Japan - June 2019

SPOTLIGHT
Savills Research

Tokyo Office Supply

savills

Oversupply fears are unlikely to materialise

Summary

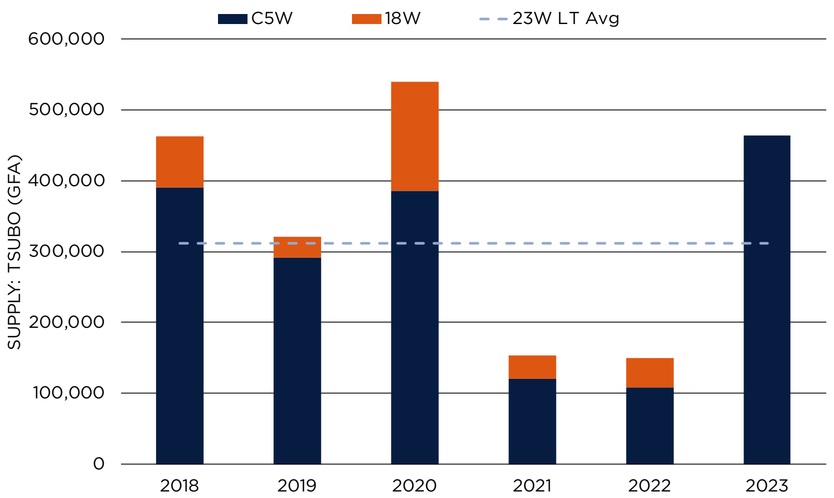
- Some 680,000 tsubo GFA will come online in the C5W in 2019 and 2020, increasing Tokyo's office stock by 5%.
- Supply will be concentrated in the C5W, though the 18W will also see a large amount in 2020.
- Shibuya will see a large portion of its pipeline completed in 2019, while 2023 will likely be a watershed year for Toranomon, expected to account for over 50% of total supply that year.
- Although secondary vacancy is currently not an issue, increasing demand for centrally located, high-specification offices could affect older buildings in peripheral submarkets.
- While the popularity of quality co-working space appears to be supporting the take up of high-grade office space, if the trend reverses, the repercussions might be more than nominal.
- While supply is unlikely to significantly affect the market trend, a potential deterioration of economic conditions could weaken the rental outlook.

SUPPLY PIPELINE

In 2018, Tokyo's office market saw the largest supply since 2013. Despite initial concerns among market participants over the absorption of such large supply, pre-leasing proceeded smoothly and vacancy did not show any sign of loosening. To the contrary, the average Grade A office vacancy rate in the central five wards (C5W) ended 2018 at 0.5%, a tightening of 0.7 percentage points from 2017, and rents grew by 4.9% year-on-year (YoY) to JPY34,592 per tsubo per month. Indeed, demand has been so strong that finding a sizeable space for relocation has become a daunting task. Although there were fears that secondary vacancy would be created as a result of new offices stealing tenants, these fears have not manifested in the central submarkets. Sound economic fundamentals are behind the real estate market's resiliency as corporate profits remain at high levels and competition for talent is fierce. A recent expansion of flexible office space is another driver, though this trend could backfire if its popularity proves fleeting.

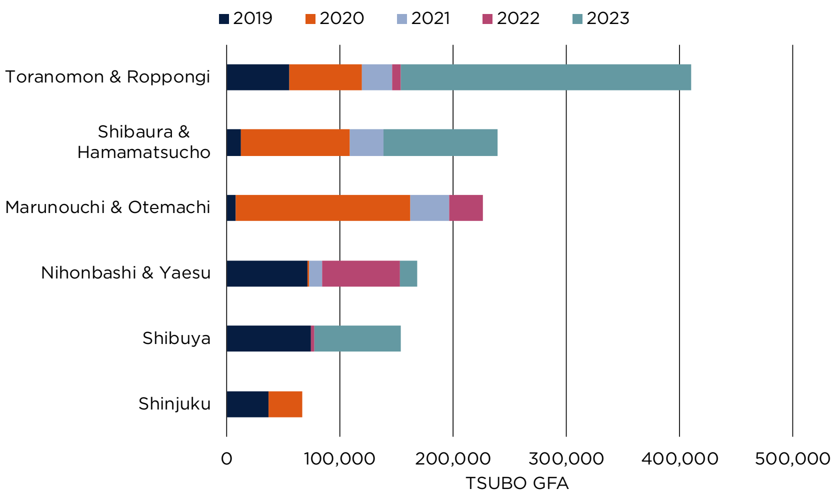
Going forward, some 680,000 tsubo of office GFA is expected to be brought online between 2019 and 2020, each year in excess of the average annual amount of 310,000 tsubo recorded between 1986 and 2018. Although supply will calm down in 2021 and 2022,

GRAPH 1: GFA Office Supply Through 2023 (C5W and 18W)



Source Savills Research & Consultancy

GRAPH 2: Supply By Submarket Through 2023



Source Savills Research & Consultancy allowing the market to digest prior years' supply, 2023 is set to be another bumper supply year. Projects in the pipeline are primarily large-scale, Grade A buildings as large floor plates are attractive for companies that try to improve internal collaboration and efficiency through consolidation of space (please see the Q2/2019 Tokyo Office Briefing). The majority of supply will arrive in the C5W, though the outlying 18W will also see a relatively large volume of supply in 2020 (Graph 1).

Indeed, while some submarkets, particularly Shibuya in 2019, Marunouchi in 2020, and Toranomon in 2023, will see a large amount of supply over a short period, certain submarkets outside of the C5W will experience a similar burst of supply. Between 2019 and 2020, three quarters of non-C5W office supply will be concentrated in just three areas: Toyosu (45%), Ikebukuro (21%), and Shinagawa (10%). Toyosu will see over 100,000 tsubo GFA of supply in 2020 and 2021, and Ikebukuro over 35,000 tsubo GFA in 2020. Despite being located outside of the C5W, pre-leasing in these submarkets appears to be going well, possibly due to their affordability compared to new offices in prime office submarkets. Additionally, a bus rapid transit (BRT) system is planned to start operating in phases from 2020 and will likely improve accessibility to the bay area.

In the C5W, 2019 will be a big year for Shibuya, with most of the major projects in the pipeline slated for completion around the station area. Following Google's relocation to Shibuya Stream in 2018, IT companies such as Cyber Agent and Mixi also plan to relocate to Shibuya Scramble Square after its completion, and GMO Internet is scheduled to move to Shibuya Fukuras, another mixed-use tower slated for completion in 2019. Furthermore, Shibuya's iconic Parco is scheduled to reopen in autumn and will likely regain its status as one of the new landmarks of the area.

Minato also sees large supply as Toranomon and its neighbouring districts are undergoing an enormous redevelopment phase and transforming into a new, prime business market. A renewed landscape is gradually forming as new skyscrapers, such as Okura Prestige Tower and Toranomon Hills Business Tower, are slated for completion in 2019. Both properties are attracting strong interest and pre-leasing is going smoothly with major corporations such as Sekisui Chemical, Facebook, and KDDI's Supership announcing plans to relocate to these towers. In 2020, the new Toranomon Hills Station is scheduled to begin operation, though its full completion is not due until 2022. This development, along with an underground

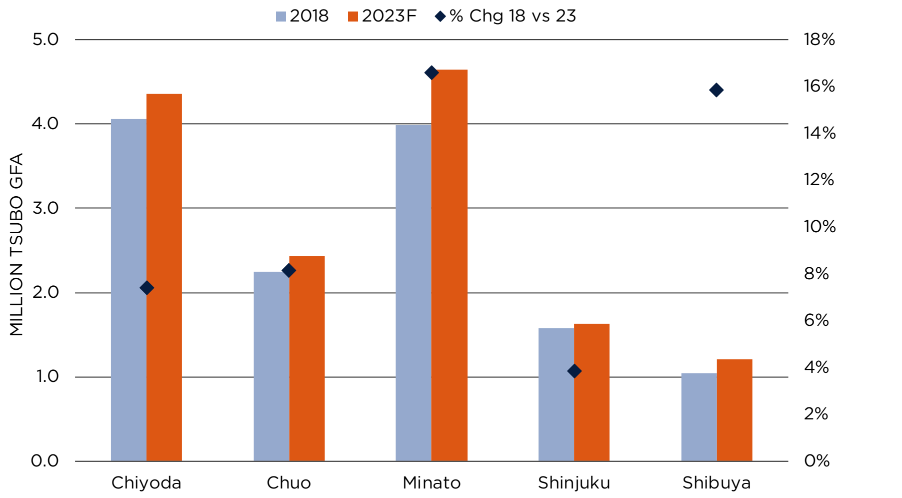
Despite high levels of supply expected for 2020, the Tokyo Olympics year, a strong tailwind of demand looks set to keep vacancy tight. Large-scale development projects are changing market dynamics, especially in Shibuya and Toranomon. As long as economic conditions remain favourable, Tokyo's office market could extend the current growth momentum.

TABLE 1: Major* Development Projects In Tokyo

BUILDING NAME	SUBMARKET	FLOORS	GFA	YEAR
Shibuya Scramble Square East Tower	Shibuya & Ebisu	47	55,000	2019
Toranomon Hills Business Tower	Toranomon & Roppongi	36	52,000	
Nihonbashi Muromachi Mitsui Tower	Nihonbashi & Yaesu	26	51,000	
Okura Prestige Tower	Toranomon & Roppongi	41	46,000	
OH 1 B	Marunouchi & Otemachi	39	60,000	2020
Tokyo World Gate / Kamiyacho Trust Tower	Toranomon & Roppongi	38	59,000	
Toyosu 2 Bayside Cross A&C	Toyosu	36	56,000	
Takeshiba A	Shibaura & Hamamatsucho	40	55,000	
Marunouchi 1-3 (Ginko Kyokai)	Marunouchi & Otemachi	29	55,000	
OH 1 A	Marunouchi & Otemachi	31	48,000	
msb Tamachi Station Tower N	Shibaura & Hamamatsucho	36	46,000	
COMORE Yotsuya	Shinjuku	31	42,000	
Tokiwabashi A	Marunouchi & Otemachi	37	44,000	2021
Shinbashi 1 chome Tamuracho	Toranomon & Roppongi	27	32,000	
Yaesu 2 chome North District A 1 Block	Nihonbashi & Yaesu	45	86,000	2022
Toranomon · Azabudai A	Toranomon & Roppongi	65	139,000	2023
Toranomon Hills Station Tower	Toranomon & Roppongi	49	77,000	
Mita 3-4 Chome A1	Shibaura & Hamamatsucho	42	68,000	
Shibaura 1 Chome Project S	Shibaura & Hamamatsucho	46	68,000	
Shibuya Sakuragaoka A	Shibuya & Ebisu	39	56,000	
Toranomon 2 chome	Toranomon & Roppongi	38	55,000	
Toranomon · Azabudai B1	Toranomon & Roppongi	63	51,000	
Kyobashi 1 chome East area B block area	Nihonbashi & Yaesu	28	31,000	

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

GRAPH 3: Supply By Ward And % Increase In Stock, 2018 and 2023F



Source Savills Research & Consultancy

pedestrian path that will connect Toranomon and Toranomon Hills stations, should significantly improve the accessibility of existing and incoming offices in the surrounding area. Mori Trust's Tokyo World Gate is also slated for completion in 2020.

Following a two-year lull, a series of developments, including Toranomon Hills Station Tower, the Toranomon 2-chome project, and the Toranomon Azabudai project, are set for completion in 2023. The combined GFA of office components during that year is expected to be close to 300,000 tsubo, an enormous amount. As opposed to rebuilding over old stock, which the majority of recent redevelopments in Tokyo have done, new towers in Toranomon will be constructed on underdeveloped land and, as such, the net supply impact should be larger. Between 2019 and 2023, Minato's office stock is expected to grow by 17% and exceed Chiyoda's level. At present, it is difficult to reasonably forecast to what extent this much supply could affect the market. Even so, it is certain that Toranomon will transform into a completely new district and help Tokyo evolve as a global gateway city.

2018 VS 2020

2018 was the year that truly tested the strength of Tokyo's real estate market, with the largest volume of supply since 2013 added to the office stock. In the run-up to that year, the global economy was shrouded in uncertainty as the world carefully watched the first year of the new US administration. Some investors were holding their breath in expectation of a potential slowdown of the real estate market. In retrospect, however, economic conditions remained firm, and Tokyo's office market maintained its resiliency, ending 2018 with vacancy of 0.5% and YoY rental growth of 4.9%.

MAP 1: Toranomon Development Projects And Existing Office Buildings

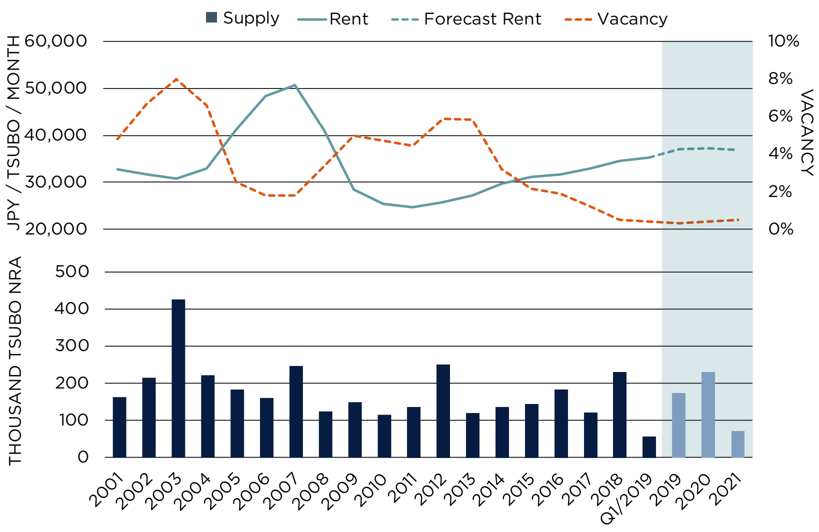
Source Press releases, corporate disclosures, Savills Research & Consultancy

TABLE 2: Comparison Of Major Barometers, 2018 vs 2020

MACRO ECONOMY	2020 METRICS		2018 METRICS	
Real GDP Growth Projection	0.70%	2020F	1.00%	2018F
Large Corporate DI	+17	Mar 2019	+16	Mar 2017
Unemployment Rate	2.40%	Apr 2019	2.80%	Apr 2017
23W Population Growth	0.9%	Apr 2019	1.0%	Apr 2017
OFFICE MARKET				
Grade A Vacancy	0.40%	Q1/2019	2.60%	Q1/2017
Grade A Rental Growth	5.60%	Q1/2019	2.50%	Q1/2017
Pre-leasing	Robust		Strong	

Source Cabinet Office, Ministry of Finance, Bank of Japan, World Bank, Savills Research & Consultancy

GRAPH 4: Tokyo C5W Rent, Vacancy And Supply Relationship, 2001 to 2021F



Actual NRA is used when possible; for projects that have only published GFA, NRA is estimated at 60% of GFA. Actual NRA is likely to somewhat differ from this estimate.
Source Miki Shoji, Sanko Real Estate, press releases, Savills Research & Consultancy

2020 is another year with a large influx of supply. Indeed, it is currently expected to be 17% larger than that of 2018. Prospects for the global economy look uncertain, and it is not surprising that many investors are growing cautious and taking a defensive stance. Nonetheless, it is also possible that concerns surrounding 2020 prove unfounded, as they did in 2018, and overly pessimistic investors could miss out on the gains of another strong year.

When observing certain key macroeconomic metrics, Japan's current conditions appear largely similar to in 2017. While the World Bank's GDP projection for 2020 as of June 2019 is slightly weaker than that for 2018 as of June 2017, the diffusion index (DI) of large corporations in March 2019 is better than in March 2017, indicating that Japanese companies are cautiously optimistic. A tightening of the unemployment rate, as well as stable population inflows to Tokyo, also suggest that sound economic fundamentals are at play. Furthermore, as central banks are increasingly becoming dovish, the powerful monetary policy by the Bank of Japan will likely stay in place, thereby moderating the risk of capital market disruptions.

It is in this context that Tokyo's office market fundamentals remain resilient. In fact, the average vacancy rate of Grade A offices in the C5W in Q1/2019 is 0.4% as opposed to 2.6% in Q1/2017. In this exceptionally tight market, it is not so surprising that YoY rental growth strengthened to 5.6% in Q1/2019. As previously mentioned, pre-leasing is going smoothly, and there is no sign of a softening in demand. In light of these indications of market strength, supply in 2020 seems unlikely to cause the market to turn south from hard assets' point of view.

That being said, there are several risk factors that did not exist before, including the tension between the US and China, as well as the planned consumption tax hike this year. Any signs of an economic slowdown warrant caution since rental growth historically has a strong correlation with the country's overall economic strength (please see Graph 6 in Appendix for detail).

Overall, while 2020's supply itself might have little impact due to the strong pre-leasing activity to date, a potential weakening of the global and Japanese economy could be a threat to office market growth. Indeed, if we assume Japan's economic growth slows down in the coming years, rental growth is forecast to flatten despite our assumption that vacancy will continue to be tight (Graph 4).

CO-WORKING ADDS MUCH DEMAND TO THE MIX

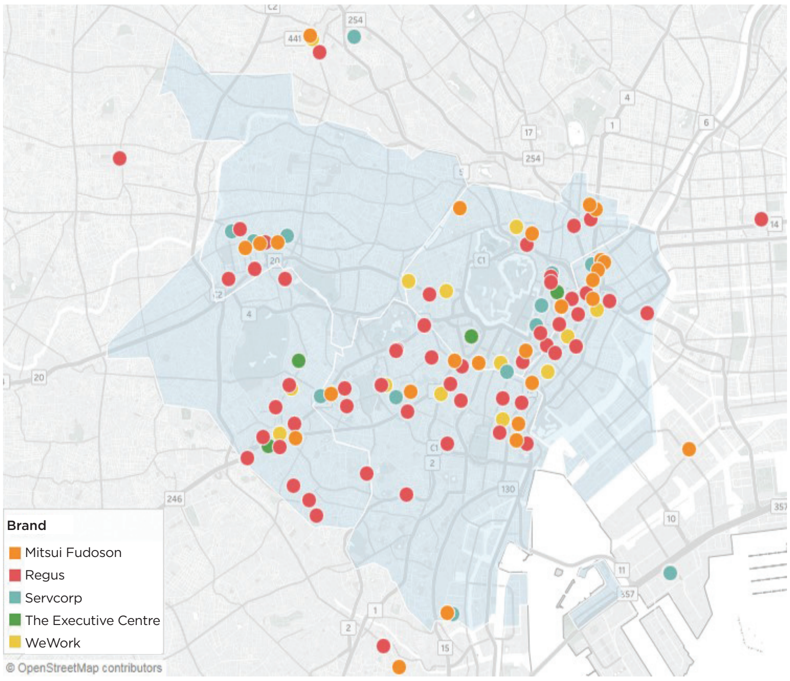
Shifts in corporate office demand, marked by Japan's emerging start-up boom and measures by traditional companies to create flexible working conditions, have led to an expansion of co-working space in high-grade office buildings. While co-working space has been growing over the past two decades, until only a few years ago, fewer than 30 were located in Grade A and large-size Grade B office buildings in the C5W; that number is now over 50, thereby affecting overall occupancy levels of investment grade buildings to a greater degree[1]. Mitsui Fudosan's entry into this sector in 2017 and WeWork's foray into the Japanese market in 2018 in particular expanded the upscale co-working market.

Co-working spaces in high-grade buildings provide opportunities for small-staffed companies to lease large-scale offices that would otherwise be too big to consider. In this sense, the popularity of co-working spaces has something in common with high-specification, mid-sized offices such as PMO and Bizcore. Additionally, the smaller initial cost to rent a co-working office compared to a typical office is favourable for start-ups, as they generally wish to focus capital on growing their core business as quickly as possible.

While co-working may be generally associated with start-ups, co-working spaces in prime buildings are also suitable for satellite offices of blue-chip companies, as well as their needs for project-based spaces.

1 The number of co-working spaces operated by Regus, Servcorp, Executive Centre, Mitsui Fudosan, and WeWork.

MAP 2: Co-working Offices By Selected Operators



Source Corporate websites, press releases, Savills Research & Consultancy

Mitsui Fudosan focuses particularly on capturing this demand and is reportedly serving 300 companies including renowned domestic and international companies. Furthermore, companies such as Mitsubishi Estate and Mitsui Fudosan create co-working labs focusing on growing industries such as FinTech and healthcare.

It is still too early to say whether this flexible office trend is a fad or will become a permanent fixture of the market. Since small tenants are inherently volatile, mixing in large corporate tenants appears essential for stable growth. If the popularity of co-working diminishes, the current trend could quickly reverse. Although co-working offices still account for a fraction of Tokyo's leasing market, recent take-up has been robust, especially in the high-grade office market. It is also known that the leasing contracts may not cover owners' initial investments. If the rapid expansion of co-working backfires, the potential impact on the overall investment outlook should not be inconsequential.

OUTLOOK

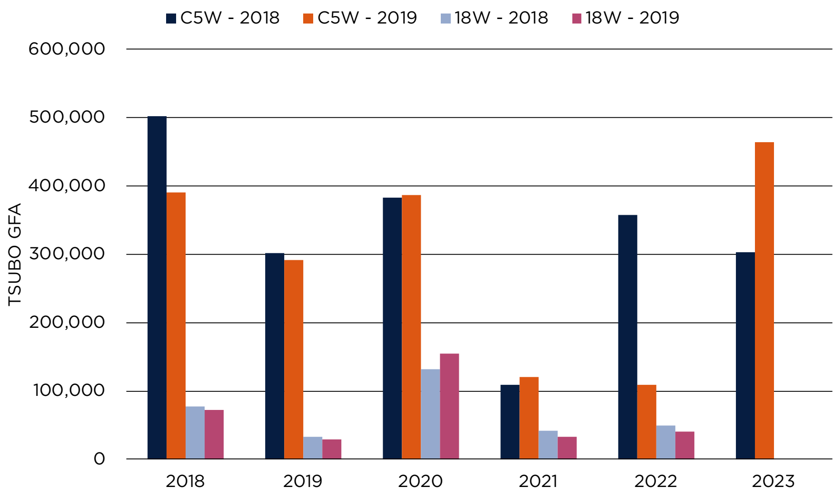
Demand for centrally located, high-specification offices remains sound, leaving little space available for relocation. Pre-leasing, at least through 2020, appears to be going smoothly, limiting the possibility of an abrupt increase in vacancy in the near term. While older offices in peripheral areas might be negatively affected as companies continue to relocate to central areas, there is little sign of a softening in the overall market, at least from hard assets' point of view.

On the other hand, the global economic outlook remains ambiguous, and its future development could significantly change the current growth trend of Tokyo's office market. In particular, the trade tension between the US and China and the planned consumption tax hike may pose a threat. As the global outlook becomes more uncertain, corporate profits have started slightly slowing down, albeit still at high levels, and capital markets have been volatile. The rapid expansion of co-working might backfire, if the current popularity proves to be a fad.

That being said, market fundamentals are still sound and Japan's resiliency continues to attract investor interest. A series of new developments are significantly improving Tokyo's real estate stock and changing the dynamics of the overall market. As tenants' desire to move to central areas appears supported by underlying social and economic changes, a continuing evolution of Tokyo's real estate will likely benefit the overall market in the mid- to long-term.

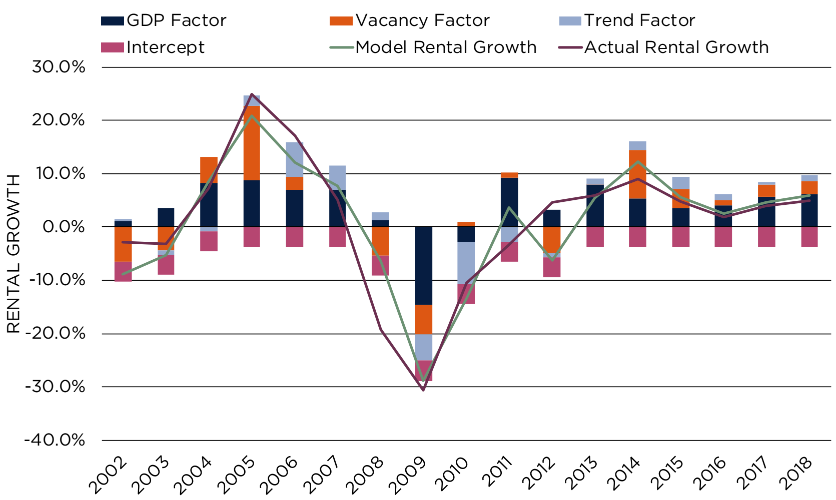
Appendix

GRAPH 5: Change In Supply Forecasts Compared To Last Year, 2018 to 2023



Source Savills Research & Consultancy

GRAPH 6: Actual Rental Growth vs Regression Model, 2002 to 2018



Source Cabinet Office, Savills Research & Consultancy

The reason for the difference in 2022 – 2023 is that four major projects' estimated completion dates have changed since last year's report. The below projects make up most of the change:

- Azabudai A from 2022 to 2023
- Toranomon Hills Station Tower from 2022 to 2023
- Toranomon 2 Chome from 2022 to 2023
- Yaesu 2 Chome centre from 2023 to 2025

Graph 6 illustrates the results of a regression analysis factoring in real GDP, vacancy rate changes, and rental growth rates of the prior year. The model nicely fits actual numbers, validating the model's explanatory power to some extent. Based on the results of this model, real GDP generally plays the largest role in determining the strength of rental growth, while variables specific to the office market (i.e., vacancy rate changes and rental growth rates of the prior year) contribute to seemingly temporary ups and downs observed in years such as 2005 and 2009.

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