MARKET IN MINUTES

Savills Research

Office Leasing

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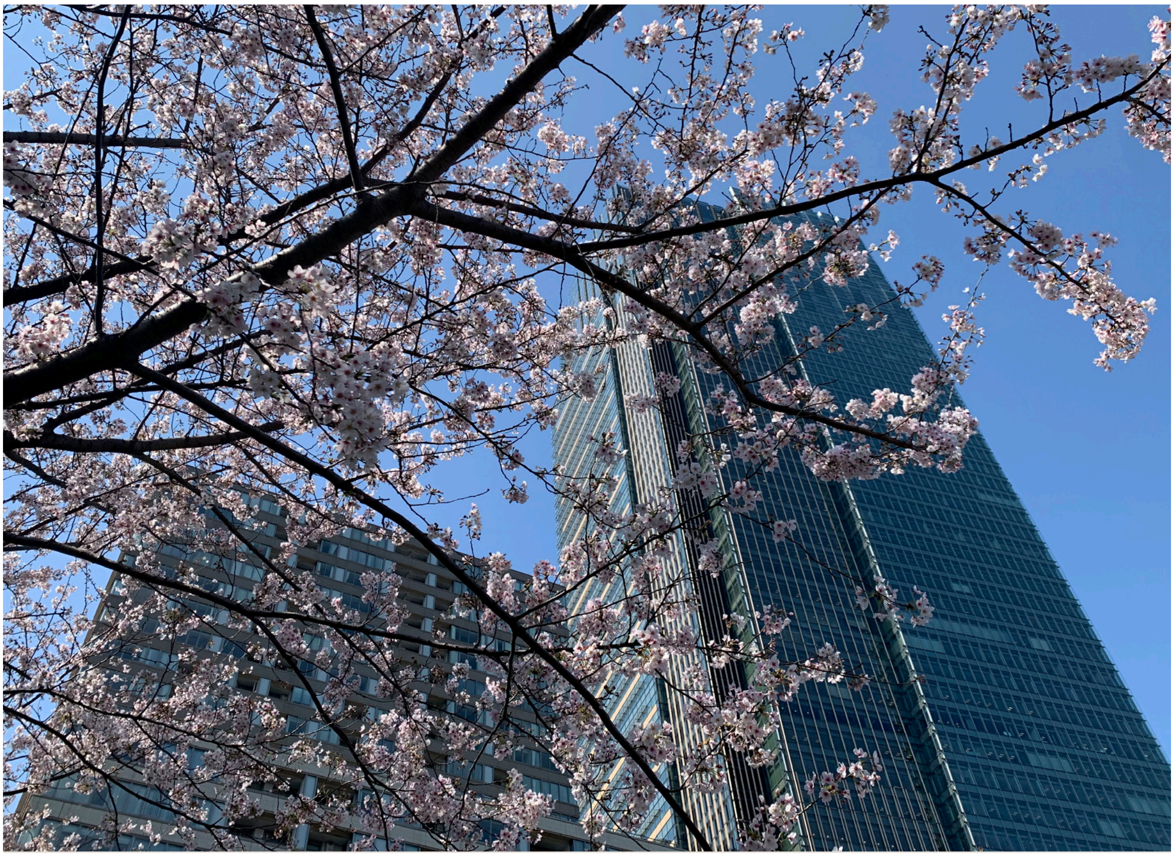

Robust office sector faces roadblock

The Grade A and B office markets both saw impressive rental growth over the year. Nevertheless, a COVID-19-induced market slowdown is likely to materialise during late-2020.

- Vacancy rates remain extremely low in the central five wards (C5W), and rents have picked up once more. That said, momentum is expected to peter out as the market grapples with the impact of the COVID-19 pandemic.
- Average rents in the C5W Grade A office market grew 1.0% quarter-on-quarter (QoQ) and 7.1% year-on-year (YoY) to JPY37,759 per tsubo[1] per month.
- The average Grade A office vacancy rate in the C5W was steady over the quarter and year, holding at around 0.3% as of Q1/2020.
- Average rents for large-scale Grade B office space rose to JPY28,558 per tsubo per month, growing by 1.3% QoQ and 6.5% YoY.
- Like its Grade A counterpart, the average large-scale Grade B office vacancy rate saw minimal change this period, standing at 0.3%.
- The Toranomon area is going through significant change and remains a popular location for prospective tenants. Nevertheless, the recent pressing need to work remotely could see a change in demand for office space going forward.
- The unknown severity and longevity of the COVID-19 outbreak is anticipated to weigh on the sector. The impact of the ensuing slowdown, however, may only be visible in late 2020, with tenant relocations taking up to six months.

"Office rents saw continued growth in Q1/2020 and vacancy rates remain extremely tight. That said, this trend will likely end, or at least pause, due to the fallout from COVID-19. Airtight vacancy and advance notice requirements for relocation should, however, serve as a buffer until later this year."

SAVILLS RESEARCH & CONSULTANCY

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

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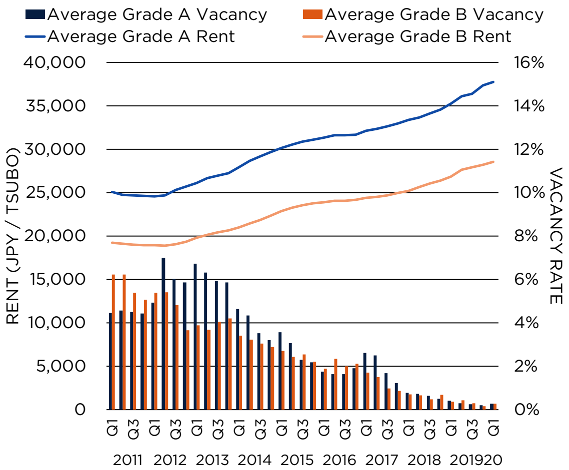
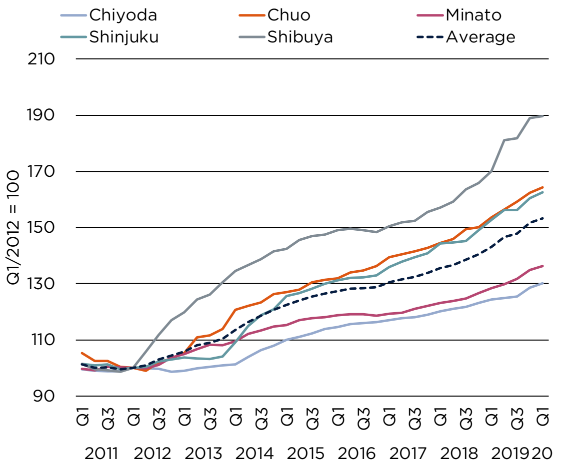
GRAPH 1: Office Rents And Vacancy In Tokyo's C5W*, 2011 to Q1/2020



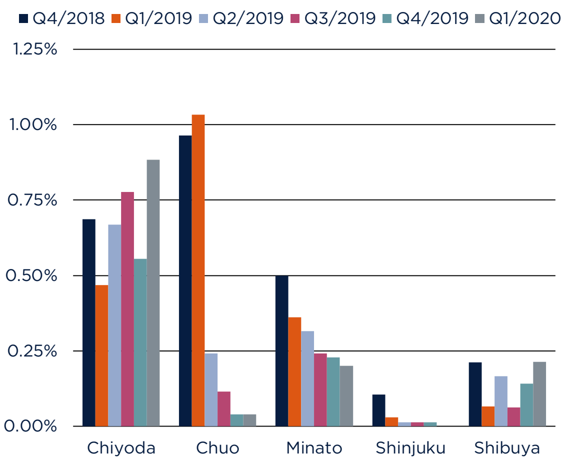
Source Savills Research & Consultancy
*Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index By Ward, 2011 to Q1/2020



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy By Ward, Q4/2018 to Q1/2020



Source Savills Research & Consultancy

GRADE A OFFICES

The office market's promising prospects at the start of the year have proved to be short-lived with the COVID-19 pandemic set to disrupt the sector. Yet, all things considered, Grade A office rents seem to have held up well. Indeed, rents now stand at JPY37,759 per tsubo[2] in Q1/2020, following growth of 1.0% QoQ and 7.1% YoY. Shibuya remained the only submarket with double-digit growth over the year, despite a marked slowdown in rental growth over the quarter. Elsewhere, Chiyoda, perhaps burdened by its status as the most expensive submarket, continued to lag its peers over the 12 months. As for vacancy rates, these remain extremely low at 0.3%, despite a slight loosening of 0.1 percentage points (ppts) over the quarter.

LARGE-SCALE GRADE B OFFICES

The story was very much the same for large-scale Grade B offices[3]. Average rents grew at a solid 6.5% YoY in Q1/2020, whilst over the quarter, growth was less impressive at 1.3%. Chiyoda experienced the least quarterly change as rental growth continued to decelerate for the third consecutive period. As in the Grade A office market, Shibuya led the way over the year with growth of 7.9%, though the ward's premium to the next best performer over the period is much tighter this time around, with Shinjuku hot on its heels after growth of 7.2% YoY. As for vacancy rates in this submarket, they loosened by 0.1ppts QoQ to 0.3%, driven by the 0.6ppts QoQ increase in Minato. With COVID-19 expected to drag significantly on the economy, there is a risk that the Grade B market or lower could suffer disproportionately considering its tenant pool of less cash-rich companies.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

When it comes to rents, Chiyoda continues to top the submarket. That said, it appears the strong quarterly growth observed in Q4/2019 was temporary, with the rate returning to around the 1% mark once more. In fact, aside from the last quarter, growth has been around this level since Q1/2015 as the submarket struggles to build meaningful momentum. Even so, rents have exceeded JPY40,000 since Q4/2017 and currently stand at JPY43,780 per tsubo following growth of 1.3% QoQ – the highest in the submarket – and 4.7% YoY. As such, the premium compared to the C5W average has held steady at around 16%. At the same time, the ward was able to slightly widen its spread over its closest rival, Shibuya, albeit as a result of a slowdown in the latter, rather than above-average growth in the former. Meanwhile, Chiyoda is home to the highest vacancy in the C5W. The rate increased by 0.4ppts YoY to 0.9%, with some of the loosening attributed to the completion of Otemachi One Tower in February. However, this should be temporary, with the new development set to welcome UBS Securities Japan during the spring of 2021.

Chuo

There remains little vacancy in this submarket, and rents have reacted accordingly, especially during the year. Indeed, rents increased by 7.0% over the period to JPY35,613 per tsubo. In fact, since bottoming out in 2012, the ward has posted the second highest rental growth – behind only Shibuya. Quarterly growth, however, was a less impressive 1.2%. As for tenant relocations, Kabuto One is set to welcome Quick, a financial data vendor, in the summer of 2021, with the firm leasing close to 2,500 tsubo across five floors. The move appears to be a consolidation into a new headquarters, with the vendor vacating two separate sites, also located in Chuo.

Minato

Unlike the other submarkets, there has been plenty of news regarding relocations in Minato during Q1/2020. The largest move concerns machine manufacturer, Sato Holdings, who has decided to move its headquarters from Meguro. The firm is due to occupy over 2,600 tsubo across three floors in msb Tamachi later this year. Indeed, the level of rent, which is currently JPY34,545 per tsubo following growth of 1.1% QoQ and 6.1% YoY, could be a possible factor behind the large number of moves within this ward. Though not the cheapest, Minato remains over 8% cheaper than the C5W average, whilst compared to the most expensive submarket, namely Chiyoda, rents sit at a 21% discount. The fact that the ward remains 30% off its 2008 highs – the widest spread in the C5W – illustrates the value available. That said, opportunities may be hard to find going forward given the 0.2ppts YoY tightening of vacancy to 0.2%.

Shibuya

Shibuya experienced an exceptional 2019, with rental growth considerably outpacing its peers. Yet, in Q1/2020, the submarket appears to have had the wind knocked out of its sails. Growth has slowed abruptly to a mere 0.4% QoQ – the slowest in the C5W. On an annual basis, however, Shibuya remains in a league of its own. Rents jumped to JPY40,524 per tsubo following an 11.5% YoY surge. Impressively, this was the fourth quarter in a row of double-digit annual growth, as well as the seventh consecutive quarter as the fastest growing ward, demonstrating its increased popularity of late. As for vacancy rates, they remain airtight. Minimal change was observed over the quarter and year as rates held somewhat firm at 0.2%.

2 Throughout the report, "per tsubo" is shorthand for "per tsubo per month".
3 "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, Q1/2020

	ORIGIN							DESTINATION
	Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other		
	3	4	13	2	2	11		
	2		2			2	6	Chiyoda
		4					4	Chuo
	1		7	1	1	6	16	Minato
			1				1	Shibuya
				1	1	2	4	Shinjuku
			3			1	4	Other

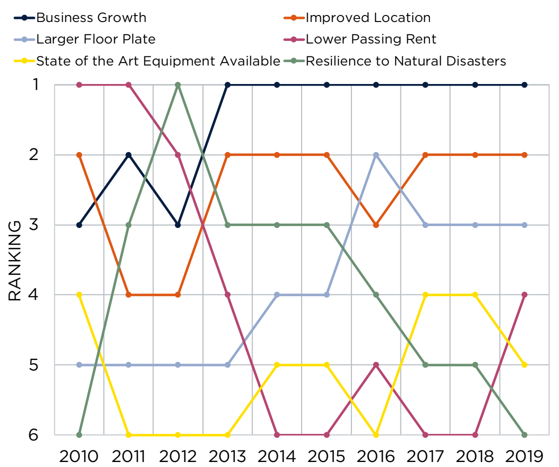
Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Q1/2020

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION	NEW LOCATION	APPROXIMATE SPACE TSUBO	APPROXIMATE SPACE SQ M
Sato Holdings	Manufacturing	HQ Relocation	Meguro Knowledge Plaza Meguro	msb Tamachi Tamachi Station Tower North Minato	2,700	8,800
Quick	Communication Services	Consolidation	Various	Kabuto One Chuo	2,500	8,100
Netflix	Communication Services	Relocation	Shin Aoyama Tokyu Building Minato	Midtown East Minato	2,200	7,400
Tokyu Agency	Communication Services	Relocation	New Office	Shimbashi Tamuracho Project Minato	2,100	6,900
UBS Group	Financial Services	HQ Relocation	Otemachi First Square East Tower Chiyoda	Otemachi One Tower Chiyoda	1,800	5,900

Source Nikkei RE, Savills Research & Consultancy

GRAPH 4: Ranking Of Respondents' Reasons For Relocating To A New Development, 2010 to 2019



Source Mori Building, Savills Research & Consultancy

Shinjuku

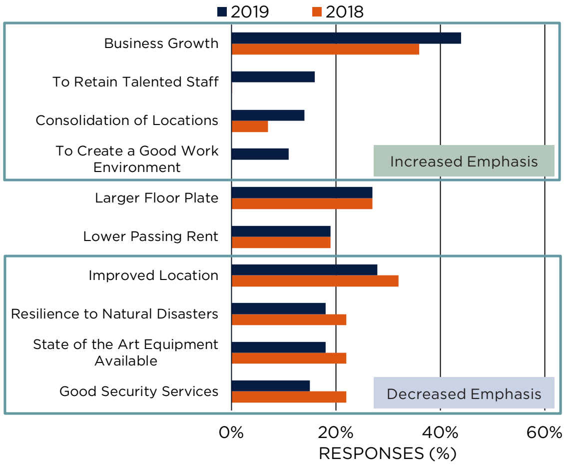
Unlike Chiyoda, for instance, office floor space in Shinjuku is limited. Furthermore, offices that do exist are less modern and are often located in inconvenient areas far from the station. Meanwhile, the ward lacks the pipeline of developments found in other submarkets, and perhaps, as a consequence, rents are the cheapest in the C5W, coming in at JPY34,333 per tsubo. That said, growth was a respectable 1.3% QoQ and 6.4% YoY. Given the dearth in supply described above, vacancy was unsurprisingly non-existent. As for leasing activity, it would seem that WeWork are still active in the market, with the co-working start-up reportedly agreeing to lease around 1,500 tsubo of D-Tower Nishi-Shinjuku from July.

CHANGES AMID UNCERTAIN TIMES

In the midst of a global pandemic, and facing an economic slowdown, office tenants are forced to make difficult decisions in order to navigate the ongoing uncertainty. As such, many projects planned before the outbreak may have to be temporarily put on the back burner in order to get through these trying times. With the hope that the world returns to some level of normalcy before long, it is worth looking at changes in tenant preferences that were emerging before the COVID-19 outbreak in order to see whether any will persist thereafter.

To be sure, Tokyo has seen its fair share of office developments over the past few years, with many modern large-scale structures popping up throughout the C5W. Amid this change, however, it would appear that tenant demand is also going through a similar transition, as evidenced in the 17th annual survey conducted in 2019 by Mori Building (1,827 respondents). The survey, which focused on tenants' office needs, showed how rent considerations were declining in importance when deciding whether to relocate to a new development. To wit, having previously been by far the most important factor at the start of the decade, it now sits in fourth place (Graph 4). In contrast, the growth in the business,

GRAPH 5: Respondents' Reasons For Leasing A New Development, 2018 and 2019



Source Mori Building, Savills Research & Consultancy
*Multiple factors can be chosen per respondent

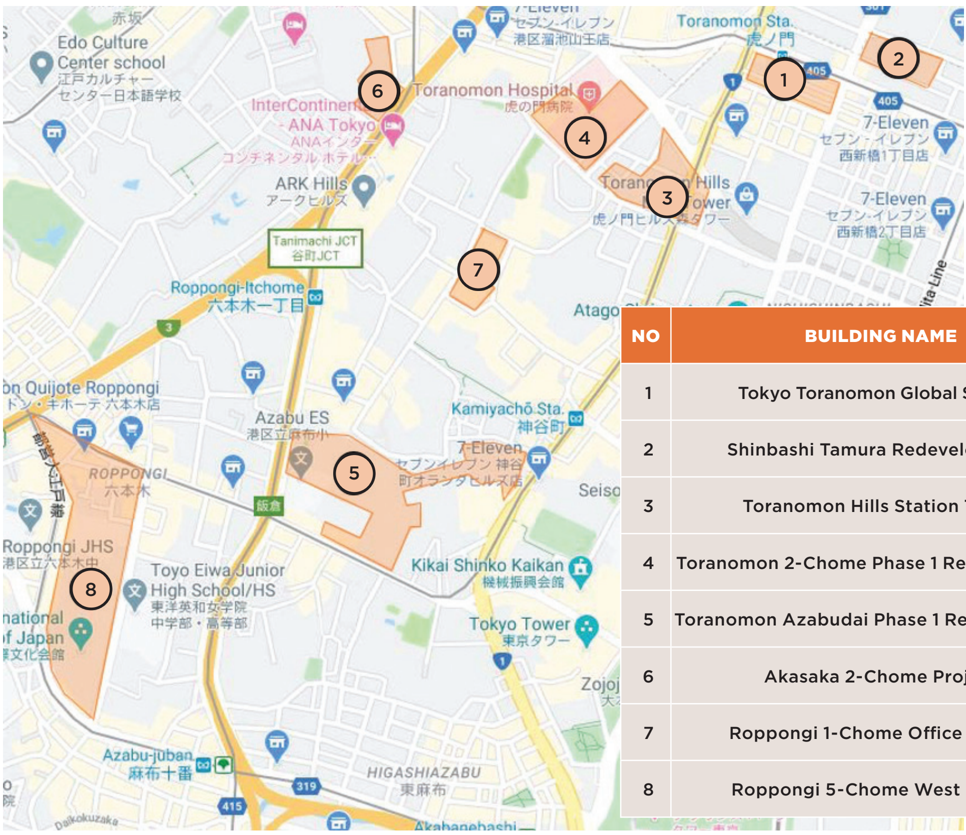
driven by the creation of new departments and an increasing workforce for instance, reigns supreme as the most important driver in 2019, as well as in every year since 2013.

When comparing reasons for moving to a new office in 2018 and 2019, there is a clear shift towards the creation of a positive workspace environment, as well as the necessity to relocate in order to retain talented staff – of particular relevance given the ongoing national labour shortage (Graph 5). These two factors, having been absent in the 2018 edition of the survey, have significantly increased in importance a year later. In contrast, factors such as moving to offices that are more resilient to natural disasters can change in importance quickly. This factor has now fallen to sixth, having peaked in 2012 following the 2011 Great East Japan Earthquake.

With governments across the globe advising or enforcing self-isolation, the requirement to work remotely is likely to shape tenant preferences in future. When looking at responses to the survey before and after the COVID-19 outbreak, a likely change to arise from this theme concerns office space. Indeed, the growing number of respondents indicating their desire to expand leased floor space in the survey may have changed their view. The current turmoil may dampen or suspend the demand for a larger workforce, whilst office expansion plans may be put on hold or re-considered. In the future, there should be cases of companies shrinking office space by maintaining some remote working practices, or setting up satellite offices closer to residential areas such as Omiya, thereby creating new opportunities for market participants.

As for the longer-term prospects of the sector, the office market is set to noticeably expand in 2020 and 2023, though a lull in between is expected. Of this rise, the lion's share will be in Minato, Chiyoda and Chuo. It is no surprise, therefore, that these three are also the most sought-after locations for respondents looking to relocate. In fact, of these three, Minato leads the way with over 90% of respondents selecting an area within the ward. Yet, when looking a little deeper, there is a clear theme that becomes apparent. Close to half of those who chose Minato, favour Toranomon and its neighbouring districts, and it is not hard to see why. The area is primed for a huge makeover in order to transform itself into a new, prime business district, with the Toranomon Azabudai project taking centre stage (Map 1). Indeed, the long term prospects for this centrally located ward certainly appear bright.

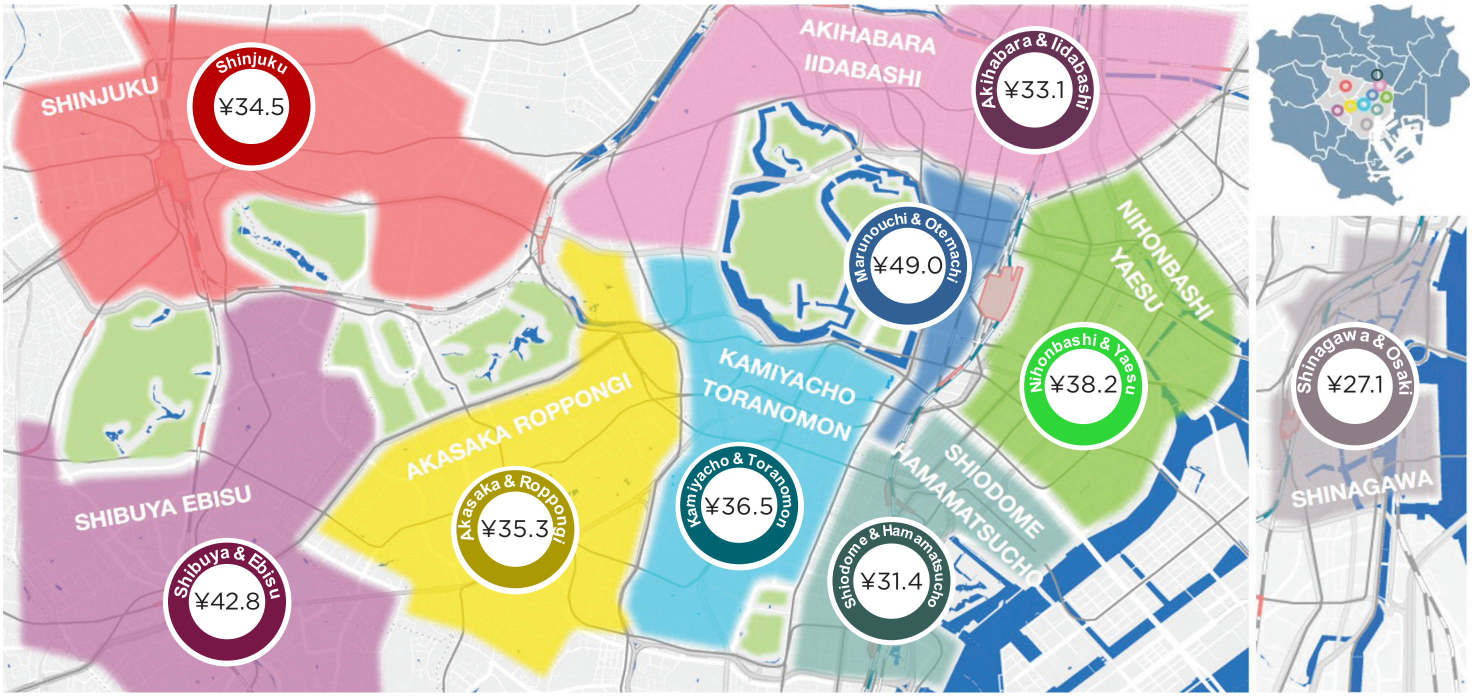
MAP 1: Major Redevelopment Projects In Toranomon, Roppongi And Akasaka, 2020 Onwards



NO	BUILDING NAME	GFA* (TSUBO)	COMPLETION YEAR
1	Tokyo Toranomon Global Square	14,300	2020
2	Shinbashi Tamura Redevelopment	31,900	2021
3	Toranomon Hills Station Tower	77,200	2023
4	Toranomon 2-Chome Phase 1 Redevelopment	55,000	2023
5	Toranomon Azabudai Phase 1 Redevelopment	260,300	2023
6	Akasaka 2-Chome Project	66,600	2024
7	Roppongi 1-Chome Office Project	33,300	2024
8	Roppongi 5-Chome West Project	317,600	n/a

Source Google Maps, Project Disclosures, Savills Research & Consultancy
*The GFA is based on the total building and not space only designated for office use.

MAP 2: Average Rents Per Tsubo In Selected Submarkets, Q1/2020



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

As the COVID-19 outbreak intensifies without a resolution in sight, a significant economic slowdown seems a question of how long and how large. With office demand somewhat moving in lockstep with the health of the economy, a non-negligible degree of concern is therefore inevitable. To make matters worse, the postponement of the Tokyo Olympics until 2021 has dampened market sentiment. Although an outright cancellation of the event was avoided, to much relief, the decision remains a blow to the economy.

That said, well over 95% of the large office supply in 2020 has been filled or pre-leased, whilst supply in 2021 and 2022 is low, helping to keep the market stable. Besides, with vacancy rates already at record lows, tenants have limited options if they did decide to move, and for that reason, landlords would be justified in keeping rents unchanged. Moreover, with the requirement to provide advance notice if they do decide to leave, the tangible impact of tenant relocations could take up to six months to emerge, adding to market stability, at least until late 2020. What's more, amid a previously buoyant market, with fierce competition for space, financial incentives such as rent-free periods were limited. Landlords therefore would likely prefer to offer these incentives to prospective tenants before reducing rents or allowing vacancies to rise.

Meanwhile, with cash holdings of around JPY500 trillion, large Japanese corporates are well-placed in weathering the ongoing crisis. Subsequently, this buffer appears to have allowed these firms to take a wait-and-see approach instead of relocating to cheaper offices or making redundancies. With this in mind, unless the current situation deteriorates significantly, the hitherto high level of occupancy should continue, at least on a short-term basis, while rents should remain flattish. The expected short-term stability of the broader market notwithstanding, not all tenants will be so lucky. Indeed, we have started to see some weakness in Grade B and smaller office markets where the negative impacts are felt disproportionately. Unsurprisingly, smaller cash-strapped firms in industries particularly impacted by COVID-19, such as event planning and travel, may soon be forced to vacate office space.

The factors determining the efficacy of relocating to a new office were undergoing change even before the COVID-19 pandemic began. Yet, with self-isolation and telework becoming a part of daily life, there could be a shift in how office space needs are assessed, especially for large companies. Some may decide to shrink office space by making remote working practices a common occurrence, while others may set up satellite offices closer to residential areas. Regardless of what companies ultimately decide, a paradigm shift in the office sector may emerge very soon.