its regional peers, vacancy in Sendai stands at 5.1% – the first time it has exceeded 5% since September 2018. In fact, over the year, this represents a loosening of 1.0ppts – once again the most among its regional group. Considering that supply has barely changed over the period, some fragility in the underlying fundamentals appears to have emerged.

Looking closer at the submarkets, the level of vacancy found in the Outer Area is hard to ignore. It stands at 9.6% as of June 2020 following a 1.5ppts increase YoY. Considering the profile of tenants located in this submarket, the likelihood of this figure contracting back to the 7.6% level - seen as recently as August 2019 - appears slim. Even so, this submarket was not where the greatest expansion was observed this period. This title goes to the Station Front – the prime submarket of Sendai. Previously home to the lowest levels of vacancy, it is perhaps not surprising that this trend has emerged given the rents attached.

Rent

Whilst rental growth in Sendai was the lowest relative to other regions, in absolute terms, the submarket has, in fact, posted its highest level of growth since the financial crisis. That said, rents only increased by 2.0% YoY to around JPY9,340 per tsubo – speaking volumes about the long-term trajectory of rents observed.

The aforementioned Station Front submarket is indeed the most expensive at nearly JPY11,000 per tsubo – over 9% higher than second-placed Station East. With rental growth of 3.4% and 3.9% YoY, respectively, these two submarkets contributed to the bulk of the region’s performance over the year. At the other end, rents in the Outer Area are the cheapest and remain unchanged over the year at around JPY7,060 per tsubo – a 35% discount to Station Front rents.

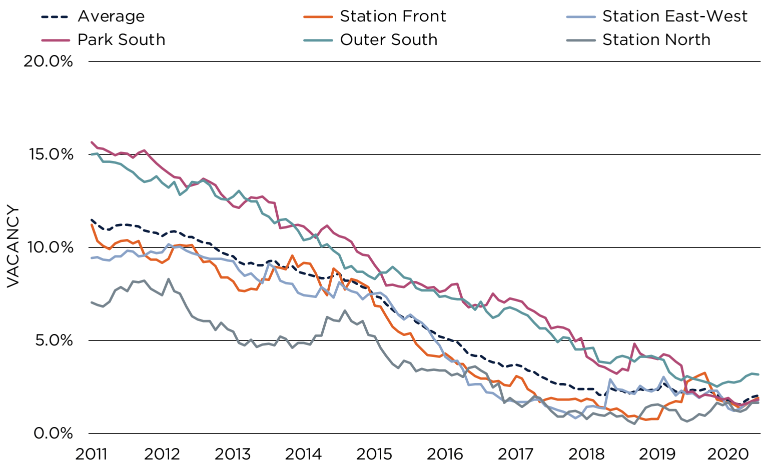
Outlook

The number of developments in Sendai has been few and far between, and this has maintained a sense of market stability. Moreover, without concerns over an abrupt surge in supply over the next few years, this should at least be one less thing to worry about amid all the global uncertainty. That said, like the country at large, the financial strain caused by the pandemic will no doubt impact office demand in Sendai. Rents are therefore expected to remain flattish, or even soften somewhat, especially in submarkets with above average vacancy.

The demographic trajectory facing Sendai, and to some extent Miyagi prefecture, in the meantime, presents a longer-term concern. Specifically, the former was forecast to see an estimated 8% decline in its working population between 2015 and 2025 – the largest among the regions surveyed in this report. When looking at the actual population numbers for 2020, whilst most prefectures are in better shape than initially forecast, Miyagi, unfortunately, does not fall into this category. Additionally, despite Sendai experiencing positive net migration between 2014 and 2019, the numbers lag regional counterparts.

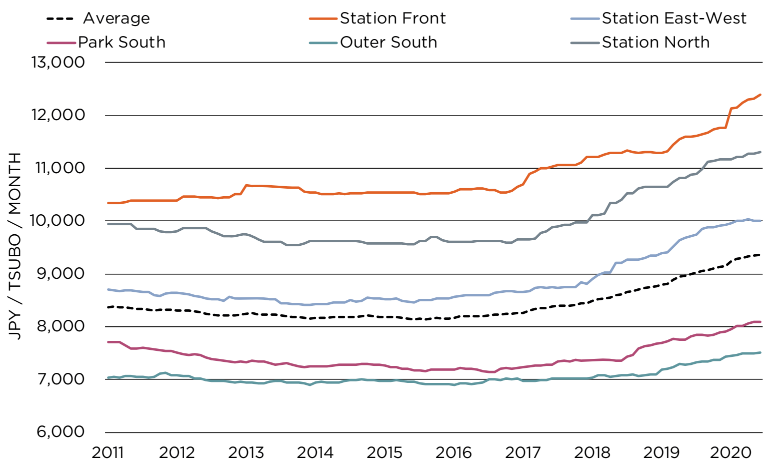
Indeed, though the short-term impact of the pandemic may be relatively manageable, as long as potential demographic headwinds hang over the region, the long-term outcome continues to be uncertain.

GRAPH 17: Vacancy Rate In Sapporo City By Area, 2011 to Q2/2020



Source Miki Shoji, Savills Research & Consultancy

GRAPH 18: Average Rent In Sapporo City By Area, 2011 to Q2/2020



Source Miki Shoji, Savills Research & Consultancy

SAPPORO CITY

Supply

It is no secret that Sapporo's office market is predominantly made up of older buildings. In fact, among major regions, the proportion of offices built in the city before 1981, when building standards concerning earthquake resistance were introduced, is the second highest after Fukuoka, at 37%. More recently, despite the implementation of initiatives in late-2018 to reverse this trend, not much has changed. Only an estimated 3,200 tsubo of NRA was added in 2019, for instance.

As for 2020, the Daido-Seimei Building was completed in March – a mixed-use facility with over 7,000 tsubo of GFA. Later this year, the tentatively named Samty Odori 5-Chome project is expected to bring around 1,400 tsubo of GFA online.

In truth, the start of this decade is predicted to be underwhelming in terms of new supply, with the lowest level of supply expected among major cities. The same cannot be said about the end of the decade, however. In anticipation of the expansion of the Shinkansen line going through Sapporo in 2030, the area around the main station will go through major change. For instance, plans call for a mixed-used tower with around 70,000 tsubo of GFA close to the South Exit. Elsewhere, on the east side of the station, JR Hokkaido plans to erect a tower complex matching the scale of Shibuya Scramble Square. Completion is planned for 2029.

Vacancy

Whilst the average all-grade vacancy rate for Sapporo has been slowly rising since

TABLE 9: Hokkaido Prefecture Key Macro Indicators*

	JAPAN	TOKYO	HOKKAIDO
Real GDP (JPY trillion)	485.2	103.6	18.3
Real GDP (YoY%)	-27.8	1.8	1.1
% of Japan (2015)	100%	20%	4%
Population (million)	125.9	14.0	5.2
Job to applicant ratio	1.1	1.4	1.0

Source Cabinet Office, Hokkaido Prefectural Government, Savills Research & Consultancy
*Real GDP for Japan is as of Q2/2020, for Tokyo, Hokkaido and % of Japan, 2015.

bottoming out in March 2020, it remains below its recent peak set in February 2019. As such, over the year, vacancy has slightly declined by 0.3ppts to 2.0%.

The Outer South submarket stands out relative to the other submarkets with a vacancy rate of 3.2% – over 1.0ppts higher than its peers. At the other end, the Station North submarket was once again the tightest submarket. Yet, despite a region low of 1.7%, over the year, this figure has actually increased by 1.0ppts.

Rent

With supply expansion outstripped by solid demand, all-grade rents in 1H/2020 continued to grow. Specifically, they increased by 4.1% YoY, and now lie at around JPY9,400 per tsubo – comfortably above pre-financial crisis highs.

Rents in the station front submarket are predictably the highest in this region at around JPY12,400 per tsubo. What was less expected, however, was the impressive growth observed in the area. Indeed, an increase of around 7% YoY places this central submarket significantly ahead of the other constituents. To put this into context, the next highest growth rate was witnessed in Station North, which saw rents increase by 3.8% YoY to around JPY11,300 per tsubo.

Outlook

Up until recently, Sapporo had been the go-to location for call centres and IT firms. Attracted by lower costs, in part supplemented with generous financial support, as well as the availability of labour, these firms had been the backbone of rental growth in the region. Yet, amid the global pandemic, this concentrated exposure to a select number of industries could become a drag on the Sapporo office sector.

In this new environment, demand from call centres appears especially vulnerable. The strict restrictions in place in the "new normal", also known as the "Three Cs", are proving particularly challenging to adhere to at the workplace, as demonstrated by the outbreak of infection clusters at these locations. Moreover, these two key sectors also appear ripe for innovation. As we have already seen elsewhere, IT firms in general have been more nimble in integrating flexible working practices. Technologies such as cloud computing and AI, meanwhile, have also been adopted by call centres, possibly further weighing on office demand.

With factors discussed above appearing unfavourable for the office sector, rents will likely be flat, or even tail off going forward.

savills

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

Simon Smith
Senior Director
Asia Pacific
+852 2842 4573
ssmith@savills.com.hk