Tokyo – Q3/2020

MARKET IN MINUTES

Savills Research

Office Leasing

Market vulnerability emerging

Whilst quarterly rental growth turned negative for the first time in almost a decade, most of this market weakness is centred in Shibuya.

- In the central five wards (C5W), some weakness in the office market has emerged. Rents have contracted slightly and vacancy rates have expanded, led mostly by adjustments in Shibuya. Yet, the gravity of these changes remains manageable.
- Average Grade A office market rents in the C5W fell 1.1% quarter-on-quarter (QoQ) but maintained growth of 2.8% year-on-year (YoY) and now stand at JPY37,421 per tsubo[1] per month.
- The average Grade A office vacancy rate in the C5W slightly increased to 0.7% in Q3/2020.
- Average large-scale Grade B office rents declined to JPY28,511 per tsubo per month – a contraction of 0.5% QoQ, but growth of 2.2% YoY.
- The average vacancy rate in the Grade B market lies at 1.0% following a loosening of 0.3 percentage points (ppts) QoQ and 0.7ppts YoY.
- The material changes in the working environment may have taken some of the attention away from the potential economic hardships on the horizon. Nonetheless, for the time being, established Japanese corporates should have enough cash, and therefore time, to draw up a thorough office strategy.
- Going forward, flattish rental movement is expected to continue as both tenants and landlords maintain their wait-and-see approach. Yet, we could see significant developments in 1H/2021 amid financial reviews in preparation for the new fiscal year, including leasing strategies.

"Signs of the potential impact of COVID-19 on the Tokyo office market have surfaced, though for now Shibuya is the main focus. Even so, given the cash holdings and short-term financial forecasts of Japanese corporates, average rents should hold steady over the next six months."

SAVILLS RESEARCH & CONSULTANCY

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

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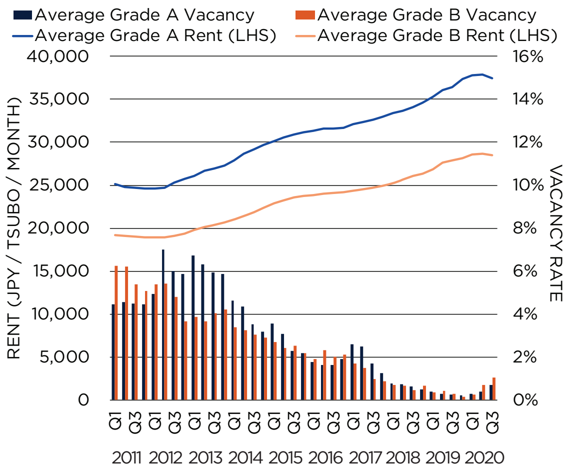
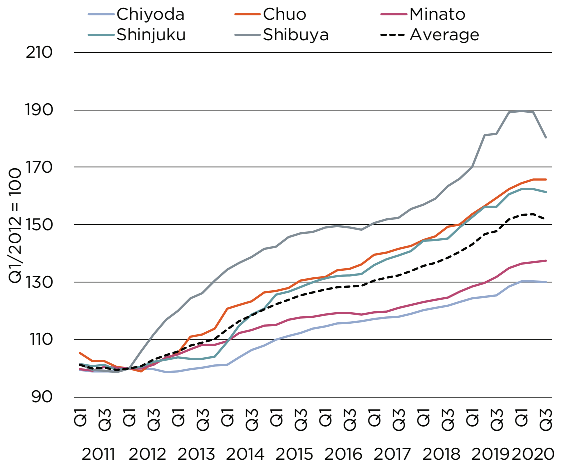
GRAPH 1: Office Rents And Vacancy In Tokyo's C5W*, 2011 to Q3/2020



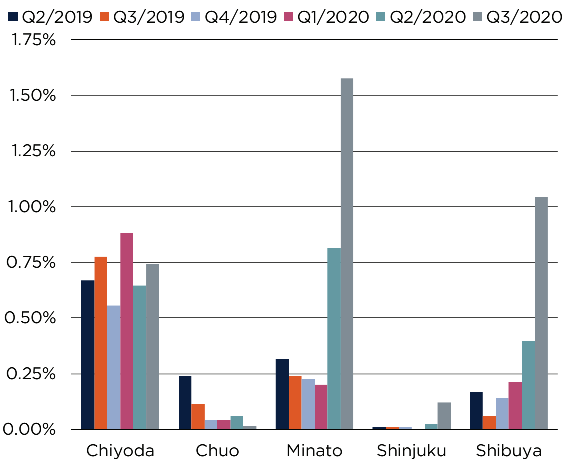
Source Savills Research & Consultancy
*Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index By Ward, 2011 to Q3/2020



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy By Ward, Q2/2019 to Q3/2020



Source Savills Research & Consultancy

GRADE A OFFICES

For the first time in almost a decade, Grade A[2] rents have posted a quarterly decline. Specifically, rents fell by 1.1% QoQ and now stand at JPY37,421 per tsubo[3] – the lowest level recorded in 2020. Unsurprisingly, this has also meant that the slowdown in annual rental growth has continued into Q3/2020.

Whilst the slight decrease in rents over the quarter could be construed as the start of something worse, looking at the performance of each submarket individually goes some way in easing these concerns. In this context, Shibuya is the stand-out submarket, for all the wrong reasons. Against a backdrop of flattish rental growth in the other submarkets, the former darling of the C5W languishes at the bottom following a near 5% QoQ reduction in rents. The story is very much the same YoY, with Shibuya being the only submarket to have experienced negative growth of around 1%. If this much-maligned submarket is taken out of the equation, however, rents would have remained flat over the quarter.

The bedrock that traditionally drives said growth, namely vacancy rates, remain airtight in the Grade A market. Indeed, speculation concerning lease agreement cancellations and the subsequent returning of some floor space aside, for the most part, tenants are staying put. Moreover, the fact that 2020 has been billed as a historic year for office supply, and yet, three quarters of the way in, vacancy rates remain close to nil is comforting. Although a future market deterioration cannot be ruled out, investors can breathe a sigh of relief, at least for now.

LARGE-SCALE GRADE B OFFICES

The Grade B[4] market was essentially a mirror image of the Grade A market in Q3/2020. For instance, rents in the former also contracted over the quarter, though the decline was milder at 0.5% QoQ. Meanwhile, annual rental growth has slowed to 2.2% this period – the lowest clip in over three years. As a result, average rents now stand at JPY28,511 per tsubo.

Following an expansion in every quarter this year, the average Grade B office vacancy rate now lies at 1.0%. Even so, Shibuya is once again the main offender. For the second period in a row, this submarket has seen its vacancy rate rise by over 1.0ppts, translating into a 2.6ppts YoY expansion to 2.9% in Q3/2020. To be sure, the broader stability demonstrated in this market segment thus far is encouraging. Yet, the concerns over how long this can go on for continues to dampen market sentiment.

By definition, our coverage within the Grade B market is limited to offices classified as "high-grade". As such, Grade B offices that do not fall under this description are likely to suffer worse from an economic downturn.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

Chiyoda's position as the most expensive submarket appears ironclad, especially when considering Shibuya's recent struggles. Despite rents adjusting to JPY43,717 per tsubo – following a slight decrease of 0.2% QoQ, but an increase of 3.6% YoY – the submarket has led the pack for well over a decade. One possible explanation for this trend concerns the tenant pool of established companies found in Chiyoda. Indeed, rental stability appears to have been underpinned by these deeper pocketed tenants, who continue to take a wait-and-see approach. As such, rents are likely to continue to maintain this calmness for the time being.

Turning to vacancy, Chiyoda has one of the higher rates in the C5W at around 0.7%. In truth, much of this is driven by vacancies found in offices completed this year, especially Kanda Square. Speaking of completions this year, Bristol-Myers Squibb is reportedly set to occupy almost 3,000 tsubo in Otemachi One Tower during 1H/2022, relocating from Shinjuku i-Land Tower, in Shinjuku, and JP Tower, in Chiyoda.

In terms of new supply for the rest of the year, this submarket is home to the two largest remaining projects in 2020 – totalling 80,000 tsubo of mixed-use GFA. Specifically, the Marunouchi 1-3 Project and the Marubeni New HQ Building are slated for completion in September and October, respectively. Even so, the fact that both projects are expected to be fully let upon completion further endorses the submarket's resilience. Hence, the prospects for Chiyoda certainly appear more upbeat.

Chuo

Perhaps somewhat overshadowed by the elevated rents in Chiyoda, the previously stunning growth rates observed in Shibuya or even the numerous redevelopment projects in Minato, Chuo has been going under the radar recently. Yet, the submarket stands out once more in terms of post-financial crisis recovery. Specifically, on the back of rents rising by 4.1% YoY to JPY35,935 per tsubo, it is the only one to be within 10% of its previous high. Rents did, however, remain unchanged over the quarter.

Meanwhile, for the first time in around eight years, Chuo is the tightest submarket. Indeed, without any supply pressures this year, the vacancy rate stands at zero once again – a milestone previously reached at the start of 2020. From here on out, with the

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.

TABLE 1: Tenant Relocations, Announced In Q3/2020

ORIGIN	Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other	DESTINATION	
Total	2	5	11	3	4	20		
	1	1	3		3		8	Chiyoda
								Chuo
		1	8	1		4	14	Minato
				1			1	Shibuya
					1	1	2	Shinjuku
	1	3		1		15	20	Other

Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Announced In Q3/2020

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION	NEW LOCATION	APPROXIMATE SPACE	
					TSUBO	SQ M
Zenkyoren and group company Chuo Computer Systems	Financial and Technology	Relocation	Kowa Kawasaki Nishiguchi Building Saiwai	Mebks Toyosu Koto	7,000	23,100
Lion	Consumer Staples	HQ Relocation	Lion Headquarters Building Sumida	Kuramae Project Taito	6,000	19,800
Bristol-Myers Squibb	Health Care	HQ Relocation	Multiple Shinjuku & Chiyoda	Otemachi One Tower Chiyoda	2,800	9,200
Shiseido Japan	Consumer Staples	Expansion	New Office	msb Tamachi Tamachi Station Tower North Minato	1,730	5,700
Synfomix	Materials	Expansion Through Merger	New Office	Shinbashi Tamuracho Project Minato	1,600	5,200

Source Nikkei RE, Savills Research & Consultancy

next surge in supply planned for 2022, rates are likely to remain extremely low. The main caveat here, as well as in all other submarkets, continues to revolve around the changes in sentiment based on the broader economy. Even so, as in Chiyoda, Chuo is home to many established Japanese companies meaning that the underlying fundamentals in the submarket are expected to remain stable for now.

Minato

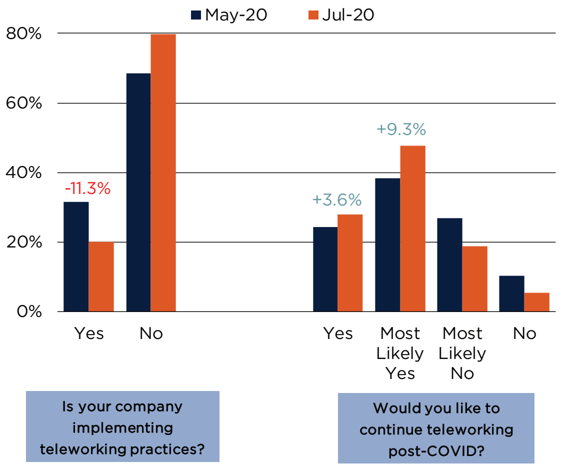
Minato has once again outperformed the broader market. Namely, the submarket was the only one to demonstrate quarterly rental growth in Q3/2020, with rents rising 0.3% to JPY34,844 per tsubo. Additionally, with growth lingering in this submarket, rents increased by 4.3% YoY – the highest in the C5W. The combination of its relative inexpensiveness – as the second cheapest submarket in the C5W – and perhaps the diverse nature of businesses located in the area may have contributed towards this dynamic.

The presence of rental growth aside, Minato is home to the highest level of vacancy in the C5W at 1.6% following a loosening of 0.8ppts QoQ and 1.3ppts YoY. On the one hand, given that the submarket is estimated to be responsible for around half of all supply completed this year – a significant sum – the level of vacancy remains manageable. On the other hand, the relocation of Konami Holdings from Midtown East (accounted for in this period but will begin in earnest in October) – the driving force behind this marked expansion – could presage a broader change in market sentiment going forward. Indeed, whilst the rate is still well below the 7% mark observed during the financial crisis, given the recent supply surge, a turn in market sentiment could be damaging. For now, however, rumours regarding major relocations are limited until at least Q2/2021, and thus, this submarket should be somewhat stable in the interim.

Shibuya

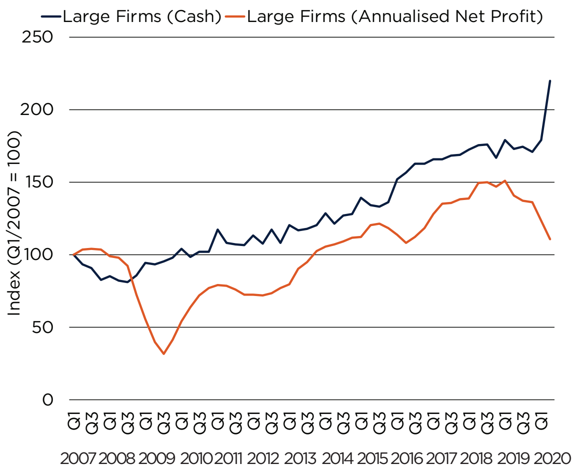
Things have turned full circle in Shibuya, and it appears to be bearing the brunt of the global pandemic. The higher exposure to technology firms and start-ups has come back to haunt the submarket, and having experienced a slight pullback last time, rents have fallen sharply this quarter. To wit, rents have dipped below JPY40,000 once more and currently lie at JPY38,524 per tsubo. Indeed, this near 5% QoQ fall is certainly eye-catching, especially considering a decline like this has not been seen since the fallout from the global financial crisis over a decade ago. Consequently, annual growth has also turned negative. Whilst this is a worrying trend, to some extent, it could be viewed as a natural correction, rather than a market deterioration, following the breath-taking upswing in rents of almost 14% observed during 2019. Regardless, the true driver of this adjustment is likely to become more apparent over the next few quarters.

GRAPH 4: Survey Responses Regarding Current And Future Teleworking Practices, July 2020



Source Japan Productivity Center, Savills Research & Consultancy

GRAPH 5: Cumulative Cash Holdings By Large Japanese Corporates, 2007 to Q2/2020



Source Ministry of Finance, Savills Research & Consultancy

Perhaps somewhat paradoxically, however, the reduction in rents has not been driven by a spike in vacancy. In truth, whilst the rate has undeniably expanded over both the quarter and year, it remains – like most of the other submarkets – tight at 1.0%. Moreover, much of these changes across rents and vacancy can be attributed to specific buildings. As such, for the rest of the offices that make up the submarket, the market fundamentals currently seem in better shape than at first glance.

Shinjuku

As a result of a dearth of redevelopment projects, Shinjuku has by far the oldest offices in the C5W. Specifically, they are, on average, a decade older than the next in line, namely Shibuya. In the absence of offices with modern high-spec layouts, demand for space has been understandably tepid and, maybe as consequence, rents remain the cheapest at JPY34,083 per tsubo.

Whilst the upside has been moderate, rental stability can be expected over the short-term for two reasons. First, perhaps partly due to these older offices, this submarket is less exposed to technology firms and start-ups, and by proxy the unprecedented change in working styles. Additionally, the total supply planned for next year and beyond is estimated to be less than the level added in 2020 alone.

In the same vein, vacancy rates in Shinjuku have also shown some durability in Q3/2020. Indeed, they remain airtight at 0.1% after minimal increases over both the quarter and year. In fact, this submarket is the only one to have had a vacancy rate below 1% for almost four years, once again demonstrating the calmness of the underlying fundamentals.

That said, there have been some rumours of potential relocations behind the scenes, which could materialise in late-1H/2021. As such, Shinjuku vacancy may face a somewhat upward trajectory over the medium-term.

ECONOMIC CONDITIONS, RATHER THAN WORKPLACE REFORM, TO IMPACT THE OFFICE MARKET

The potentially devastating impact to the office sector following the reforms in the working environment has been well-documented, but the warnings appear to have been inflated. For example, Fujitsu's announcement to have half of their employees working remotely, whilst eye-catching, is ambiguous given the timeline of at least three years. What's more, being a technology firm, not only would this transition be easier than most, and thus not a representation of the broader market, it also helps that these headlines aid the marketing of their products.

Adding further credence to this view is a survey conducted by the Japan Productivity Center (1,100 respondents) in July 2020. Specifically, compared to the May edition of the survey, the implementation rate of remote working across the country fell by 11.3ppts to 20.2% over the period (Graph 4). Whilst the decline is likely to be less marked in Tokyo, it represents a change nonetheless.

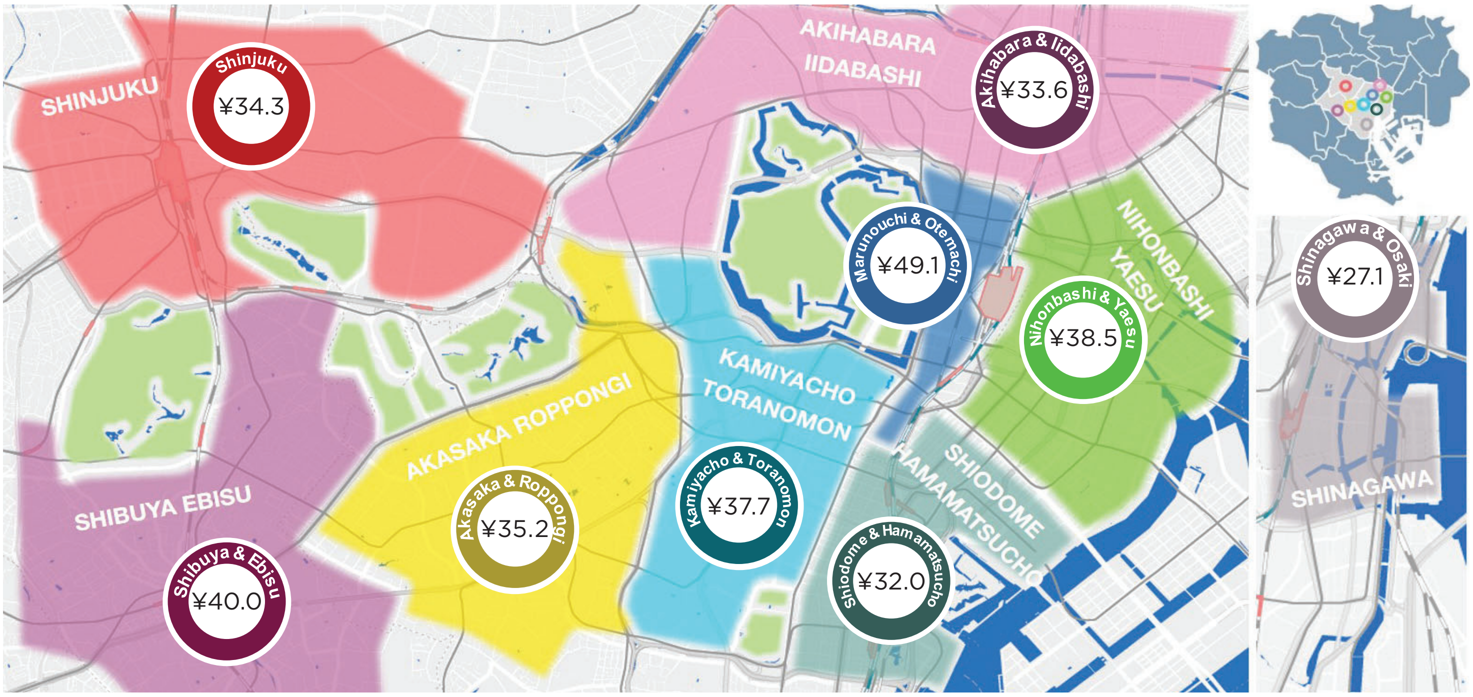
Other hurdles also exist elsewhere. Broadly speaking, the tendency for Japanese society to be context-based means business culture thrives in a more direct, office setting. Additionally, unlike Western counterparts, Japanese workers are contracted to undertake a broad range of functions determined by the company itself, rather than within a specific function. As such, converting the workforce en masse to teleworking would not be that simple.

Even so, COVID-19 has certainly accelerated the trend in Japan's rather rigid business culture. In the same survey, the proportion of respondents who wanted to continue working remotely post-COVID increased by around 13.0ppts. Therefore, it is probable that some element of telework will remain going forward, and this is a significant development, especially for female workers. For instance, this flexibility is conducive for those with young families, who may have traditionally left the workforce on a temporary basis, as well as those who have delayed starting a family. As one can imagine, the potential long-term economic benefits from the increase in productivity, in concert with a slowing of the declining population, are huge.

Regardless, average Grade A rents have somewhat softened and vacancies have ticked higher, revealing that there are underlying forces at play being overshadowed by the impact from this remote working trend. Indeed, market-wide effects may be a symptom of a potential economic deterioration weighing on office demand, rather than workplace reforms. In this regard, listed Japanese corporates have gradually begun releasing forecasts – which had been delayed amid the outbreak – for the upcoming financial year, and it makes for grim reading. According to the Nikkei, net profits are expected to continue falling, with the figure halving between 2018 - the recent peak - and 2021. Whilst this contraction is understandable and seemingly not that bad amid a pandemic, it is likely to weigh on office demand going forward.

Despite these forecasts providing evidence for the debilitating impact of COVID-19, in the meantime, large established Japanese firms (those with more than JPY1bn of capital) – commonly tenants of Grade A offices – have an ace up their sleeve. Specifically, having gone into the pandemic with a sizeable cash pile, this has grown at an even greater clip in the period since (Graph 5). Thus, this should act as a buffer for the next six months or so, adding to the subdued nature of the market so far.

MAP 1: Average Rents Per Tsubo In Selected Submarkets, Q3/2020



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.

OUTLOOK

For the most part, the Grade A office sector continues to demonstrate resilience in the face of the global pandemic. Although rents have fallen slightly, this has been predominantly driven by the submarkets most exposed to the teleworking movement, specifically Shibuya. Even in this submarket, downgrades in both rents and vacancies are representative of the idiosyncrasies of particular offices, rather than being a widespread phenomenon.

Concurrently, pre-leasing of supply expected in 2021 appears to be sound with around 80% already filled. Whilst encouraging, this demand relates to modern offices in convenient locations. Hence, sentiment towards the broader market remains uncertain.

With decent near-term forecasts for established Japanese corporates, supported by their notable levels of cash, for now, the C5W's prospects should be determined by how the more vulnerable submarkets (such as Shibuya, Minato and to some extent Shinjuku) fare. Thus, average rents should remain somewhat flattish as both tenants and landlords maintain their wait-and-see approach. Indeed, in most cases, landlords are yet to turn to rental reductions or free-rent incentives as tenant appetites have been supressed amid the outbreak, and leasing activity has slowed regardless of the level of rent. Average vacancy rates, meanwhile, look likely to remain tight next quarter, perhaps even remaining below the 2% mark in the likes of Minato and Shibuya.

Overall, therefore, the Grade A market, whilst stable currently, remains in a precarious position. As such, considering all the above, 1H/2021 will be key indeed. With corporate strategy for the upcoming fiscal year decided during the Spring, ultimately, over the medium-term, it will probably be the economic fallout from the pandemic that drives market fundamentals rather than workplace reforms.

To make matters worse, global geopolitical headwinds have resurfaced and are likely to weigh on the domestic economy as well as the global economy. Despite the Japanese economy appearing relatively more stable, market participants will certainly be hoping for any sign of recovery going forward.