

Japan - June 2020

Q
SPOTLIGHT
Savills Research

Tokyo Office Supply

savills



Imminent supply appears manageable but potential paradigm shift awaits

Summary

- With existing vacancy airtight and new supply in 2020 mostly filled or pre-leased, the Grade A office market, which typically hosts high credit tenants, currently remains on firm ground.
- 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 central five wards (C5W) alone. After a lull in the two years to follow, 2023 is the next milestone, likely succeeded by 2025 thereafter.
- Although much of the new supply remains concentrated in the C5W, the relative value offered in the 18 outer wards (18W) should lead to a rise in the area's proportion of projects over the next few years.
- Shibuya, which saw significant levels of new supply in 2019, will be much quieter this time around. Business districts such as Otemachi and Toranomom will instead lead the charge in 2020. Meanwhile, 2023 is likely to be a year to remember for the latter, following the completion of the Toranomom-Azabudai Project.
- COVID-19 has already had a profound impact on daily working life for employees. For landlords, the crisis appears to have made prime assets even more valuable as location now matters more than ever.
- With the transition in work styles notably varying amongst companies of different industries and scale, the landscape of the Grade A office market in the C5W could undergo noticeable change.
- Alternatively, the rapid and widespread distribution of a viable vaccine could see these seismic shifts crimped.
- Uncertainties abound and some market volatility is expected on the path to normalisation, with vacancy rates likely to pick up going forward.

SUPPLY PIPELINE

With 2019 being an average year in terms of new office supply, amid the intense competition for space, Grade A office vacancy in the C5W was close to nil. Meanwhile, underpinned by solid corporate profit growth – particularly in the technology sector – rents continued their upswing. Specifically, by year end, average Grade A rents in the C5W had reached JPY37,373 per tsubo per month – an increase of 8.0% year-on-year (YoY). Indeed, fundamentals appeared solid heading into the new decade, only for the COVID-19 outbreak to scupper the sector's previously optimistic prospects.

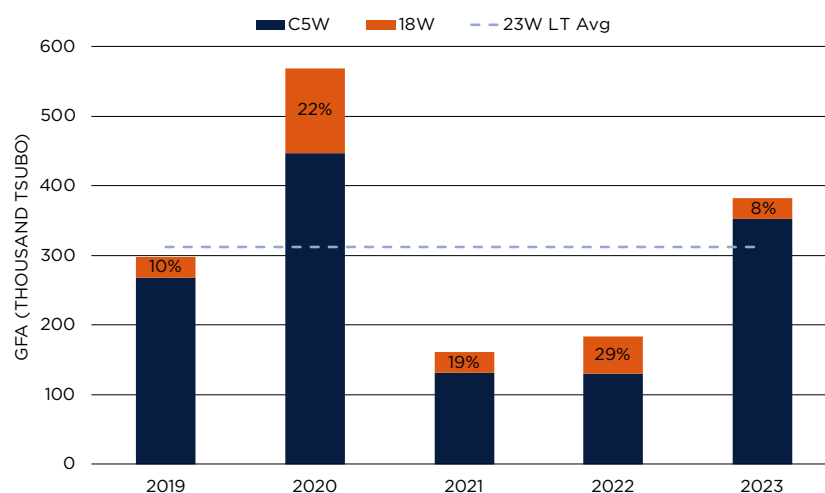
Looking further ahead, the Grade A office market could be set for a bumpy ride. Supply this year is predicted to be almost double that of 2019 (Graph 1), and the most since 2003. Thereafter, the next surge in supply is expected in 2023, where around 380,000 tsubo could come online. Bookended by these instances of significant supply, the difference during 2021 and 2022 will be stark. The lower levels of new supply expected in these years will do much to alleviate the pain from secondary vacancy, which will likely make a noticeable appearance in 2021. As such, viewing this four-year period as a whole, supply is anticipated to be somewhat similar to the long-term average. As for 2024, whilst information is limited, the expectation is for supply to be similar to 2019. In contrast, 2025 is anticipated to see another supply boom led by East Japan Railway's Shinagawa Development Project (phase I).

The development will certainly be a boon for Tokyo's status as a dynamic, global city, though its large office component may soften mid-term rental growth in the sector.

Of the many projects to be completed, a common theme is size. In fact, aligned with the previous calls for larger floor plates in order to foster collaboration, the number of large-scale projects (with GFA of over 30,000 tsubo) in 2020 is set to be the most in history (Table 1). Yet, the requirements for social distancing, and the emergence of both remote work and flexible hours as part of corporate life, could have a marked impact on office preferences in the post-pandemic world. That said, the talk of potentially drastic changes might be premature without a known timeline for the availability of a viable vaccine. After all, large companies may end up keeping the majority of currently leased space for the time being if, during strategic review and before implementation – which could easily take more than a year, the threat of the pandemic starts to subside.

Unsurprisingly, given the economic importance of the C5W, most new office developments are located in this submarket. That said, there are signs that developers are looking further afield in search of opportunities. For instance, having accounted for around 13% of new office supply in 2018 and 2019, the 18W's average share is likely to increase to around 18% during 2020 to 2023. Most notably in 2022, this figure could be as high as 29% (Graph 1), with Shinagawa

GRAPH 1: Combined Office Supply (GFA) Estimates for the C5W and the 18W, 2019 to 2023



Source Savills Research & Consultancy

making up an estimated 50% of this floor space. Indeed, functioning as something of an extension to the C5W, this ward is set to undergo significant redevelopment, with projects such as Sumitomo Fudosan Osaki East Project bringing close to 15,000 tsubo of GFA to the table. Meanwhile, with the arrival of the Maglev line in 2027, the area around Shinagawa station is also undergoing substantial change. For example, the tentatively named Shinagawa Development Project (phase I) is anticipated to add around 260,000 tsubo of mixed-used space by 2025, likely exceeding Roppongi Hills on a GFA basis.

(Please refer to our Spotlight Report “[Shinagawa](#)” for further insight into the developments shaping the future of Shinagawa)

Despite the significant levels of office supply expected this year, any lingering concerns about a glut have been eased with most of it already filled or pre-leased. For now, office fundamentals appear sound, but the long-lasting effects of the pandemic and the resulting acceleration of workplace reform could lead to a paradigm shift in the office market.

TABLE 1: Major Development Projects In Tokyo, 2020 to 2024

BUILDING NAME	SUBMARKET	FLOORS	GFA	YEAR
Otemachi One Tower	Marunouchi & Otemachi	39	60,000	2020
Tokyo World Gate / Kamiyacho Trust Tower	Kamiyacho & Toranomon	38	59,000	
Toyosu Bayside Cross Towers A & C	Toyosu	36	56,000	
Tokyo Port City Takeshiba Tower	Shibaaura & Hamamatsucho	40	55,000	
Marunouchi 1-3 Project	Marunouchi & Otemachi	29	55,000	
Toranomon Hills Business Tower	Kamiyacho & Toranomon	36	52,000	
Mitsui-Bussan Building	Marunouchi & Otemachi	31	48,000	
msb Tamachi Station Tower N	Shibaaura & Hamamatsucho	36	46,000	
COMORE YOTSUYA	Shinjuku	31	42,000	
Tokyo Station Front Tokiwabashi Project Tower A	Marunouchi & Otemachi	37	44,000	
Shinbashi Tamuracho Project	Kamiyacho & Toranomon	27	32,000	2022
Yaesu 2-Chome North District A-1 Block	Nihonbashi & Yaesu	45	86,000	
Toranomon-Azabudai Project District A	Toranomon & Roppongi	65	140,000	
Toranomon Hills Station Tower	Toranomon & Roppongi	49	77,000	
Mita 3-4 Chome Mixed Use Tower 1	Shibaaura & Hamamatsucho	42	61,000	
Shibuya Sakuragaoka Project A District	Shibuya & Ebisu	39	56,000	
Toranomon 2-Chome Centre Redevelopment	Kamiyacho & Toranomon	38	55,000	
Toranomon-Azabudai Project District B-1	Toranomon & Roppongi	63	51,000	
Park Tower Kachi Doki Mid	Nihonbashi & Yaesu	45	42,000	
TTM Project	Shibaaura & Hamamatsucho	29	34,000	
Shibaaura 1-Chome Project S	Shibaaura & Hamamatsucho	45	68,000	2023
Akasaka 2-Chome Project	Akasaka & Roppongi	43	67,000	
Shin-Toda Building	Nihonbashi & Yaesu	28	31,000	
				2024

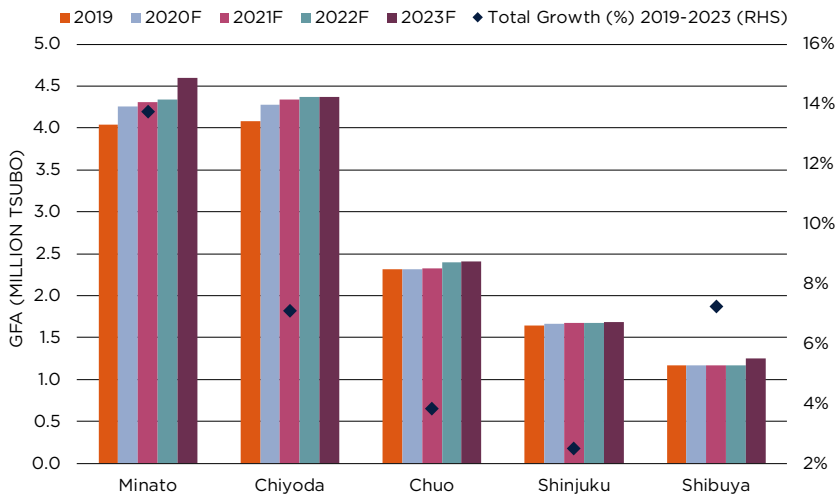
*Projects whose GFA is over 30,000 tsubo
Source Savills Research & Consultancy

2019 was certainly a big year for Shibuya and competition for space was particularly fierce. Faced with labour shortages, especially among software engineers, a focus on retaining and attracting talented staff by improving the working environment had further enhanced the appeal of the modern, open-spaced, high-grade office. As a result, completion of projects such as Shibuya Scramble Square – a B7/47F structure with around 55,000 tsubo of GFA – saw a variety of technology companies with solid profit growth, such as SoftBank, join the fray. Rents duly responded with double-digit YoY growth.

Even so, a reversal in this trend is likely to be on the cards going forward amid the ongoing workplace reforms, especially surrounding working from home. This could be especially pronounced in Shibuya, home to a cluster of technology companies and where recent rental growth in the C5W has been the strongest. Neighbouring submarkets such as Ebisu and Gotanda are likely to have collateral damage as a result.

Elsewhere, having seen the least change in office supply over the same period, Chiyoda and Minato are expected to lead the way in 2020 (Map 1), with both submarkets likely to expand by around 5% over the year. Notable projects include Otemachi One in the former – a huge multi-tower complex with around 80,000 tsubo of GFA completed in February – and Kamiyacho Trust Tower in the latter – a B3/28F structure with a GFA of over 40,000 tsubo. A clear divergence manifests between the two submarkets in 2023, however, and with the momentum in Chiyoda running out of steam, Minato could eventually become home to the largest stock of offices in the C5W (Graph 2). What’s more, with the ward

GRAPH 2: Total Office Stock By Ward and % Increase, 2019 to 2023



Source Miki Shoji, Savills Research & Consultancy

containing relatively more residences and amenities than its central peers, any material changes to working habits may actually be a somewhat tailwind over the longer term compared to the other C5W constituents.

For the three main business districts anticipated to undergo a marked expansion during the early part of this decade, 2019 was

somewhat placid. In fact, the Marunouchi & Otemachi district – set to witness the greatest change in 2020 – saw less than 10,000 tsubo come online last year. That said, this was perhaps understandable considering the significant expansion that took place in 2018. In total, the area looks likely to see an additional 150,000 tsubo of GFA in

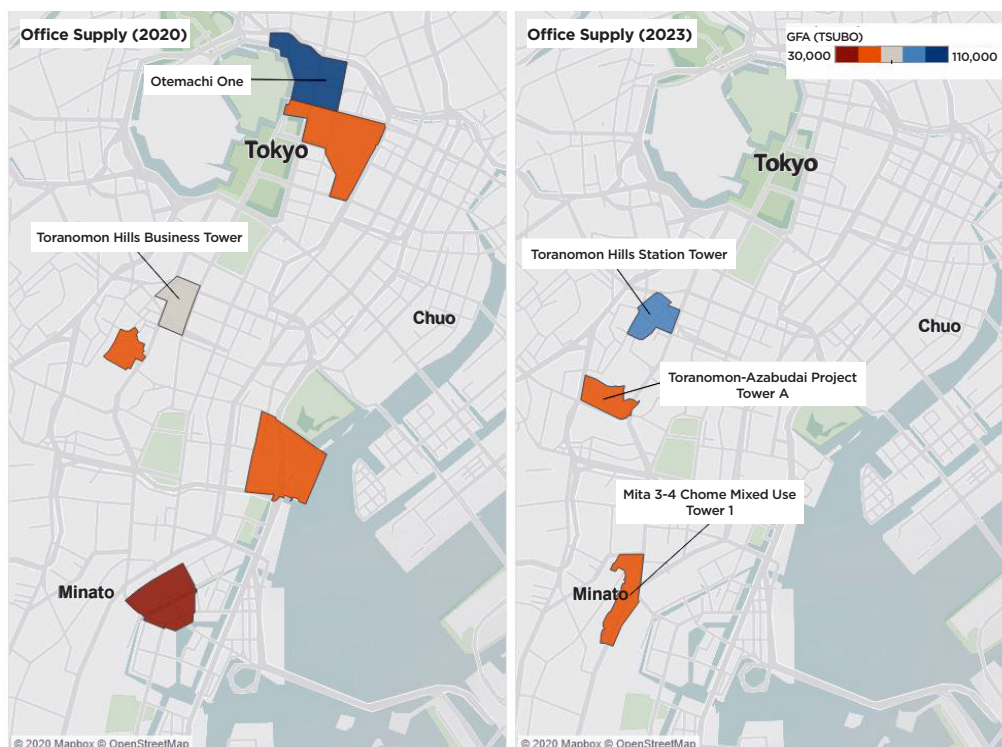
2020 (Graph 3), with the aforementioned Otemachi One project counting towards around half of that total. Interest in the property was strong from the outset, with demand from international companies such as UBS and PwC. With close to 70% of its imminent pipeline set to be completed this year, however, activity in the main financial district of Tokyo could be fairly quiet towards the end of the supply boom in four years’ time.

Meanwhile, given the tenant profile in this area – where large Japanese corporations are concentrated – the response to COVID-19 is likely to be observed later than in other areas. Indeed, though not unheard of globally, it is perhaps more likely in Japan for these types of multinational firms to take a year or two to make decisive decisions such as company-wide work style reforms.

THE “NEW NORMAL” IN A POST-COVID WORLD

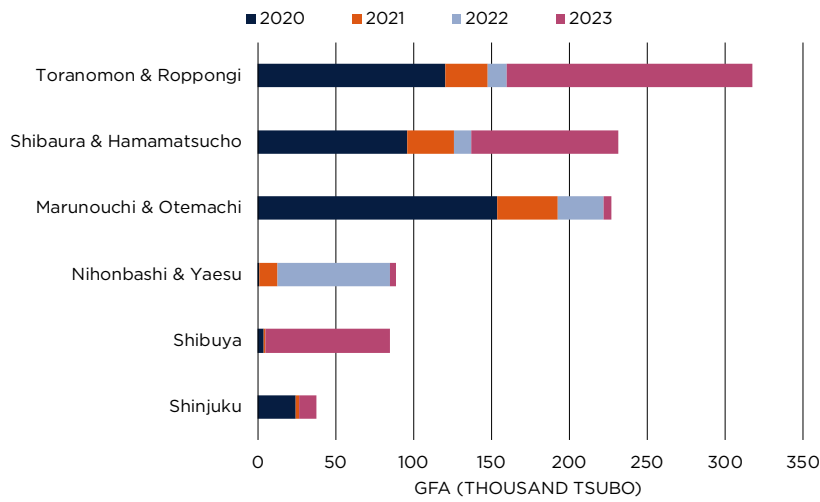
Amid the ongoing global pandemic, what has become abundantly clear is that noticeable parts of the working environment that had persisted before the outbreak may need to change post-COVID-19. This is especially true for Japan, where workplace reforms have often lagged western counterparts. Still, to some degree, this suggests that there is

MAP 1: C5W Office Supply, 2020 and 2023



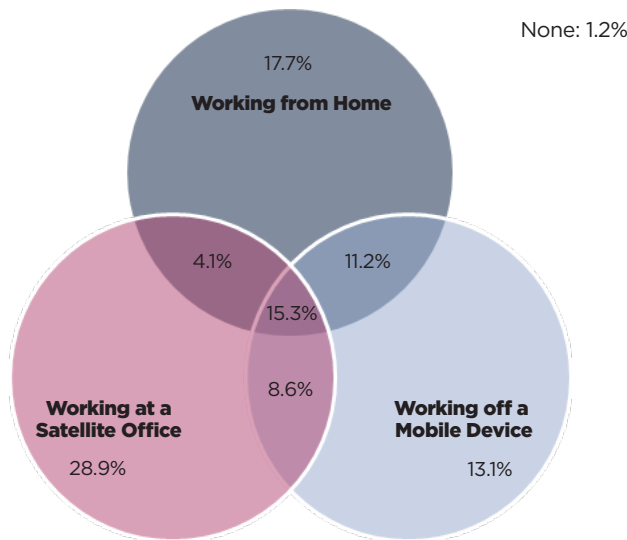
Note: Highlighted areas above reflect office supply in the “Cho” (neighbourhoods) where GFA is 30,000 tsubo or greater. Source Savills Research & Consultancy

GRAPH 3: Supply By Submarket, 2020 to 2023



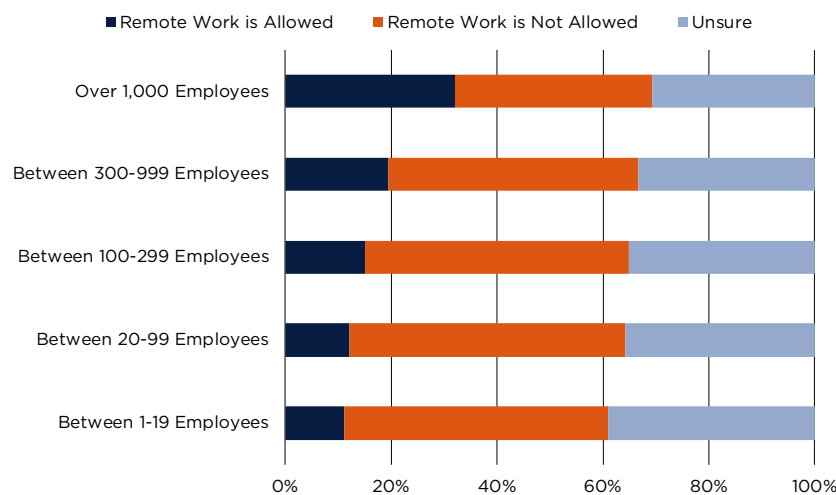
Source Savills Research & Consultancy

GRAPH 4: Remote Work Utilisation, 2019



Source MLIT, Savills Research & Consultancy

GRAPH 5: Remote Work Adoption By Company Size, 2019



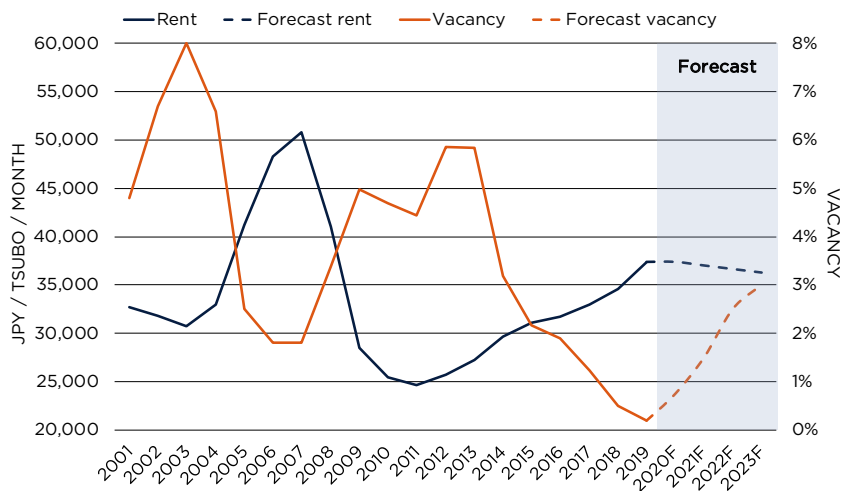
Source MLIT, Savills Research & Consultancy

plentiful room for improvement with changes such as improved productivity (subsequent wage growth) and an increased fertility rate (through flexible work arrangements). Some aspects of reform had already been underway before the virus struck, however, which should now be accelerated. Looking at working practices before and during the outbreak, therefore, could shed some light into what the “new normal” may look like, and the potential impact this may have to the broader office market over the longer term.

According to a study conducted by Xymax in December 2019 (2,060 participants), among the reasons for workplace environment dissatisfaction, the inability to work flexibly and the lack of policies surrounding teleworking ranked highly. Perhaps unsurprisingly, therefore, before the turn of the decade, only 13% of those asked had worked remotely. Yet, when instead queried as to whether they wanted to do so, this figure jumped to 35%. At the same time, when questioned about their views on what working practices in 2025 could entail, many of the responses related to the merits of working from home, such as a better use of time due to the lack of commuting and an improvement in the work-life balance that allows more time for non-work-related activities. It would appear, therefore, that much of what was predicted may become reality sooner than anticipated.

Even so, working from home is far from a panacea. In fact, in the same study, of those who demonstrated some hesitancy towards the new work style, one of the most common responses was the difficulty in switching between work and private life. As such, alternatives such as satellite offices have gained some popularity of late. For example, in a study conducted by the Ministry of Land Infrastructure, Transport and Tourism (MLIT) in October 2019, where 40,000 workers (including the self-employed) across the largest regions in Japan were asked about telecommuting policies, the most common location for those who worked remotely (6,172 people) was a satellite office. To wit, nearly 30% of respondents said they primarily used these facilities whilst working (Graph 4). In contrast, those who solely worked from home or without a fixed location, but on a personal device, had responses of 17.7% and 13.1%, respectively. With social distancing measures somewhat hindering shared offices, satellite offices appear well-placed to satisfy requirements in the “new normal”.

Meanwhile, whilst the overall take-up of those working remotely was relatively low before reform began in earnest, the divergence in the proportion of users varied markedly by company size. As demonstrated in the MLIT study, around 19% of those at medium-sized companies (between 300 and 999 employees) and 32% of those at larger companies (above 1,000 employees) were

GRAPH 6: Grade A Vacancy Rate and Rent Forecasts, 2001 to 2023F

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

permitted to work remotely in one form or another (Graph 5). The equivalent at smaller firms (between 20 and 99 employees) was 12%. This trend has persisted even in the midst of the pandemic. According to the Tokyo Metropolitan Government, between March and April 2020, these medium-to-large sized companies (more than 300 employees) saw remote work usage jump from 45% to close to 80%. For the small firms, the proportion stood at 55% over the same period.

This dynamic has been clearly demonstrated by companies such as NTT, who is reportedly looking to keep 50% of its 180,000 employees working from home, at least until a vaccine is widely available. Meanwhile, Hitachi has said that it expects around 70% of its roughly 33,000 person workforce to come to the office on just two or three days a week, whilst Mitsubishi Electric Corp. has also announced similar initiatives. Indeed, with the Keidanren – the country’s largest business lobby – encouraging companies to embrace various working styles, initiatives such as teleworking and flexible working hours look likely to be permanent fixtures for the time being, benefitting the broader economy.

SUMMARY AND FORECASTS

With all the potential unknowns to emerge over the coming months and years, the Grade A office sector may find itself at a crossroads. On the one hand, vacancy is air-tight and cash-rich Japan Inc. tenants are unlikely to make any immediate, drastic changes over leased space. Instead, preferring to steadily navigate the uncertainty over a year or two as they come to grips with the new meaning of having a centrally located office and any lingering effects from the pandemic. On the

other hand, the likelihood of flexible working practices remaining as a part of corporate life may negate the need for office consolidation, and in its place, diversification of locations and the emergence of satellite offices. Even so, centrally located offices are deemed to be necessary to retain in order to cultivate idea generation through collaboration, foster teamwork and nurture a sense of belonging. As such, those closest to transport links should garner the most demand. The idea being, any time reduced commuting could be better used, thus increasing productivity.

Indeed, the paradigm shift at these larger companies mentioned above, who are commonly tenants of Grade A Offices, could have a profound impact on the dynamics of the wider office sector in the “new normal”. At the same time, the pandemic has come at a delicate juncture for the broader economy. Unlike some of its international peers, the Japanese economy went into the outbreak already in a fragile state following the Consumption Tax hike in October. With the economy now in a technical recession – it’s first since 2015 – office demand is waning. In truth, thinly capitalised tenants, facing financial difficulty as a result, may even be forced to return some leased space, further exposing the disparity in performance amongst office tenants and submarkets. These weak links may have a more widespread impact if the economic recovery is prolonged.

Under the current circumstances, the emergence of some vacancy later this year should come as no surprise (Graph 6). Yet, with the availability of office space already at historic lows, coupled with the dearth of suitable alternatives, the loosening of Grade A vacancy rates in the C5W appears manageable this year. As for rents, the expansion experienced up to this point

is forecasted to take a breather or even reverse, with the office location and quality likely playing a major role in determining the outcome. We therefore predict flattish rental movement overall, assuming both the economy and pandemic are somewhat under control with strong support from government policies. Indeed, when the full impact of the pandemic becomes a little clearer, the market will know the direction and the magnitude of the changes. We may even see rental growth resume in 2022 if the economy recovers.

Some wards and areas are expected to suffer more than most with Shibuya likely to bear the brunt given its exceptional growth of late, as well as its tilt towards technology firms. These weaker performing markets are likely to drag down average C5W rents, even if other markets are resilient or strong. Still, the lull in 2021 and 2022 is more than welcome, allowing some breathing space in the market, whilst also preparing for the significant jump in supply a year later. Speaking of 2023, it is worth mentioning that a large proportion of total supply is attributed to a few developers. With a focus on tenants with better creditworthiness and by building long-term relationships rather than achieving the highest rents possible – observed recently – this should help alleviate concerns regarding vacancy over that period. By that time, however, with the hope that the economy is back on track, strong office demand may return, with rental growth following in tow. Even so, the extent to which this plays out could also depend on how the large level of supply predicted to come online in 2025 is received.

Finally, regarding the co-working sector, as covered in last year’s report, it had emerged as a tailwind for the office market on the back of solid momentum. Unfortunately, with the pandemic significantly weighing on the industry, it has become a headwind. Despite the proportion of office supply owned or leased by industry players being relatively less than other international equivalents, the potential downside to the broader office market in the C5W cannot be ignored. With social distancing measures loosening somewhat, however, there may be some hope for this battered industry.

OUTLOOK

With the office market riding high towards the end of 2019, the mid-term prospects of the sector appeared bright, even when considering the high levels of supply expected in 2020 and 2023. Yet, the COVID-19 outbreak has led much of this positivity to dissipate as the clouds of uncertainty started to loom large.

It is worth remembering, however, that well over 95% of the supply expected in 2020

has already been filled or pre-leased, whilst existing supply has little vacancy. What's more, thanks to their strong balance sheets, Grade A office tenants are allowed the luxury of taking a wait-and-see approach in order to comprehend the full impact of COVID-19. As such, we have yet to see notable new cases of relocations amongst the Grade A office market. Assets considered Grade B and lower may not be so lucky over the shorter term, however. With instances of smaller firms in general, and start-ups in particular, deciding to reduce or get rid of office space completely, some vacancy is likely to emerge. Looking ahead, technology companies may also follow suit, regardless of their size. Nonetheless, with much of the upcoming supply focused on Grade A assets, at least supply concerns amongst the Grade B or smaller office markets are limited.

Meanwhile, within wards and business

districts, the location of an office looks set to play a major role in determining its rental growth prospects. With higher quality tenants often in prime locations, the gap in rents with less conveniently located offices, housing their financially weaker peers, looks likely to widen even more. Indeed, crises typically make the strong even stronger.

Finally, having made significant strides to reform the workplace, it is no shock that the previous trend of office expansion has been reconsidered. Even so, depending on how space is utilised even after a vaccine becomes widely available, it could determine the long-term demand for office supply in the capital. For example, as evidenced in a 2019 study conducted by Mori Building (1,827 respondents), after the 2011 Great East Japan Earthquake, resiliency to natural disasters was the most important aspect of an office. Within five years, however,

this feature was not even in the top three considerations for would-be tenants. It is therefore conceivable that whilst the emphasis on a good work-life balance remains, teleworking as the "new normal" may not be significant come 2023. As such, demand for high quality central offices in prime locations should remain for the foreseeable future, though the large supply anticipated in 2025 could soften growth expectations over the mid-term.



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