MARKET IN MINUTES
Savills Research

Office Leasing

Tokyo office market resilient for now

Rental growth has noticeably slowed in the Grade A and B office markets. At the least, underlying fundamentals should ease some concerns amongst Grade A office landlords.

- In the central five wards (C5W), despite signs that the pandemic is starting to take its toll on the office market, vacancy rates continue to be airtight and rental growth has persisted, albeit marginally.
- Average Grade A office market rents in the C5W grew 0.2% quarter-on-quarter (QoQ) and 4.8% year-on-year (YoY) to JPY37,840 per tsubo[1] per month.
- The average Grade A office vacancy rate in the C5W increased slightly to 0.4% in Q2/2020.
- Average rents for large-scale Grade B office space rose to JPY28,656 per tsubo per month, growing by 0.3% QoQ and 3.7% YoY.
- The average vacancy rate in the Grade B market loosened slightly by 0.4 percentage points (ppts) QoQ and 0.3ppts YoY to 0.7%. A larger-than-average increase in Shibuya appears to be the main culprit.
- The high level of office supply expected this year is unlikely to raise alarms considering most of it has been filled or pre-leased. With supply levels drastically reducing in 2021 and 2022, the market should have some time to recover.
- With the spectre of COVID-19 casting a shadow of uncertainty over the office market, office quality and location matters more than ever. The true test for the sector looks set to take place in the remaining quarters of this year and next, especially at the lower end of the quality spectrum.

"Despite COVID-19's paralysing effect on the broader economy, the Grade A office sector has displayed resiliency thus far. With signs of potential fragility emerging in the lower-quality segment of the market in Q2/2020, however, an inflection point may have been reached. That said, the sound underlying fundamentals should ensure that market weakness is manageable for a while."

SAVILLS RESEARCH & CONSULTANCY

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

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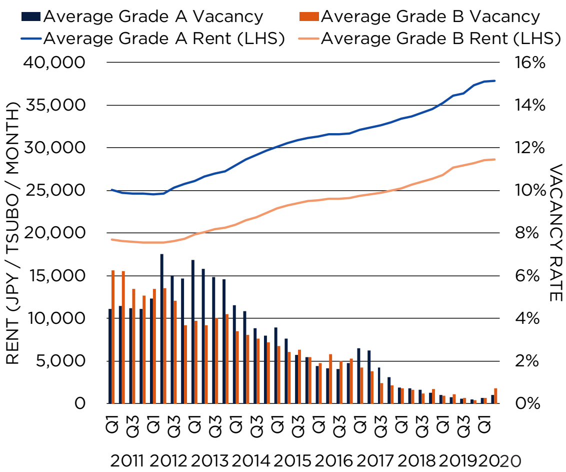
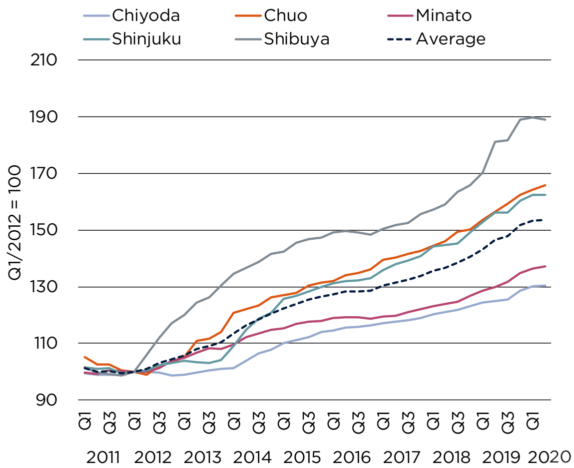
GRAPH 1: Office Rents And Vacancy In Tokyo's C5W*, 2011 to Q2/2020



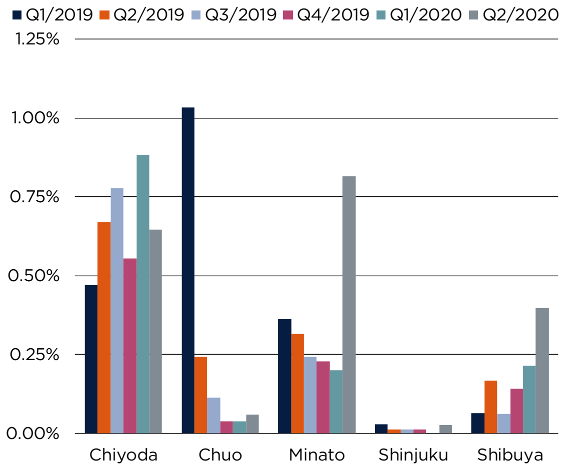
Source Savills Research & Consultancy
*Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index By Ward, 2011 to Q2/2020



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy By Ward, Q1/2019 to Q2/2020



Source Savills Research & Consultancy

GRADE A OFFICES

Whilst the full impact of the COVID-19 outbreak has been taking shape in the broader economy, the symptoms of the pandemic may have just started to emerge in the office sector. Quarterly rental growth has pretty much ground to a halt, with the lowest growth rate observed since the end of 2016. Meanwhile, multiple office floors are being returned, albeit only small ones for now. As such, the vacancy rate is likely to inch up further, with gradual, moderate increases expected to continue in the near term.

With less than half of the submarkets exhibiting any sign of growth, Grade A[2] rents increased by a mere 0.2% QoQ to JPY37,840 per tsubo[3] in Q2/2020. Over the year, the uptick in rents was more noticeable, coming in at 4.8%. The presence of growth, however, regardless of the magnitude, suggests that office fundamentals remain somewhat solid during these challenging times, at least for now. Moreover, with the vacancy rate entrenched below 0.5% since the end of 2018, and with nearly all the significant supply expected this year filled or pre-leased, a sudden and immediate deterioration of the market seems unlikely. That said, with the expectation that any relocations could take some time to manifest, the true test may lie in the quarters to come.

LARGE-SCALE GRADE B OFFICES

Unsurprisingly, rents in the Grade B[4] office market were not spared from the slowdown. Over the quarter, rental growth was very similar to its higher-grade peer, with rents increasing slightly to JPY28,656 per tsubo. As for annual rental growth, the rate contracted sharply to 3.7% – the lowest rate in over two years. Meanwhile, vacancy is where some divergence from the Grade A market appears. Namely, rates have loosened by 0.4ppts QoQ and 0.3ppts YoY, landing at 0.7% in Q2/2020.

Once again, Shibuya takes the spotlight, with growth over the year standing out in particular. To wit, the submarket now languishes at the bottom over the period – the first time in over a decade – with Minato taking its place at the top for the first time since mid-2017. The widening of vacancy rates was also particularly evident in Shibuya, where they increased by 1.2ppts QoQ and 1.1ppts YoY to 1.3% – the highest in the C5W.

As discussed previously, given that tenants housed in this market segment have relatively weaker balance sheets, and given Grade B offices tend to be in less convenient locations, fragility in this market is likely to emerge before the Grade A market.

2 "Grade A office" refers to buildings with a GFA of 9,000 tsubo (30,000 sq m) and a building age of less than 15 years. Some buildings are included that do not fit this definition.
3 Throughout the report, "per tsubo" is shorthand for "per tsubo per month".
4 "Large-scale Grade B office" refers to buildings with a GFA of 4,500 tsubo (15,000 sq m) and a building age of less than 25 years. Some buildings are included that do not fit this definition.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

With the effervescent rental growth experienced of late in Shibuya fizzing out in Q2/2020, Chiyoda can breathe a sigh of relief as it remains the most expensive submarket in the C5W. There may not be much to cheer about, however, considering rents remained pretty much flat over the quarter at JPY43,817 per tsubo. Rental growth over the year also slowed to 4.3% YoY, albeit not as much as some of its peers. Indeed, given the concentration of highly creditable tenants, rents in this submarket appear to be the most resilient amid the ongoing market stress. As a result, Chiyoda has managed to avoid being ranked at the bottom of the pack – the first time since Q3/2018. That said, it was only a slight improvement to fourth place, meaning it has been unable to break out of the bottom-two for around three years.

With an increasing number of tenants occupying Otemachi One Tower – which was completed in February – the vacancy rate in Chiyoda has come down by 0.2ppts QoQ to 0.6%. It remains unchanged over the year, however. Despite the contraction over the quarter, Chiyoda continues to have one of the highest levels of vacancy, once again highlighting how airtight the overall market has been of late. Looking ahead, the tentatively named Marunouchi 1-3 Project is slated for completion in September, bringing around 55,000 tsubo of mixed-use GFA online.

Chuo

Rental growth in this submarket was the highest in the C5W over both the quarter and year – the first time this feat has been achieved in around three years. Average rents are now JPY35,935 per tsubo following growth of 0.9% QoQ and 6.0% YoY. Despite this solid growth, rents remain around 5% cheaper than the C5W average, making Chuo an attractive proposition under the current economic uncertainty. Moreover, with the level of new supply in this ward expected to be limited until at least 2022 – where close to 32,000 tsubo of GFA is planned to be added in Yaesu – any concerns over market instability should be manageable for the time being. With that in mind, considering that the last time Chuo led the C5W across both time frames, it had already done so for four consecutive quarters, any resemblance of a repeat would be welcomed by landlords. As for vacancy, rates contracted by 0.2ppts YoY, hovering just

TABLE 1: Tenant Relocations, Announced In Q2/2020

ORIGIN						DESTINATION	
Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other		
9	9	10	3	4	20		
7	2	1			2	12	Chiyoda
	2				4	6	Chuo
	1	8	2	2	4	17	Minato
					2	2	Shibuya
			1	1	1	3	Shinjuku
2	4	1		1	7	15	Other

Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Announced In Q2/2020

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION	NEW LOCATION	APPROXIMATE SPACE	
					TSUBO	SQ M
Nomura Holdings and Subsidiaries	Financial Services	HQ Relocation	Nihonbashi Nomura Building, Chuo	Toyosu Bayside Cross Tower, Koto	12,000	39,700
Fuji Xerox	Technology	HQ Relocation	Roppongi T-Cube, Minato	Toyosu Bayside Cross Tower, Koto	6,000	19,800
PwC Japan Group (PwC Consulting, PwC Tax Japan, PwC Legal Japan)	Professional Services	Consolidation	Marunouchi Park Building, Chiyoda	Otemachi One Tower, Chiyoda	5,640	18,600
Mynavi	Communication Services	Business Expansion	New Office	Kabukiza Tower, Chuo	4,300	14,200
Mitsubishi Corporation Fashion	Consumer Staples	HQ Relocation	Ebisu SS Building, Shibuya	Sumitomo Fudosan Tamachi Building East Wing, Minato	2,000	6,600

Source Nikkei RE, Savills Research & Consultancy

above zero. There was no change over the quarter.

Minato

Other than Chuo, Minato was the only submarket to have experienced noticeable rental growth over the quarter. Specifically, rents increased by 0.5% QoQ to JPY34,733 per tsubo. Also similar to Chuo, annual growth in this submarket comfortably exceeded the C5W average, coming in at 5.6%. Despite these solid growth rates, Minato remains the submarket that perhaps offers the most value in the C5W. Indeed, rents are still around 30% below previous highs seen in 2008, suggesting there is some downside protection compared to the likes of Shibuya.

Going forward, the submarket's relative affordability is likely to continue given the significant levels of supply expected to come online in 2020 and 2023 – where supply in Minato is likely to account for over 70% of the C5W's total. As such, with workplace reform gaining traction, the evolution of office demand in the intervening years could determine the longer-term prospects for this growing submarket. For now, however, some secondary vacancy has emerged following a slackening of 0.6ppts QoQ and 0.5ppts YoY. Even so, with the rate standing at 0.8%, any nerves should be kept in check for now.

Despite the above, the relocation of Konami Holdings from Midtown East – expected to take place later this year – could raise some concerns given its scale. Namely, the digital entertainment firm is reportedly vacating over 10,000 tsubo of NRA mainly in order to move into its company-owned office in Chuo, which was completed in November 2019. Given that the vacated space accounts for over 1.0% of the ward's total stock, the move is hard to ignore. What's more, with the rents remaining as high as they currently are, despite some of the floors finding a new tenant, filling all of this substantial space in a short period of time may prove difficult under the current conditions.

Shibuya

For a while now, Shibuya has been the C5W darling when it comes to rental growth. Yet, elements of a potential reversal in sentiment were observed in the submarket this period. Indeed, it would appear that the previously robust growth seen in this submarket has now resulted in it becoming the hardest hit from the COVID-induced market instability. To wit, rents contracted by 0.4% QoQ to JPY40,381 per tsubo. Meanwhile, over the year, rents only increased by 4.3%, meaning that the submarket's streak of four consecutive quarters of double-digit growth has finally been broken. Considering that Shibuya experienced growth of around 14% YoY as recently as Q4/2019, this sharp slowdown certainly stands out.

With a greater concentration of technology firms as tenants, the submarket finds itself at the forefront of the workplace environment transformation. This change in sentiment, therefore, could have legs. Yet, in some ways, this adjustment in rental growth could also be deemed necessary in order to reign in the previously exuberant demand, with this mean reversion returning some resemblance of normality to the submarket. At the same time, some weakness in vacancy was also visible, albeit not at the same scale as rental growth. Namely, rates ticked up by 0.2ppts over both timeframes to 0.4% - the highest level since Q3/2018. Meanwhile, considering the above, there is the possibility that these adjustments could also lead to some collateral damage to neighbouring areas such as Ebisu, Gotanda and Osaki.

Shinjuku

Shinjuku continues to lag its C5W brethren in terms of new developments. For instance, other than Yotsuya Tower – completed in January this year – the last project to be completed was back in 2012. The same can be said for rents, and this status quo looks likely to persist for the foreseeable future, especially with the lack of rental growth over the quarter in Q2/2020. To wit, rents were unchanged at JPY34,333 per tsubo. Growth was more encouraging over the year at 4.0%, though like rents, it was the lowest in the C5W. This combination of affordability and the lack of availability – Yotsuya Tower was fully occupied from the outset for instance – has resulted in the vacancy rate remaining firmly at zero since the start of 2019. What's more, the tightness of the submarket has meant that Q2/2020 was the first time in almost seven years that the submarket has ranked at the bottom for annual rental growth.

SIGNIFICANT, YET MANAGEABLE OFFICE SUPPLY THIS YEAR

2020 is set to be a historic year in terms of office supply, with some 450,000 tsubo of GFA estimated to come online in the C5W alone. After a lull in the two years to follow, 2023 is the next milestone, likely succeeded by 2025 thereafter. As for the wards in the C5W, Shibuya, which saw significant levels of new supply in 2019, will be much quieter this time around – perhaps a blessing in disguise considering the sharp slowdown in rental growth observed in Q2/2020. The Minato and Chiyoda submarkets will instead be home to the largest increase in supply this year.

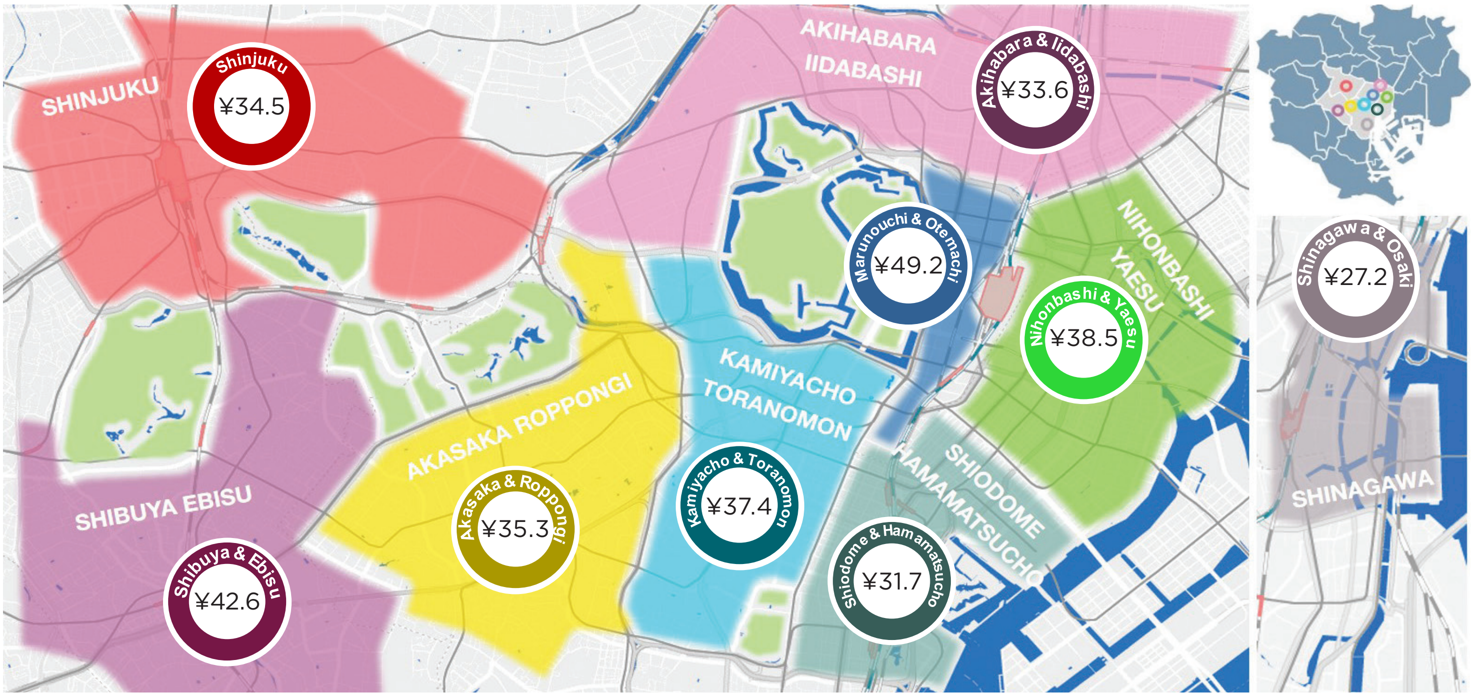
Meanwhile, in addition to having a profound impact on the working environment, COVID-19 could also enlarge the gulf in rents between offices in the Grade A and below markets, as well as those in prime locations, likely near a station, and those in inconvenient areas. Over the medium term, however, the prospects for office rents could be determined by the recovery of the economy, how permanent and significant telecommuting becomes, as well as the progress made along the path to finding a viable vaccine.

(For further information regarding the current and upcoming levels of office supply in Tokyo please refer to our "Tokyo Office Supply" report published in June 2020)

OUTLOOK

Despite the debilitating impact of COVID-19

MAP 1: Average Rents Per Tsubo In Selected Submarkets, Q2/2020



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

Savills monitors rents and vacancy levels at more than 450 buildings located in Tokyo's central five wards with a GFA of 3,000 tsubo (10,000 sq m) or above. Unlike similar market information issued by other research institutions, the rental data provided relates to estimated passing rents, inclusive of common area management fees, as opposed to asking rents. Meanwhile, vacancy figures reflect current vacant space without the inclusion of 'expected' vacancy, or that reported prior to tenants vacating their premises. As a result, benchmark figures, particularly vacancy rates, tend to be lower than other market indices.

on the Japanese economy, which had already been suffering from the consumption tax hike in October 2019, the Grade A office sector has fared relatively well up to this point. Sudden imbalances in market forces have been averted, thanks in part to tenants made up of cash-rich Japan Inc. companies who have avoided making rash decisions. This is not to say that the Grade A office market has been immune, however. The sharp slowdown in annual rental growth in Shibuya, for example, clearly indicates a potential tipping point for the sector, whilst this is also backed up by the absence of quarterly growth in most submarkets. All the while, vacancy rates have started to inch higher as a result of tenants returning office floors, albeit the vacated space remains small for now.

Amid the ongoing market uncertainty, like in crises of the past, the strongest will get stronger, and this time around, performance across the office sector is set to diverge based on a few key factors. Firstly, tenant quality or creditworthiness will be vital, especially given the financial difficulties affecting the broader economy. Indeed, the relatively large upticks in vacancy found within the lower-grade markets could be a canary in the coal mine for what is to come. At the same time, the impact from the paradigm shift in the working environment, such as working from home, will vary amongst industries and corporate sizes, with technology firms likely to be in the forefront of this change. Meanwhile, in line with this shift, office location will be key. Seeing as the home is now a viable workplace, offices far away from stations or in inconvenient areas could be disproportionately hurt by this new trend, particularly considering well-located offices could now be chosen for the main purpose of increasing productivity and idea generation. Given the above, therefore, submarkets that are able to satisfy these conditions should be able to come out of the pandemic relatively unscathed.

As for office supply, the significant levels expected in 2020 may have caused concern in previous years, but vacancy rates were already stubbornly low and pre-leasing activity had been solid. The timing of below-average supply anticipated in 2021 and 2022, meanwhile, be it by luck or design, is certainly welcome. That said, a noticeable increase in secondary vacancy is likely in 2021 considering the large supply this year and the market's delayed reaction to the pandemic so far. The hope is, however, with the relatively low infection rates observed in Japan, the economic recovery can begin in earnest sooner rather than later, with the aim for office demand to return well before the next surge in supply arriving in 2023.

The Grade A market has, therefore, reached a critical moment, and the quarters to follow this year and next should reveal the true impact of the pandemic. Yet, the sector's relative resilience means that the turbulence in the interim should be manageable.