Xymax Real Estate Institute
TOPIC REPORT

Deciphering Changes in the Office Market

Signs of change in emphasis on "near, new and large" office buildings

July 10, 2024

Introduction

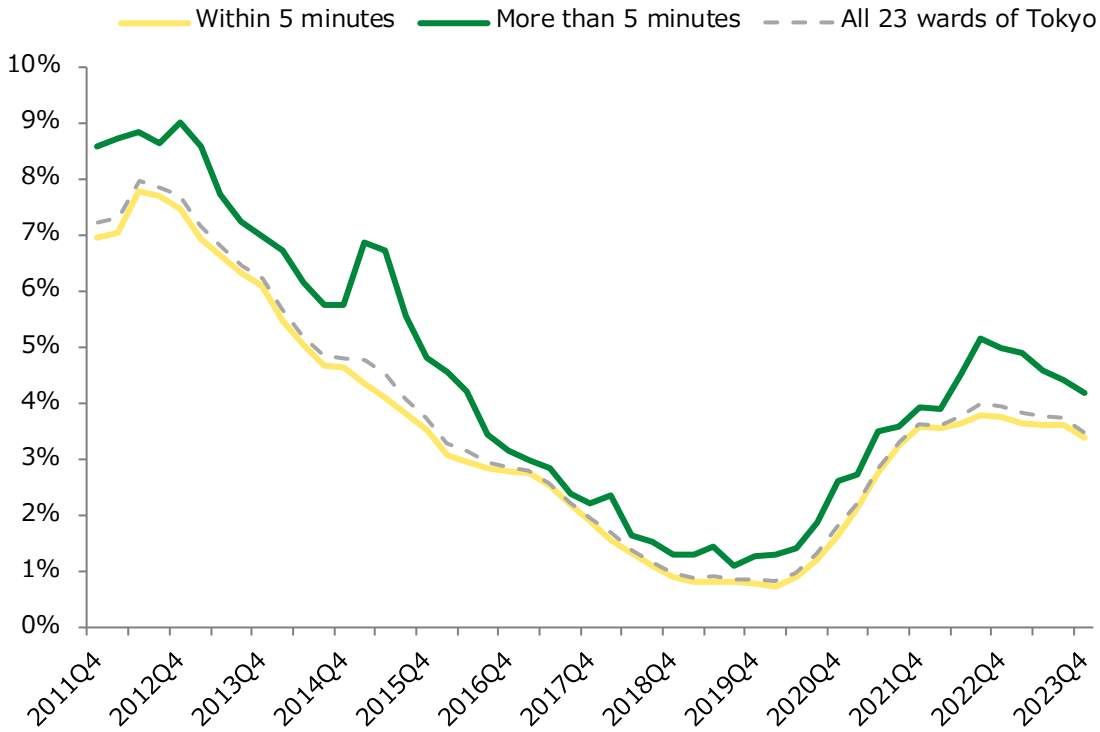
In the office market, the preference for "near, new and large" office buildings has historically been a factor influencing a building's competitiveness. "Near, new and large" refers to 1) the competitive location of the building (near a train station), 2) the competitive age of the building (new), and 3) the competitive size of the building (large). When it was assumed that employees would come to the office five days a week, the general idea was that buildings with these three factors would attract greater demand and be more competitive. However, following a major environmental change that was the COVID-19 pandemic, many companies are now introducing hybrid work, involving working from the home or a satellite office, or changing/rethinking the usage and positioning of the office. This may have led to changes in the traditional values that place importance on "near, new and large" office buildings. In this report, we identify the trends of the office markets in the 23 wards of Tokyo before and after the pandemic in terms of each of the "near, new and large" factors, analyze the backgrounds from both the supply and demand perspectives, and examine the points that we believe are important in considering future changes in the market.

1. Vacancy Rates by "Near, New and Large" Factors

1.1. "Near"—Disparities based on the distance to the nearest station still exist—

Our first focus is on the "near" factor. **Figure 1** shows vacancy rates by the number of minutes on foot to the nearest train station in two categories: "within 5 minutes" and "more than 5 minutes."

Figure 1: Vacancy Rates by Number of Minutes on Foot to Nearest Train Station



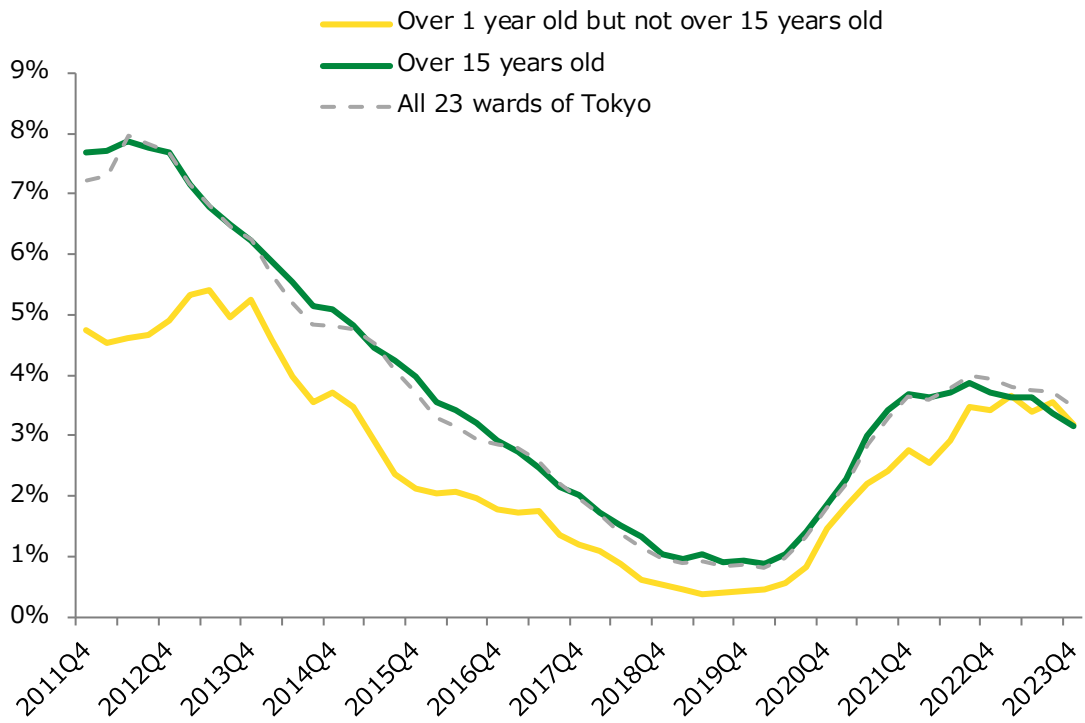
(Office buildings in the 23 wards of Tokyo (n=9,497))

When the vacancy rate of the entire 23 wards of Tokyo was high, the vacancy rate of buildings located more than a 5-minute walk from the nearest station was high. However, as the vacancy rate declined, buildings far from stations were also selected, and their vacancy rate gradually approached that of buildings located within a 5-minute walk of the nearest station. As overall market vacancy rates rose after the COVID pandemic ended, vacancy rates increased regardless of the number of minutes on foot to the station. As overall market vacancy rates subsequently leveled off, the vacancy rate increased only for buildings located more than a 5-minute walk from the station. Although it is currently on a downward trend, it remains higher than that of buildings within a 5-minute walk. Based on these developments, we can see that the advantage of a building based on its distance from the nearest station exists as it did before the pandemic and has become apparent once again as vacancy rates in the overall market have increased.

1.2. "New"—Vacancy rate differences based on building age have narrowed—

We then focus on the "new" factor. **Figure 2** shows vacancy rates by building age in two categories: "over 1 year old but not over 15 years old" and "over 15 years old." This analysis excludes buildings that are not over 1 year old, which have unstable occupancy.

Figure 2: Vacancy Rates by Building Age



(Office buildings in the 23 wards of Tokyo (n=9,497))

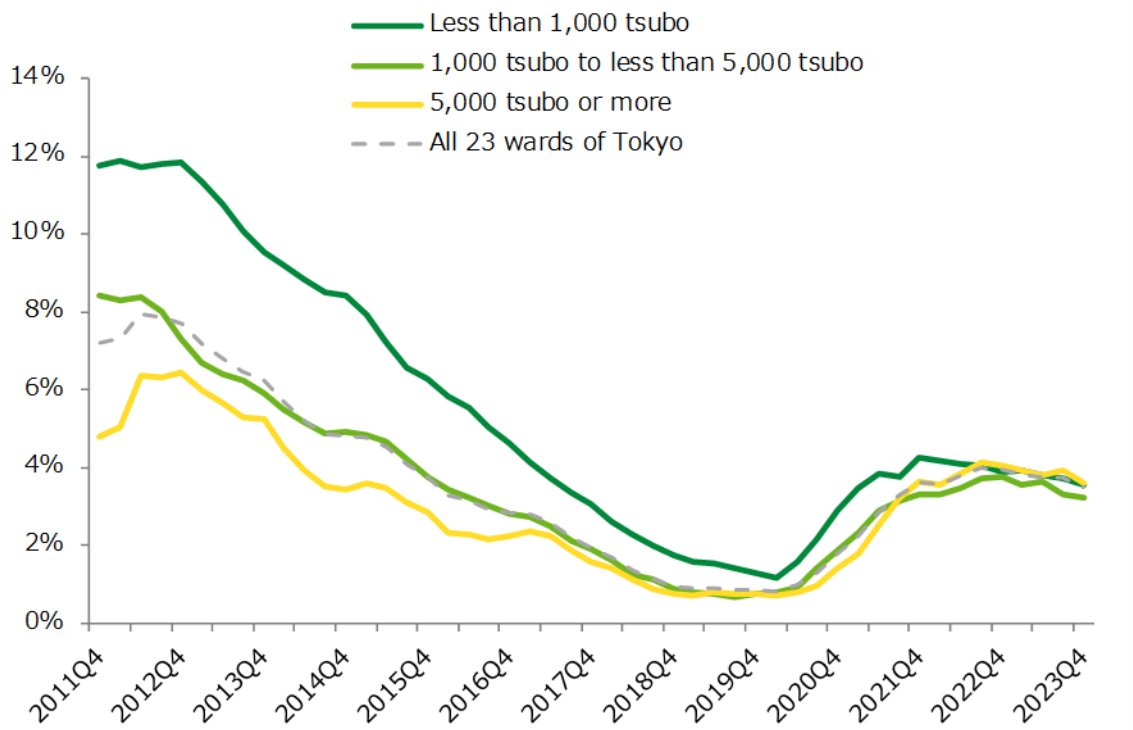
*Buildings 1 year old or younger are excluded as newly built buildings.

When comparing the vacancy rates of buildings over 1 year old but not over 15 years old to those over 15 years old, the vacancy rate of the former was consistently well below the vacancy rate of the latter prior to the pandemic. However, as the overall market vacancy rates have leveled off or trended downward after rising during the pandemic that began in 2020, the vacancy rate for buildings over 1 year old but not over 15 years old has increased to the same level as the vacancy rate for buildings over 15 years old. Currently, there is no clear difference in vacancy rates. There may have been a change in the pre-pandemic trend of relatively new buildings being filled in preference to older buildings.

1.3. "Large" —Vacancy rate differences based on building size have narrowed—

Our final focus is on the "large" factor. **Figure 3** shows vacancy rates by building size in three categories: gross floor area (GFA) of "less than 1,000 tsubo," "1,000 tsubo to less than 5,000 tsubo" and "5,000 tsubo or more." (1 tsubo = 3.33 sqm)

Figure 3: Vacancy Rates by Gross Floor Area



(Office buildings in the 23 wards of Tokyo (n=9,497))

During the phase of falling vacancy rates through 2020, the smaller the building, the higher the vacancy rate. However, the gap narrowed as vacancy rates began to fall across the entire market. This indicates a clear preference for large buildings prior to the COVID pandemic, where vacancies in buildings with larger GFA were filled faster than other buildings, and vacancies in buildings with smaller GFA were filled later. Looking at the trend since the end of the pandemic, following a rise in vacancy rates in all 23 wards of Tokyo, there is currently hardly any difference in vacancy rates between the different GFA groups, which leads us to estimate that the difference in preference based on building size has diminished after the pandemic.

1.4. Changes in the office market in recent years

—Of "near, new and large," the vacancy rate gaps based on "new" and "large" have changed—

So far, we have examined vacancy rates by category in relation to the three elements, "near, new and large." As a result, we found changes in the pre-pandemic trends, in that while there was no change in the trend that vacancy rates tended to be higher for buildings located farther from the nearest station, the vacancy rate gaps between the different categories in terms of building age and size have narrowed. In particular, we no longer see the pre-pandemic tendency for vacancy rates to be lower in larger GFA

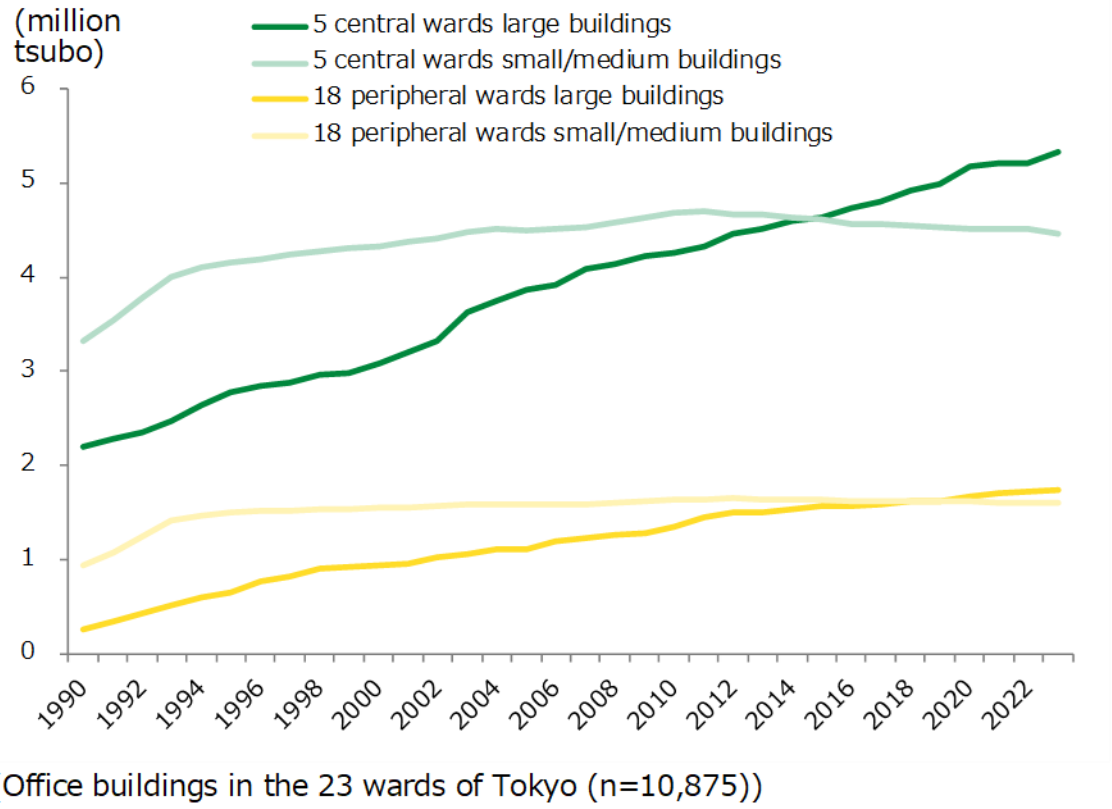
categories, suggesting a shift in the market structure. In the next chapter onward, we take a close look at what has happened in the office market in recent years from the perspective of both supply and demand, which are the determinants of vacancy rates that represent a supply-demand gap, to explore changes in the "near, new and large" values.

2. Office Market Trends from a Supply Perspective

2.1. An increasing number of large buildings in the 5 central wards

Figure 4 shows the trend of the office market from a supply perspective in terms of the total stock of large buildings (GFA of 5,000 tsubo or more) and small and medium buildings (GFA of less than 5,000 tsubo) in the 5 central wards and 18 peripheral wards.

Figure 4: Office Stock by Area and Building Size (Rentable Area Basis)



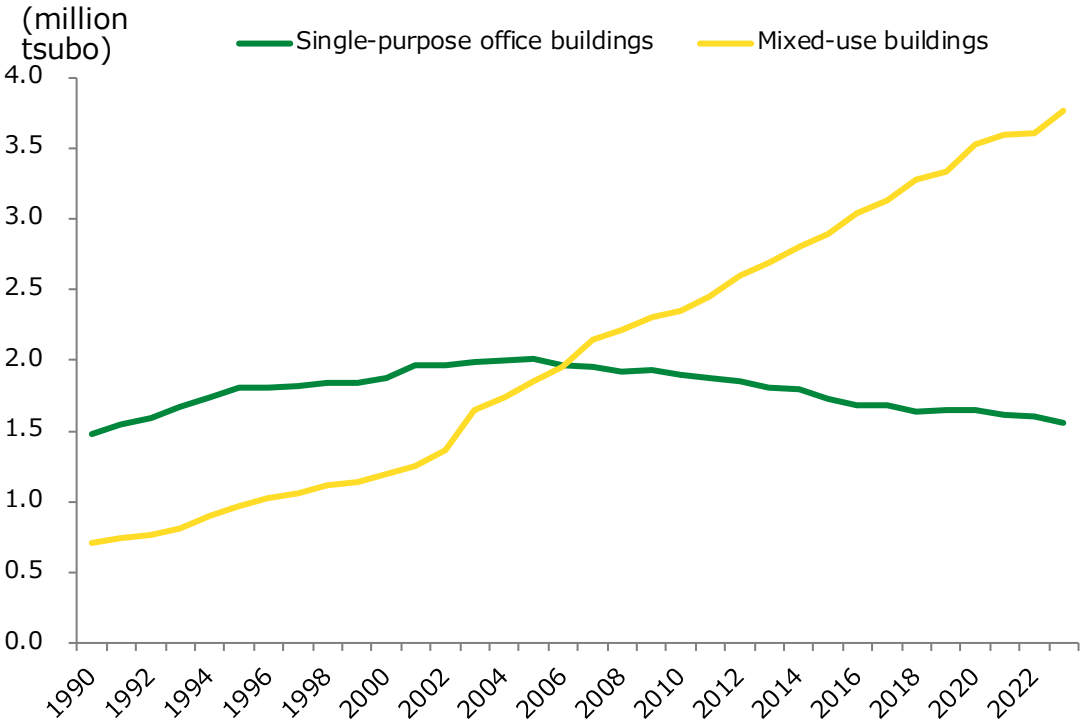
(Office buildings in the 23 wards of Tokyo (n=10,875))

Looking at the office stock by area and building size since 1990, the stock of large buildings in the 5 central wards increased in particular, reaching 5.33 million tsubo by the end of 2023. The stock of small and medium buildings in the 5 central wards was the largest among the four categories in 1990, but it peaked in 2011 and fell below large buildings in the 5 central wards in 2015, declining to 4.47 million tsubo by the end of 2023. The stock of large buildings also gradually increased in the 18 peripheral wards, surpassing the stock of small and medium buildings in 2018. These developments suggest that large buildings have become commoditized in the office market in recent years, as supply has increased primarily in large buildings in the 5 central wards, resulting in intensified competition among large buildings.

2.2. Mixed-use buildings increasing among large buildings in the 5 central wards

Figure 5 shows the trend of the stock of large buildings in the 5 central wards categorized into single-purpose office buildings and mixed-use (commercial, hotel, residential, etc.) buildings.

Figure 5: Stock of Large Buildings in 5 Central Wards:
Single-purpose Office Buildings and Mixed-use Buildings – By Gross Floor Area



(Buildings in 5 central wards with GFA of 5,000 tsubo or more that include office use (n=657))

Looking at the trend of the stock of single-purpose and mixed-use buildings, we can see that the stock of mixed-use buildings has been increasing continuously, while the stock of single-purpose office buildings peaked in 2005 and declined to 1.56 million tsubo by the end of 2023, less than half the stock of mixed-use buildings. Mixed-use buildings include buildings with small shops on the first floor, but in recent years, there has been an increase in large buildings that also accommodate other purposes, such as shopping venues, hotels, and residences, in the 5 central wards. In addition to mixed-use buildings, there has been an increase in buildings with amenities such as meeting booths and refreshment areas in the common areas, suggesting that developments with unique features that go beyond simply providing office space are becoming mainstream.

2.3. Supply-side trends

From the above, we can see that the supply side in recent years has focused on large buildings, especially mixed-use buildings, in the 5 central wards.

The background to this is the simplification of urban planning procedures through the National Strategic Special Zone system established in 2013 and the relaxation of the floor-area ratio for hotel and residential

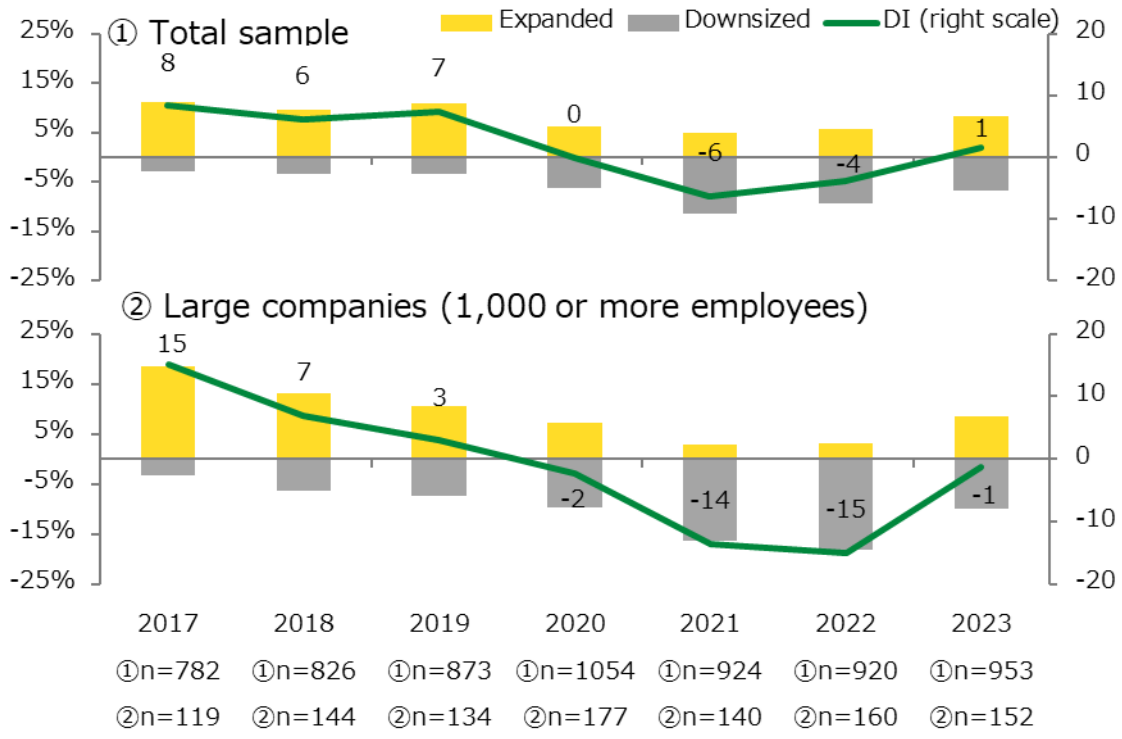
use in central Tokyo, which encouraged the construction of mixed-use buildings in central Tokyo. If these policies continue, it is likely that future new supply will be centered on the development of mixed-use office buildings based on these policies. On the other hand, the labor shortage in the construction sector, also known as the "2024 problem," and the recent surge in the price of construction materials have caused construction projects to be delayed or reconsidered. Add to this the possibility of a rise in interest rates, and future new supply could be reduced, depending on the situation.

3. Office Market Trends from a Demand Perspective

3.1. Downsizing of office prominent among large companies during the pandemic

Next, we use the "Metropolitan Areas Office Demand Survey Autumn" conducted by Xymax Real Estate Institute ("Xymax REI") to examine demand-side developments before and after the pandemic. **Figure 6** shows the percentage of office area expansion or downsizing between one year prior to each year's survey and the time of the survey, and the DI, which is the percentage of expansion minus the percentage of downsizing, for the total sample of the analysis and for large companies (i.e., 1,000 or more employees). In this analysis, responses from companies located in the 23 wards of Tokyo whose office type is head office, sub-office, branch office, or sales office were extracted and analyzed.

Figure 6: Percentage of Office Area Expansion/Downsizing and DI – By Company Size



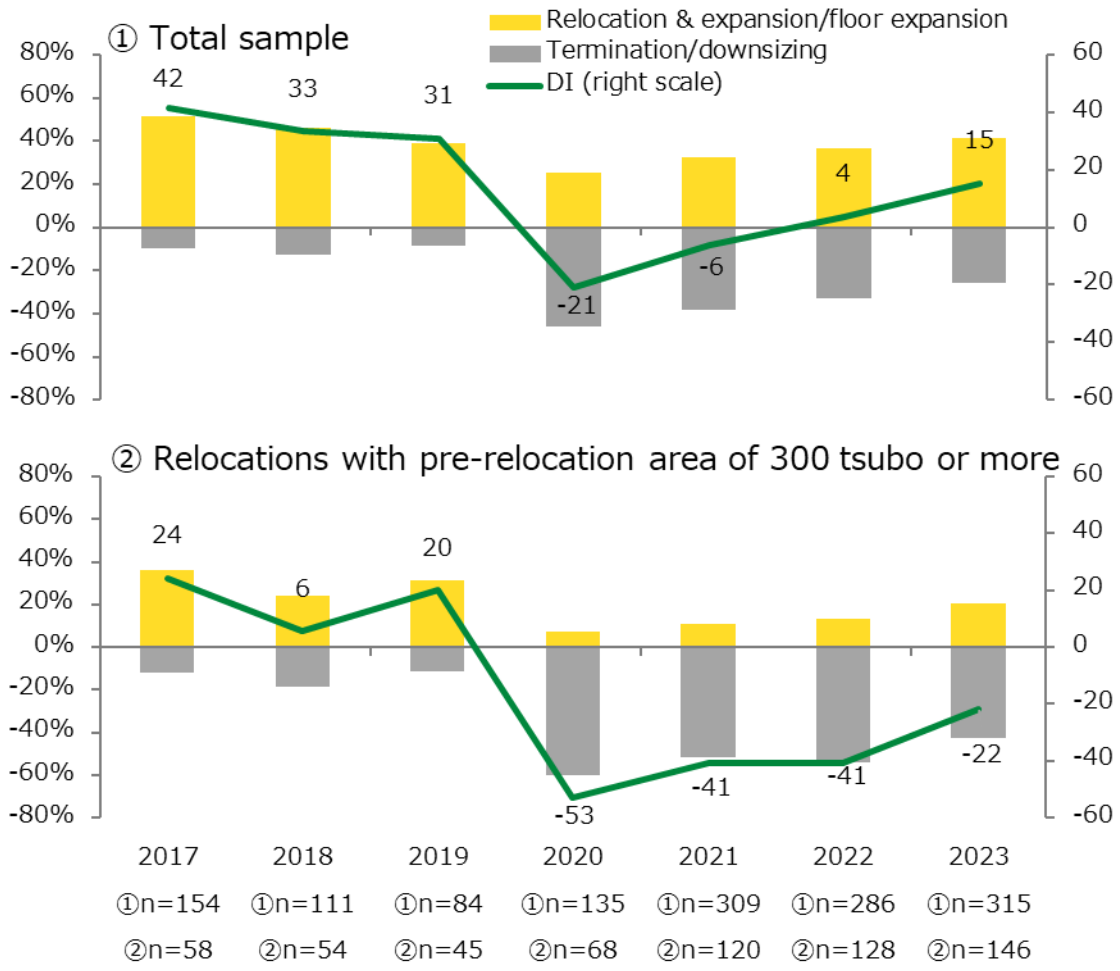
Looking at the total sample, the DI was positive until 2019 but fell to 0 in 2020 and then to negative territory in 2021 and 2022. This is likely due to office downsizing associated with restrictions on coming to the office during the pandemic. Office expansion again outweighed downsizing in 2023. Compared to the total sample, large companies had larger negative DIs in 2021 and 2022, suggesting that their office downsizing during the pandemic was more pronounced. On the other hand, the DI was -1 in the 2023 survey, a decrease in the difference between expansion and downsizing and similar to the result of the

total sample. This suggests that office reorganization after the pandemic is not biased toward downsizing, even among large companies.

3.2. Office downsizing prominent among parcels of 300 tsubo or more

Of the relocation information collected independently by Xymax REI between 2017 and 2023, we extracted those where the pre-relocation area and relocation details were known. **Figure 7** shows the percentage of relocation & expansion/floor expansion and termination/downsizing for the total sample and for relocations where the pre-relocation area was 300 tsubo or more.

Figure 7: Percentage of Office Area Expansion/Downsizing and DI – By Parcel Size



In terms of the total sample, the percentage of relocation & expansion/floor expansion was high until 2019, with the DI in positive territory. However, the percentage of termination/downsizing increased significantly in 2020, when vacancy rates rose due to the pandemic, exceeding the percentage of relocation & expansion/floor expansion by 21 percentage points. Subsequently, the percentage of termination/downsizing gradually declined, with the DI returning to positive territory in 2022. In 2023, the percentage of relocation & expansion/floor expansion exceeded that of termination/downsizing by 15 percentage points.

Meanwhile, when we narrow down to relocations where the pre-relocation area is 300 tsubo or more, the DI was positive until 2019, but the percentage of termination/downsizing exceeded 60% in 2020, with

the DI at -53. While the gap has gradually narrowed thereafter, the DI remains at -22 in 2023.

3.3. Demand-side trends

Looking at the trend of office expansion and downsizing from the demand side, office downsizing during the COVID pandemic was more prominent among large companies and tenant companies occupying large parcels.

Possible factors include large companies being more proactive in changing employee work styles, for example by introducing hybrid work, and the greater scope for rethinking the office in large parcels than in small ones, resulting in a greater effect of reducing fixed costs when downsizing. This may have led to a decline in demand for large parcels and thus a decline in demand for large buildings.

Meanwhile, amid moves to return to the office and create offices that employees want to come to in preparation for the end of the pandemic, the difference between expansion and downsizing has narrowed even among large companies. In considering future office demand, it is worth paying attention to how work styles and the use of the office will change in companies.

4. Key Points in Predicting the Market Going Forward

Thus far, we have identified the changes in the office market before and after the COVID pandemic, focusing on the "near, new and large" elements, and analyzed the factors behind the changes from both a supply and demand perspective. The vacancy rate trends show that the difference in vacancy rates between "new" and "large" buildings and other buildings has narrowed compared to before the pandemic. In particular, for the "large" element, the pre-pandemic tendency for larger buildings to have lower vacancy rates has disappeared. A likely factor is a decline in the advantage of large buildings due to, on the supply side, an increase in the stock of large buildings in central Tokyo, especially mixed-use buildings that include retail stores and hotels, resulting in intensified competition among large buildings, and, on the demand side, active office downsizing during the pandemic, especially among large companies and large parcels.

We have analyzed recent trends as the above, but further changes on both the supply and demand sides are expected in the future. In this chapter, we will list the points that are considered important in predicting the future of the market.

4.1. Key points from the supply perspective

Rent and parcel adjustments in large buildings

Although the difference in vacancy rates by building size has disappeared, rents for large buildings remain higher than for small and medium buildings. Furthermore, large building parcels can be subdivided to accommodate the need for small and medium parcels. If large buildings begin to absorb the need for small and medium parcels through rent adjustments or parcel segmentation, large buildings may regain an advantage, resulting in a decline in the vacancy rate of large buildings as before the pandemic.

Impact of higher construction costs on new supply

Supported by the National Strategic Special Zone system, among others, there has been a noticeably large supply of buildings in central Tokyo. Recently, however, the labor shortage in the construction sector, also known as the "2024 problem," and the soaring price of construction materials have led to delays in

the completion of construction and reconsideration of construction plans. If supply becomes constrained, new large buildings may become increasingly scarce.

Generalization of new added values of office buildings

In this report, we showed that the number of mixed-use large buildings is increasing in central Tokyo. The quality of office buildings has been changing not only by becoming mixed-use but also by incorporating new added values into buildings, such as "environmental performance" to address companies' sustainability requirements; "smart buildings" that incorporate IoT and AI to provide high convenience, security, and energy efficiency; and "ample amenities and common areas" to make offices an attractive place for employees to come to work. Going forward, being equipped with these new added values may become a common, important indicator for measuring the competitiveness of offices.

Renovation of old buildings

With construction costs soaring, there has been an increase in renovations rather than reconstruction as a way to enhance the value of office buildings. Older buildings are also undergoing upgrades of common areas and renovations to meet the demand for set-up offices. Going forward, an increase in buildings with various added values, regardless of their building age, may weaken the focus on "new" buildings.

4.2. Key points from the demand perspective

Changes in work style

The COVID pandemic has led to the proliferation of hybrid work in many companies, which combines working in the main office with teleworking. Following the reclassification of COVID-19 as a Class 5 infectious disease, different companies have adopted different policies concerning the ratio of teleworking and coming to the office. The development of the office market may be influenced by how work styles change within the companies.

Diversification of functions required in offices

With the proliferation of hybrid work, coming to the office every day is no longer a given, and web meetings and remote work have become the norm. To increase the organization's productivity under these circumstances, companies have set up private rooms for web meetings and spaces to facilitate smooth communication. It is likely that the functions tenant companies require in offices will become more diverse.

Diversification of added value required in buildings

In the section on the supply side, we mentioned that there has been an increase in buildings with new added values such as "environmental performance." We also believe that demand-side added value requirements for office buildings will become more diverse. With changes in work styles within companies and in companies' requirements of functions in offices, it is also expected that more companies will choose buildings based on values other than the traditional "near, new and large," such as "environmental performance" and "ample amenities and common areas."

Conclusion

In light of past office market trends and the future supply and demand key points we have presented in this report, it is likely that the future office market will experience a shift away from traditional values that placed importance on being "near, new and large" and will experience greater diversification and complexity from both a supply and demand perspective.

Going forward, the supply side will need to further consider the type of added value it should add to office buildings in order to differentiate in the face of ample existing stock and potentially greater constraints on new supply due to soaring construction costs. It is also likely that there will be more opportunities for buildings that have not been highly rated based on traditional values to be highly rated by adding new value.

The demand side is likely to be more inclined to consider the work style that suits the company and the type of office it should choose to achieve it, in addition to the traditional way of rating buildings, i.e., whether the building is well located, new and prominent.

Xymax REI will continue to provide useful information by anticipating market changes through research on the changes in office market trends and office stock, and the types of offices required by the demand side.

For further inquiries please contact below:

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