MARKET IN MINUTES

Savills Research

Tokyo - Q3/2024

Office Leasing

Recovery continues in earnest

Improvements continue in the Tokyo office market as appetite for office space remains firm.

- Office rents experienced sustained rental growth among both Grade A and Grade B properties. Grade A office vacancy was largely stable, although some weaknesses in certain submarkets were observed over the quarter.
- Average Grade A office rents in the C5W increased by 0.7% quarter-on-quarter (QoQ) and 2.5% year-on-year (YoY) to JPY33,235 per tsubo per month.
- The average Grade A office vacancy rate in the C5W loosened by 0.2 percentage points (ppts) QoQ, but tightened by 0.3ppts YoY to 3.1%.
- Average large-scale Grade B office rents improved by 0.6% QoQ and 3.0% YoY to JPY25,154 per tsubo per month.
- Vacancy rates in the Grade B market loosened marginally by 0.3ppts QoQ to 2.9%, but tightened on an annual basis by 1.1ppts.
- The limited office supply in 2024 has provided stability for the meantime. While the large office supply forecast in 2025 may lead to some volatility, many major incoming developments have received firm pre-leasing interest.
- Elevated construction costs will continue to force delays and redesigns to development projects. However, delays should also create more breathing room for existing properties to reduce vacancies.

"Improvements continue unabated and appetite for office space remains firm. This has contributed to rental growth, and raises the prospect of the uneventful absorption of incoming space. However, some weaknesses persist, with a few completions struggling to gain traction. In addition, high construction costs appear to be delaying relocations and development projects."

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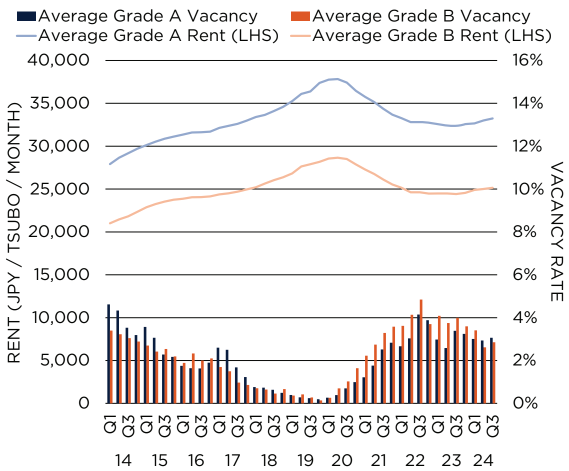
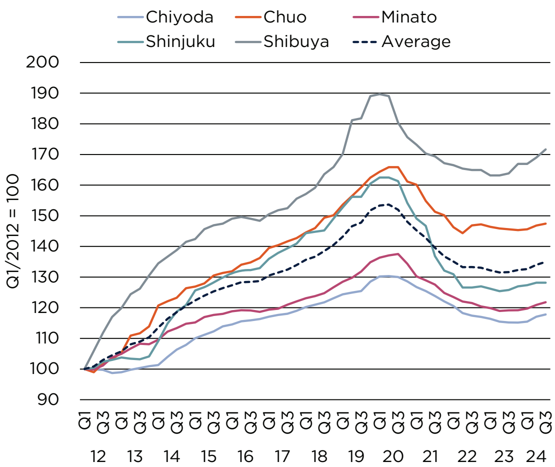
GRAPH 1: Office Rents and Vacancy in Tokyo's C5W*, 2014 to Q3/2024



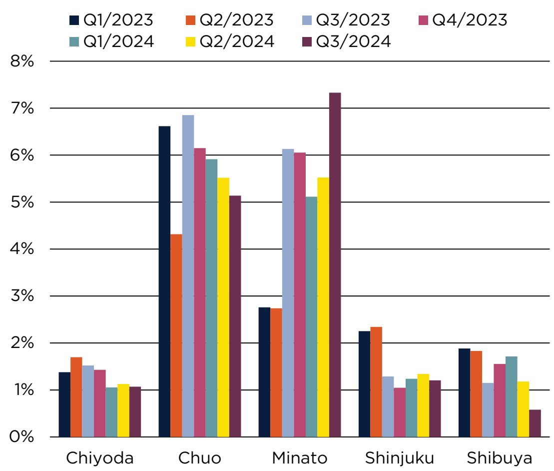
Source Savills Research & Consultancy
* Chiyoda, Chuo, Minato, Shibuya, and Shinjuku

GRAPH 2: Grade A Office Rental Index by Ward, 2012 to Q3/2024



Source Savills Research & Consultancy

GRAPH 3: Grade A Office Vacancy by Ward, Q1/2023 to Q3/2024



Source Savills Research & Consultancy

GRADE A OFFICE

Improvements continue unabated in the Tokyo Grade A office market, with moderate rental growth observed over the quarter. Average office rents increased in the C5W by 0.7% QoQ and 2.5% YoY to JPY33,235 per tsubo in Q3/2024, the highest rental figure so far in the post-pandemic period, with growth spread out fairly evenly across the wards.

The average vacancy rate for Grade A offices in the C5W inched up by 0.2ppts QoQ to 3.1%, although tightening on an annual basis by 0.3ppts. This situation can largely be attributed to changes in Minato, where a handful of new properties appear to be struggling with elevated vacancy. Elsewhere, changes were minimal, and most wards continue to improve and perform well. In particular, vacancy in Shibuya tightened further to the lowest level amongst members of the C5W at 0.6%, and is approaching the ultra-tight level of the pre-pandemic period.

Corporate performance has been remarkably strong in 2024, and interest in relocations among tenants, together with demand for greater amounts of office space have been high. Indeed, in a June 2024 survey carried out by Mitsubishi Estate on company real estate needs, 29.4% of respondents answered that they had either relocated offices within the past one year or were considering doing so in Q1/2024, up from 24.4% in Q3/2023. Headcount and business operation expansions, a desire to improve office environments, and boosting productivity were the most common reasons cited for doing so. At the same time, elevated moving costs remain a barrier that continues to prevent some companies from executing relocation plans. Overall, the market still has some way to go towards full recovery, but tenants are in a favourable position with many choices.

LARGE-SCALE GRADE B OFFICES

Similarly, the large-scale Grade B market displayed moderate improvements in Q3/2024, with average office rents in the C5W increasing by 0.6% QoQ and 3.0% YoY to JPY25,154 per tsubo. The Grade B office market in Shibuya performed particularly well over the quarter, with rents increasing by 1.3% QoQ. Elsewhere, Minato and Chiyoda saw positive rental growth at 0.9% QoQ and 0.6% QoQ, respectively. Meanwhile, rents in Chuo dipped marginally by 0.2% QoQ.

Average Grade B vacancy loosened marginally by 0.3ppts QoQ to 2.9%, although performed well on an annual basis, tightening by 1.1ppts. Grade B vacancy in Shibuya and Chiyoda are at the tight level of 1.0% and 1.1%, respectively. On the other hand, vacancy in Shinjuku loosened by 1.8ppts QoQ to 3.9%, as a handful of older properties have elevated levels of vacancy. Nonetheless, the situation appears to be stable overall in the ward.

A handful of older properties in inconvenient locations continue to struggle with vacancies, particularly in Chuo ward's Harumi, and in the Tokyo Bay area of Minato. Moreover, further progress may be dampened by heightened fit-out costs due to Japan's chronic labour shortages and elevated materials costs; smaller firms, which are typical tenants of Grade B office buildings, are likely to be more hesitant to relocate because of the hefty price tag, and may hence be forced to reconsider or postpone relocation plans. That said, the positive trajectory of the economy, coupled with high corporate profits and waning levels of hybrid work should boost the prospects for further improvements in the coming quarters.

GRADE A RENTS AND VACANCY RATES BY WARD

Chiyoda

In Q3/2024, average rents in Chiyoda increased by 0.6% QoQ and by 2.3% YoY, reaching JPY39,613 per tsubo, which are by far the highest among the constituent C5W. Meanwhile, vacancy remained unchanged at 1.1% over the quarter. Although a handful of notable office developments are in the pipeline that will transform the submarket throughout the decade, including the iconic TOKYO TORCH in 2028, the number of new completions will be limited over the next few years, so this stable and tight situation should continue for the meantime.

Mitsubishi Jisho Design announced the relocation of its head office to the Otemachi Gate Building. The company will reportedly take a lease of 3,100 tsubo in the building, which is slated for completion in 2026. Another notable move will be Eiken Chemical's reported headquarters relocation to Ochanomizu Sola City in 2025, leasing an estimated 900 tsubo in the property.

Chuo

Average rents increased by 0.4% QoQ and 1.3% YoY to JPY31,941 per tsubo, while average vacancy tightened by 0.4ppts QoQ to 5.1%. Although Chuo's vacancy rate is among the highest in Tokyo's premier office district, the situation is healthy overall, with pockets of high vacancy largely limited to the Tokyo Bay area, such as Harumi. On the other hand, districts near Tokyo station such as Yaesu and Nihonbashi have very limited office availabilities, and have seen stronger rental growth than other districts.

BofA Securities Japan will reportedly relocate its headquarters from the Nihonbashi 1-Chome Mitsui Building to the main tower of the Nihonbashi 1-Chome Central District Redevelopment Project, which is scheduled for completion in 2026. The company aims to lease between 2,600 and 3,900 tsubo in the new development - a moderate reduction from its current office space. JERA will also relocate its headquarters to the same main tower, although its new office footprint has not yet been disclosed. Elsewhere, a number of moderately sized relocations are scheduled to take place in Chuo, including Teito Motor Transportation leasing nearly 500 tsubo in the KDX Hakozaki Building and Nihon Parkerizing leasing 500 tsubo in the Onward Park Building.

Minato

Rents in Minato increased by 0.7% QoQ and 2.2% YoY to JPY30,866 per tsubo. Vacancy loosened by a notable 1.8ppts QoQ to 7.3%, largely due to the recent completion of a large development that has yet to gain traction, and will likely take more time to do so. Nevertheless, the ward has a large office market, and aside from a handful of properties experiencing difficulties, including those located in the Tokyo Bay area, the ward has been making definite improvements overall.

The largest relocation announced in Minato in Q3/2024 was Kobe Steel's plan to relocate its Tokyo headquarters to THE LINKPILLAR 2 in 2026, leasing an estimated 5,500 tsubo in the building. Meanwhile, Toppan Digital will move to THE LINKPILLAR 1 South, which is scheduled to open in 2025. The company will reportedly lease a floor area of 4,000 tsubo in the building. Elsewhere, Megmilk Snow Brand will reportedly lease nearly 3,200 tsubo in Toranomon Alcea Tower, which will be completed in 2025, while Itokin Daiwabo Information System will relocate its Tokyo office to Sumitomo Fudosan Tokyo Mita Garden Tower, leasing an estimated 2,000 tsubo in the property.

Major recent developments, Toranomon Hills Station Tower and Azabudai Hills Mori JP Tower also appear to continue making improvements in Q3/2024. Mitsui O.S.K. Lines will lease 1,000 tsubo, MBK Partners will lease 400 to 450 tsubo, and Crocs Japan will lease 300 tsubo in Toranomon Hills Station Tower, which has already welcomed several major tenants and is effectively filled. Meanwhile, Zenken will reportedly lease nearly 500 tsubo in Azabudai Hills Mori JP Tower, in addition to CrowdWorks, which will lease 300 tsubo in the property. Although there is some room for improvement, the property appears to continue attracting firm interest from potential tenants, and should continue to fill its floors, especially given the iconic nature of the office building and the popularity of the wider Azabudai Hills development.

Shibuya

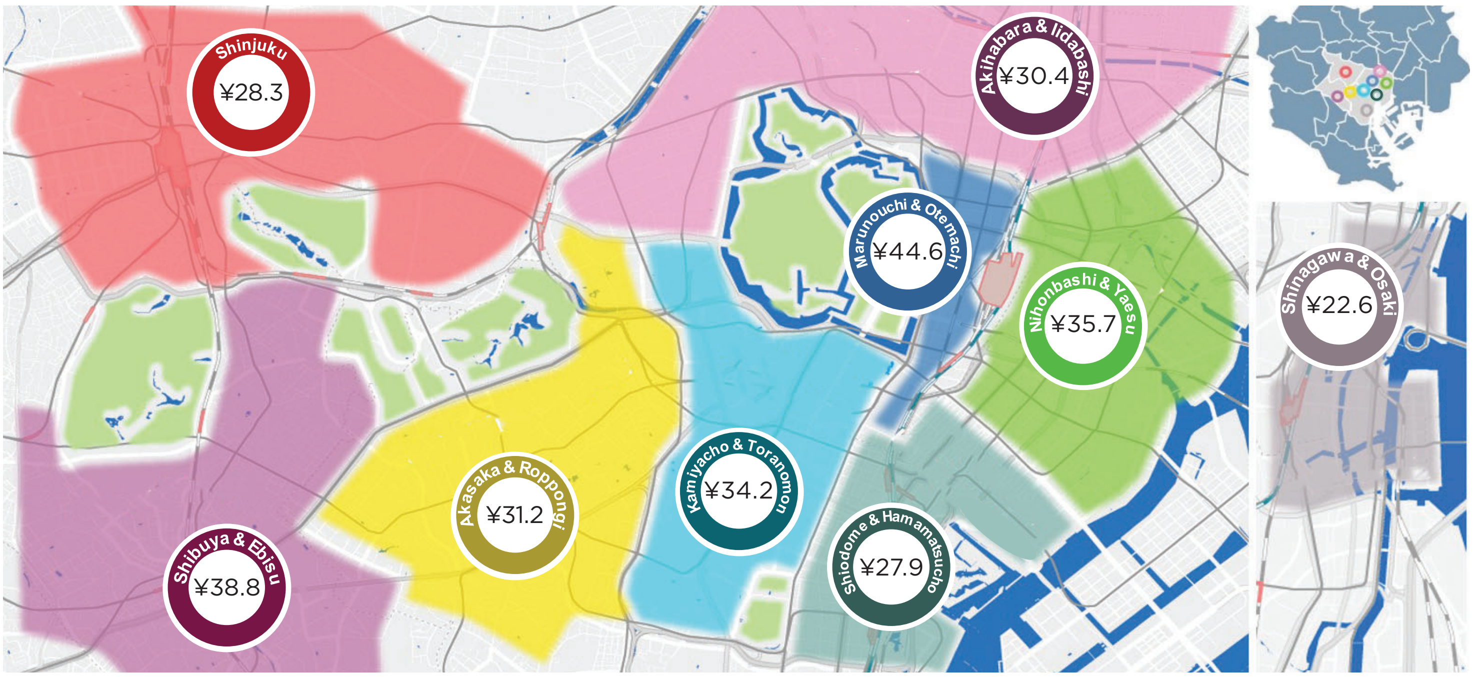
The office market in Shibuya continues to go from strength to strength, with average rents increasing by 1.6% QoQ and 4.8% YoY to JPY36,674 per tsubo, the second highest in the C5W by a comfortable margin. In addition, vacancy tightened further by 0.6ppts QoQ to 0.6%, which are the tightest in the C5W, and are nearing the ultra-tight levels seen in the pre-pandemic period. This strength can be demonstrated by the leasing performance of SHIBUYA AXSH, which arrived to the market completely filled. A series of upcoming mixed-use office developments, many of which will be located in the vicinity of Shibuya station, will further polish the image of Shibuya and generate new demand, and will likely face few challenges in being absorbed.

Given the popularity of Shibuya and the slew of modern office developments, tenant relocation activity in the ward has been notable. For instance, Square Enix will open an office in Shibuya Tower, leasing 10 floors, amounting to an estimated 8,100 tsubo. United Arrows' move to the Sendagaya Center Building Reconstruction Project will also be another large relocation, reportedly planning to lease 2,500 tsubo in the building. Elsewhere, a handful of moderate relocations include i-mobile leasing 800 tsubo in the Kanden Fudosan Shibuya Building, the Japan Health Insurance Association leasing nearly 800 tsubo in the Shinjuku Bunka Quint Building, and Hitachi Astemo leasing over 500 tsubo in Shibuya Tower, among others.

Shinjuku

In Q3/2024, average rents in Shinjuku remained flat over the quarter at JPY27,083 per tsubo, which are the most affordable among the constituent office markets of the C5W. Meanwhile, vacancy tightened by 0.1ppts QoQ to 1.2%. Overall, it appears that Shinjuku is popular among tenants, evidenced by demand for footprint expansion in current premises among existing tenants, in addition to rumours of strong interest in upcoming developments, such as the Meiji Yasuda Seimei Building. Amidst this generally stable situation, there were no major office relocations disclosed in the ward in Q3/2024.

MAP 1: Average Rents Per Tsubo in Selected Submarkets, Q3/2024



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

TABLE 1: Tenant Relocations, Q3/2024

ORIGIN: Chiyoda	Chuo	Minato	Shibuya	Shinjuku	Other		DESTINATION	
8	9	4	8	4	21			
6		1			2	→	9	Chiyoda
1	8			1	2	→	12	Chuo
1	1	3	2	2	8	→	17	Minato
			5		4	→	9	Shibuya
					1	→	1	Shinjuku
			1	1	4	→	6	Other

Source Nikkei RE, Savills Research & Consultancy

TABLE 2: Notable Office Leasing Transactions, Q3/2024

COMPANY	BUSINESS SECTOR	TYPE	FORMER/CURRENT LOCATION		NEW LOCATION	APPROXIMATE SPACE TSUBO	APPROXIMATE SPACE SQ M
Square Enix	Electronics	Expansion	N/A N/A	→	Shibuya Sakura Stage Shibuya Tower Shibuya	8,100	26,800
Kobe Steel	Manufacturing	HQ Relocation	ON Building Shinagawa	→	THE LINKPILLAR 2 Minato	5,500	18,200
Toppan Digital	Information Technology	Expansion	N/A N/A	→	THE LINKPILLAR 1 South Minato	4,000	13,200
Megmilk Snow Brand	Food	Relocation	Undisclosed Undisclosed	→	Toranomon Alcea Tower Minato	3,200	10,500
Mitsubishi Jisho Design	Architecture	HQ Relocation	Marunouchi 2-Chome Building Chiyoda	→	Otemachi Gate Building Minato	3,100	10,300

Source Nikkei RE, Savills Research & Consultancy

GRAPH 4: Change in Average Cost of Steel and Concrete in Tokyo, FY2016 to FY2023

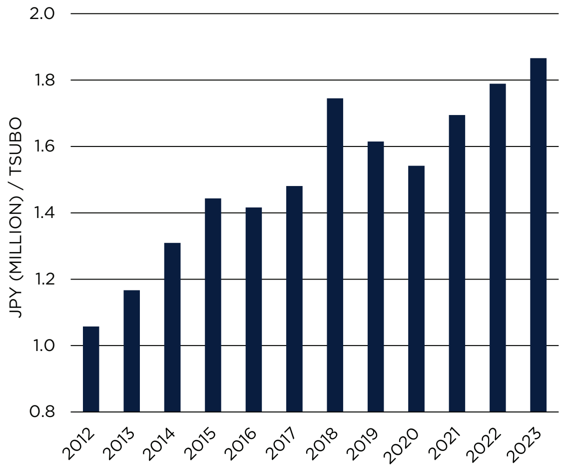
Source Economic Research Association, Savills Research & Consultancy

IMPLICATIONS OF ELEVATED CONSTRUCTION COSTS

The Japanese real estate market has been grappling with elevated construction costs. According to data from the Economic Research Association, the average unit cost of steel in Tokyo has increased by over 60% between FY2020 and FY2023, while the cost of concrete in Tokyo has increased by over 30% during the same period (Graph 4), which has contributed to a considerable increase in overall construction costs. For instance, the cost of steel frame office buildings in Tokyo has increased by nearly 50% over the same period (Graph 5). As a result, many projects would likely deviate considerably from initial target returns, and this issue has forced many developers to delay and redraw their development plans.

Notable causes include heightened materials and energy costs, as well as labour costs. Since a large proportion of building materials used in the Japanese construction sector are imported, both the weakened yen and heightened global demand for construction materials have exacerbated these cost issues. The construction sector is also plagued by chronic labour shortages, which have been compounded by recent regulations on overtime work, and will undoubtedly reduce the capacity of the construction sector to complete new projects. In addition, strong demand from nationwide large projects such as Expo 2025 Osaka, semiconductor manufacturing facilities, Integrated Resorts, and the Chuo Linear Shinkansen also appear to exacerbate the situation further. Given these challenges, the time taken for completing major developments over the past five years appears to have become noticeably longer compared to similarly sized developments

GRAPH 5: Average Construction Cost for Steel Reinforced Concrete Office Buildings in Tokyo per Tsubo, 2012 to 2023



Source MLIT, Savills Research & Consultancy

completed between 2001 and 2009, as is indicated by a sample of major office development projects in Tokyo (Table 3).

Several instances of ongoing project delays can be observed. For instance, the redevelopment of the iconic Nakano Sun Plaza is reported to have further increased in costs, this time by an additional JPY90 billion in September 2024, which could put the total cost of the project at JPY354 billion – nearly double the original budget of JPY181 billion only a few years ago. In addition to construction delays, these staggering increments could also result in a complete overhaul and revision of development plans. Elsewhere, plans for the large mixed-use redevelopment of the Gotanda TOC Building, which was initially scheduled to start construction in spring 2023 with a target completion of 2027, have been significantly altered. Inflated construction costs have likely impacted the feasibility of the project, and a new plan is reportedly being drawn up, with construction revised to an anticipated starting date of 2033. Beyond Tokyo, a large mixed-use office development by NTT Urban Development in the vicinity of Sapporo station was initially scheduled for completion in 2024 in anticipation of the extension of the Hokkaido Shinkansen to Sapporo. However, the project appears to be delayed by around two years to a total construction timeline of nearly five years, with the developer citing elevated materials and labour costs. Moreover, the redevelopment of the current Mitsukoshi Department store in Nagoya's prime Sakae area into a large mixed-use office and commercial complex was slated for completion in 2029, although elevated construction costs in addition to other challenges have forced the project to be put on hold, and the developer is reportedly considering reducing the scale of the project on the grounds of feasibility.

TABLE 3: Construction Period for Major Office Developments* in Tokyo, 2001 to 2009 and 2019 to 2024

COMPLETION YEAR	NAME	LOCATION	CONTRUCTION MONTHS	GFA (SQ M)
2001	Cerulean Tower	Shibuya	40	105,900
2002	Marunouchi Building	Chiyoda	40	159,900
2002	Dentsu Headquarters Building	Minato	36	231,700
2003	Shiodome City Center	Minato	34	210,200
2003	Roppongi Hills Mori Tower	Minato	36	379,400
2004	Nihon Seimei Marunouchi Building	Chiyoda	38	95,500
2005	Nihonbashi Mitsui Tower	Chuo	38	133,900
2007	Midtown Tower	Minato	32	246,400
2007	Shin-Marunouchi Building	Chiyoda	25	195,400
2008	Akasaka Biz Tower	Minato	36	186,900
2009	JA Building	Chiyoda	24	88,700
2009	Marunouchi Park Building	Chiyoda	26	195,600

COMPLETION YEAR	NAME	LOCATION	CONTRUCTION MONTHS	GFA (SQ M)
2019	Nihonbashi Muromachi Mitsui Tower	Chuo	40	166,700
2019	Okura Prestige Tower	Minato	38	180,900
2019	SHIBUYA SCRAMBLE SQUARE	Shibuya	62	181,000
2020	Toranomon Hills Business Tower	Minato	36	172,900
2020	Otemachi One	Chiyoda	46	357,700
2020	Tokyo World Gate Kamiyacho Trust Tower	Minato	42	198,800
2021	Tokiwabashi Tower	Chiyoda	42	146,400
2022	Tokyo Midtown Yaesu	Chuo	45	289,800
2023	Azabudai Hills Mori JP Tower	Minato	47	461,800
2023	Toranomon Hills Station Tower	Minato	45	253,500
2023	Tamachi Tower	Minato	32	112,200
2023	Shibuya Tower	Shibuya	55	184,700
2024	Akasaka Trust Tower	Minato	44	209,700

Source Savills Research & Consultancy
* Construction period and GFA may include retail and other spaces in developments.

This issue looks to persist for the time being, and will likely trigger financial difficulties for some vulnerable developers and building owners. Indeed, the diversification of floor usage is usually only feasible for large mixed-use projects by adding more residential or retail space, but a majority of large developments have already exhausted this option. As such, office building developers are likely to only be able to recoup ballooning investments through higher rents for office tenants. While this should be possible for prime assets, this would be significantly more difficult for others, especially in the post-pandemic market with the slightly subdued levels office demand. Moreover, given that fit-out costs are also at elevated levels, large rental increments may not be palatable to many prospective tenants. As such, expensive developments will require increasingly deliberate planning, that may involve project delays and extensions in order to spread out the costs, or projects being shelved altogether.

However, this situation may have some silver linings. Firstly, project delays may result in new supply being more spaced out, which should provide greater breathing room for the market to absorb existing supply. This would be especially welcome in the case of years with large amounts of new supply, such as in 2025 and 2028, and would prevent excessive secondary vacancies and general instability in the market. Secondly, this sustained inflationary trend is a sign that the Japanese economy has achieved a more normalised state of constant nominal growth, which should increase rental growth at least nominally. In addition, higher demolition and reconstruction costs will likely be an impetus for landlords to explore refurbishing and renovating buildings at periodic intervals, rather than demolishing and rebuilding. This strategy would be significantly more cost effective in this inflationary environment, on top of being ESG friendly, and would allow rents to keep up with total cost.

OUTLOOK

The Tokyo office market does not appear to have deviated from its steady path of recovery in Q3/2024. Indeed, the Tokyo Grade A and large-scale Grade B office market saw moderate rental growth, despite some nominal loosening of vacancy rates over the quarter. We anticipate further recovery throughout the year, especially given the moderate amount of new office supply in 2024, as well as strong corporate performance.

Some concerns persist regarding demand for relocations from tenants, and improvements in vacancy rates may be gradual. This stems largely from established hybrid work arrangements and elevated construction costs that make moving offices significantly more expensive. However, market players appear to be offering solutions. Indeed, these issues have contributed to the heightened popularity of set-up offices and satellite offices, and many developers are increasingly looking to integrate these office types into their development projects. Moreover, some landlords even appear to be offering to cover a portion of fit-out costs in order to attract tenants and remain competitive.

New supply in 2025 appears to be of a similar volume to that of 2023, which has raised some concerns given the still recovering state of the office market. That said, Tokyo's office market has rebounded notably well compared to many of its global peers, largely due to its relative return to pre-pandemic workstyle norms, as well as the favourable performance of Japanese corporations over the past years. Indeed, several major incoming office developments are already enjoying sound interest from tenants, in particular THE LINKPILLAR 1 slated for completion in 2025, and the Nihonbashi 1-Chome Central District Redevelopment Project in 2026, which should ease some concerns.

Elevated construction costs will continue to be a major issue for developers and landlords going forward, threatening the financial viability of some development projects, and contributing to many notable project delays. Nevertheless, this may be serendipitous for the steady recovery of the market. Indeed, project delays should create breathing room to absorb existing vacant supply, and also prevent significant levels of secondary vacancy. Overall, the Tokyo office market is in a healthy state, seeing consistent moderate improvements, and should continue on this positive trajectory throughout this year at least.

Savills monitors rents and vacancy levels of more than 500 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 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, our benchmark figures, particularly vacancy rates, tend to be lower than other market indices.