Office Market Report

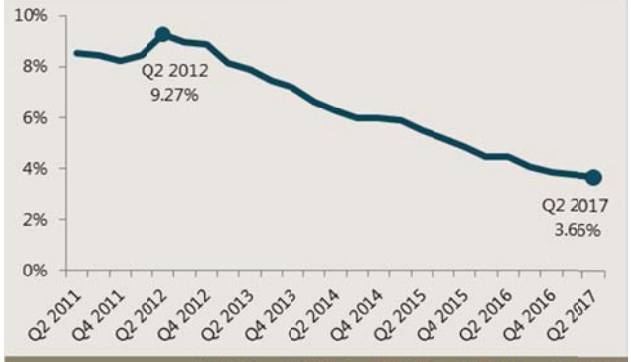
Tokyo | Q2 2017

August 2, 2017

Summary

- In the June 2017 quarter, the Tokyo 23 Wards' office market remained tight with the low vacancy rate at the 3% level. Although some of the new contract rent indicators showed slowdowns, it does not mean that the overall market turned weak.
- The **vacancy rate** was 3.66%, a decrease by 0.10 points. **Decrease in Vacant Space** was 232,000 tsubo while the **Increase** was 217,000 tsubo; the decrease was larger than the increase. **Vacancy Turnover Ratio** (the ratio of vacant space leased during the quarter to all the vacancy stock) is rising.
- **New Contract Rent Index** (the level of new lease rent) was 104, a decrease by 4 points. **Contract Rent Diffusion Index**, calculated by subtracting the percentage of buildings with a rent decrease from the percentage of buildings with a rent increase, remained unchanged over the quarter at +6.
- **Paying Rent Index** (the level of new lease rent and the level of existing lease rent combined) was 91, an increase by 3 points.
- The free rent period is becoming shorter. **Average Free Rent Month of Lease with Free Rent** was 3.7 months, a decrease by 0.1 months.
- The quarter's results somewhat varied. We will see whether they were the signs of change.

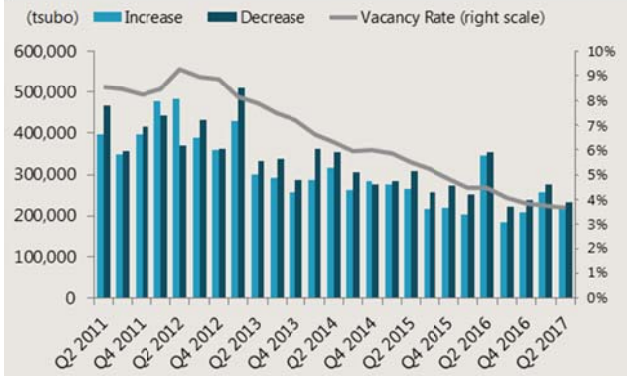
Figure 1: Vacancy Rate



	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017
Vacancy Rate	4.45%	4.08%	3.85%	3.76%	3.66%

Source: Xymax Real Estate Institute

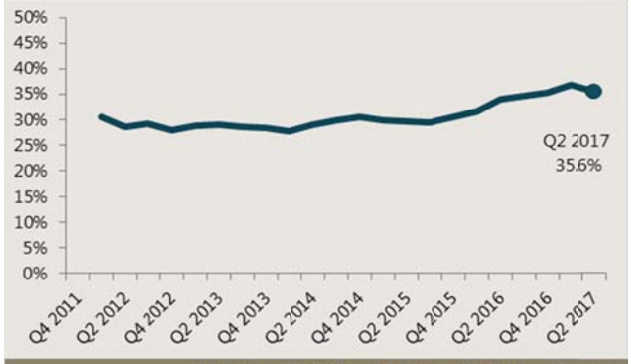
Figure 2: Increase and Decrease in Vacant Space



	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017
Increase	345,000	184,000	210,000	258,000	217,000
Decrease	354,000	222,000	238,000	276,000	232,000
Vacancy (right scale)	4.45%	4.08%	3.85%	3.76%	3.66%

Source: Xymax Real Estate Institute

Figure 3: Vacancy Turnover Ratio (4-quarter moving average)



	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017
Vacancy Turnover	33.9%	34.6%	35.2%	36.9%	35.6%

Source: Xymax Real Estate Institute

Vacancy

Figure 1 shows changes in **vacancy rate** in Tokyo 23 Wards since 2011. The vacancy rate in the second quarter of 2017 decreased by 0.10 points quarter-on-quarter to 3.66%. The rate kept decreasing since the third quarter of 2012.

The market remained tight with the low vacancy rate at the 3% level, reflecting the continuous strong demand of companies to expand the office space to accommodate new workers. Available spaces on the market are limited in number. Tenants often take available spaces in their current building to expand their office. Some tenants are even waiting for new availability in the building where they are.

Figure 2 shows a quarterly increase and a quarterly decrease in vacant space (**Increase and Decrease in Vacant Space**). Both the increase and decrease were smaller than those in the previous quarter because this quarter had fewer new completions. The increase was 217,000 tsubo while the decrease was 232,000 tsubo; the decrease exceeded the increase for ten consecutive quarters since the first quarter of 2015, influencing the continued decrease in the vacancy rate.

Figure 3 shows the **Vacancy Turnover Ratio (four-quarter moving average)**, which is the ratio of the vacant spaces leased to tenants during the quarter to all the vacant office stock (vacancy at the start of the quarter + vacancy added during the quarter).

The graph shows a decrease of the ratio in this quarter but it is still more than 1 point above the year-ago level. A slow upward movement continued, indicating that available spaces are steadily taken up by tenants.

Figure 4: New Contract Rent Index

	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017
New Contract Rent Index	98	104	107	108	104

Source: Xymax Real Estate Institute

Figure 5: New Contract Rent Index by Size of Building

	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017
Small & Medium Buildings	99	105	107	107	103
Large Buildings	101	111	109	109	107

Source: Xymax Real Estate Institute

Figure 6: Contract Rent DI (Tokyo 23 Wards)

	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017
Contract Rent DI	17	21	18	6	5

Source: Xymax Real Estate Institute

New Contract Rent

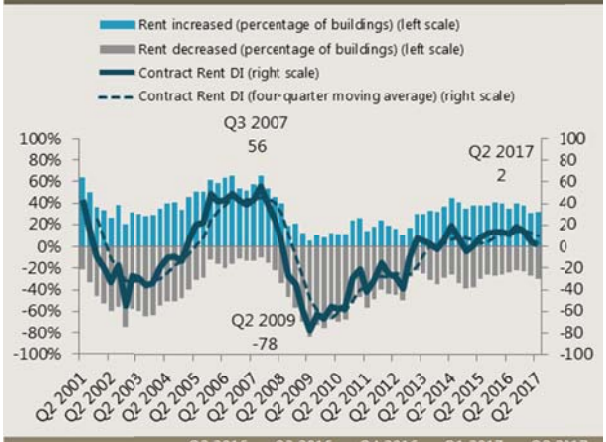
Figure 4 shows changes in the **New Contract Rent Index** (Tokyo 23 Wards), which is the index of the level of new lease rent. The index for the second quarter of 2017 was 104, a decrease by 4 points from 108 in the previous quarter. It decreased for the first time in nine quarters since the first quarter of 2015. The upward trend continued for five years since the second quarter of 2012. We will pay attention to what happens next to determine whether the decrease in this quarter was only a temporary decrease or not.

Figure 5 shows changes in the New Contract Rent Index **by size of buildings.** The index for small and medium buildings (gross floor area: below 5,000 tsubo) was 103, a decrease by 4 points and the index for large buildings (gross floor area: over 5,000 tsubo) was 107, a decrease by 2 points.

Both large buildings and small and medium buildings saw increases in new lease rents since the third quarter of 2012. The rent of large buildings repeated a small increase and decrease while the rent of small and medium buildings kept increasing for more than two years but decreased this quarter for the first time in ten quarters. The growth of new lease rents is slow regardless of the building size.

Figures 6 and 7 are changes in the **Contract Rent Diffusion Index (DI)** (Tokyo 23 Wards, central three wards). They show where the changes in new lease rents are headed. The DI in this quarter remained unchanged from the previous quarter at +6 for Tokyo 23 Wards and decreased by 3 points to +2 for the central three wards. The DI remained positive for nine consecutive quarters, meaning the buildings with a rent increase continued to exceed the buildings with a rent decrease. The DI remained below ten and is nearing the turning point (zero). Such trend is prominent for the central three wards, at +2 this quarter.

Figure 7: Contract Rent DI (Tokyo Central Three Wards)



	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017
Contract Rent DI	12	18	15	5	2

Source: Xymax Real Estate Institute

Some of the new contract rent indicators showed signs of slowdowns. The rental growth of new lease is slow despite the tight market with the 3% level vacancy rate. The reason behind this situation is that a great volume of large new completions will start next year; landlords are careful and not able to take a strong stand on increasing the rent. Some landlords put priority on filling vacancies rather than achieving high rent. Another reason may be found on the tenants' side; they wait, unless they are in a hurry, until the impact of the new completions become clear.

Figure 8: Paying Rent Index

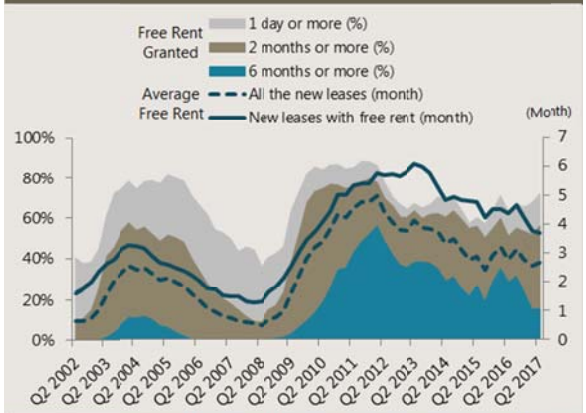
	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017
Paying Rent Index	82	84	86	88	91

Source: Xymax Real Estate Institute

Paying Rent

Figure 8 shows changes in the **Paying Rent Index**, in which new lease rents and existing lease rents are both covered. The index in the second quarter of 2017 was 91, an increase by 3 points. It continued the modest growth since the third quarter of 2013. The increase was contributed by the increase in rent of new lease and by the increase in rent of existing tenants.

Figure 9: Free Rent



		Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017
Ratio of Free Rent Granted	1 day +	63.4%	67.2%	65.6%	67.8%	72.3%
	2 mon. +	51.2%	55.2%	53.6%	52.1%	56.3%
	6 mon. +	28.5%	31.3%	23.2%	14.9%	15.1%
Average Free Rent Month	All	2.8	3.1	2.8	2.6	2.7
	w/ FR	4.4	4.7	4.2	3.8	3.7

Source: Xymax Real Estate Institute

Free Rent

Figure 9 shows changes in the ratio of new leases with free rent to all the new leases (**Ratio of Free Rent Granted**) and changes in the average free rent period (**Average Free Rent Month**).

The Ratio of Free Rent Granted in the second quarter of 2017 increased for all the periods. The Average Free Rent Month of All the New Leases was 2.7 months, an increase by 0.1 months from the previous quarter.

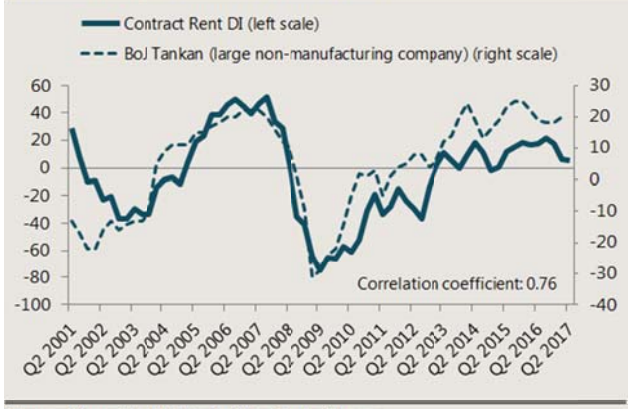
However, such long-term free rents are only limited to buildings that had struggled to attract tenants or buildings that are new completions. In overall, the free rent period is becoming shorter. As a result, the Average Free Rent Month of Lease with Free Rent decreased by 0.1 months to 3.7 months.

Figure 10: Market Cycle

	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017
Vacancy Rate	4.45%	4.08%	3.85%	3.76%	3.66%
Contract Rent Index	98	104	107	108	104

Source: Xymax Real Estate Institute
(Vacancy rates before March 2011 are based on data by major leasing agent.)

Figure 11: Contract Rent DI (Tokyo 23 Wards) and BoJ Tankan (Large Non-Manufacturer)



Source: Xymax Real Estate Institute, Bank of Japan

Figure 12: Contract Rent DI (Tokyo 23 Wards) and Tokyo Stock Exchange Stock Price Index

Source: Xymax Real Estate Institute, Tokyo Stock Exchange
Note: The stock prices applied here are the closing price at the end of quarter.

Market Cycle

Figure 10 is a graph plotted by quarter based on vacancy rates on the horizontal axis and the New Contract Rent Index on the vertical axis. It shows that the market is cyclical; the plot started to move to lower right in 2001 (vacancy up, rent down) and remained static in 2003-2004, then it started to move to upper left in 2005 (vacancy down, rent up) and to lower right again in 2008 (vacancy up, rent down).

The market entered the recovery phase in 2013 and remained there in 2017. This quarter, the plot moved to the lower left because the vacancy rate decreased but the new contract rent also somewhat decreased.

Topic

Figures 11 and 12 show the Contract Rent DI together with the economic indicators such as Bank of Japan's Tankan (short-term economic survey) of large non-manufacturing companies and the price index of Tokyo Stock Exchange. In general, real estate indicators are said to be ragging behind actual economy, but the graphs show that the Contract Rent DI has a high correlation with actual economy.

The economy is growing modestly. It is the third longest growth in the post war period, longer than the bubble era around 1990, with the current Tankan on the positive area and the steady growth of stock prices.

Our company survey* found that demand for office space will likely to continue as the surveyed companies responded that they expect to increase the number of workers and need to expand the office space. Regarding the large volume of new supply starting from 2018, some companies responded that it would expand the choices of quality buildings, while others said they will wait until 2018 to plan relocations and expansions. The survey results show that companies are careful on how much money to spend on lease of office space.

Such changes in market balance are likely to influence the rent of new lease in the future.

* Report "Metropolitan Areas Office Demand Survey" released on the same day (August 2, 2017)

Reference

Figure 13: Major Building Completions (Q2 2017)

Name	Floors Above Ground / Below Ground	Ward	Address	Completion	Gross Floor Area (tsubo)
SHIBUYA CAST.	16/2	Shibuya	1-23-21 Shibuya	Apr 2017	6,898
Hibiya Park Front (Uchisaiwaicho 2-chome Project)	21/4	Chiyoda	2-1-6 Uchisaiwaicho	May 2017	11,334
S-GATE Otemachi Kita	10/1	Chiyoda	2-3-4 Uchikanda	May 2017	1,787
X-PRESS Yurakucho	12/1	Chiyoda	2-2-1 Yurakucho	May 2017	1,402
PMO Shibuya	14/1	Shibuya	1-17-4 Shibuya	Jun 2017	1,093

Source: Compiled by Xymax Real Estate Institute based on information released by companies

Figure 14: Major Office Relocations (Q2 2017)

Company	From	To	Month Year	Purpose	Size (tsubo)
Linical Co., Ltd.	Sumitomo Fudosan Shiodome Hamarikyu Building, *Chuo Ward*	Shiodome Sumitomo Building *Minato Ward*	May 2017	Expansion	1,085
Saison Information Systems Co., Ltd.	Sunshine 60 Building *Toshima Ward*	Akasaka Intercity AIR *Minato Ward*	Nov 2017	Better efficiency	1,566
Warabeya Nichiyo Holdings Co., Ltd.	Tenant-occupied building *Kodaira City, Tokyo*	Humax Shinjuku Tomihisacho Building (temporary name) *Shinjuku Ward*	Jan 2018	Consolidation	2,087
Nissan Chemical Industries, Ltd.	Kowa Hitotsubashi Building *Chiyoda Ward*	Nihonbashi 2-chome Category I Urban Area Redevelopment Project (District D) (temporary name), *Chuo Ward*	Jul 2018	Better facilities	1,600

Source: Compiled by Xymax Real Estate Institute based on information released by companies.
The size of the office space is an estimate.

Overview of Researches

	Vacancy Rate	Increase and Decrease in Vacant Space	Vacancy Turnover Ratio	New Contract Rent Index
Description	Vacant space versus total office stock in the market.	A quarterly increase and a quarterly decrease in volume of vacant space in the market.	The ratio of the vacant space leased during the quarter to all the vacant office stock in the market.	Office rent index based on new contract rents. This index uses a statistical method to remove property-specific influences such as size and age of buildings.
Main Point	Supply and demand balance in the market	Supply and demand balance in the market	Supply and demand balance in the market	Level of contract rents
Sector	Office Building	Office Building	Office Building	Office Building
Market	Tokyo 23 Wards	Tokyo 23 Wards	Tokyo 23 Wards	Tokyo 23 Wards
Building Size	All	All	All	All / Large / Small & Medium
Release	Every Quarter	Every Quarter	Every Quarter	Every Quarter
Data Source	Data of available vacant spaces and buildings. Independently collected by Xymax.	Data of available vacant spaces and buildings. Independently collected by Xymax.	Data of available vacant spaces and buildings. Independently collected by Xymax.	Data of new contract rents including CAM charge. Independently collected by Xymax.
Data Used in Recent Quarter	30,922 buildings	24,643 contracts	24,643 contracts	1,055 contracts
How to Calculate	• Vacancy rate = vacant space ÷ rentable space • Vacant Space Total available vacant space in completed buildings as of the time of the research. • Rentable Space Rentable space of completed buildings as of the time of the research. Where rentable space is not available, the rentable space is estimated from the gross floor area of the building using the formula developed in the joint study with the laboratory of Professor Naoki Kato at Kyoto University Graduate School of Engineering.	• Increase in volume of vacant space a. Space in existing buildings formerly occupied by tenants b. Total rentable area of new completions • Decrease in volume of vacant space a. Space in existing buildings leased under a new agreement b. Space in new completions but lease is signed prior to the completion c. Space that had been vacant but the owner decided not to lease Where rentable space is not available, the rentable space is estimated from the gross floor area of the building using the formula developed in the joint study with the laboratory of Professor Naoki Kato at Kyoto University Graduate School of Engineering.	• Vacancy Turnover Ratio = Volume of vacant space leased during the quarter ÷ (Initial vacancy + Vacancy added during the quarter) Then, compute the four-quarter moving average amount with the ratio derived from this formula. • Volume of vacant space leased during the quarter: Same as the 'decrease in volume of vacant space). • Initial vacancy: Total volume of completed buildings that are available for lease as of the start of the quarter. • Vacancy added during the quarter: Same as the "increase in volume of vacant space"	1) Develop a rolling hedonic model (overlapping period: five quarters) based on the collected new contract data with property-specific factors as variables (location, building size, building age, facilities, date of signing of lease, etc.). 2) Estimate the quarterly contract rent by assigning the values of a typical building to the model developed in the preceding step. 3) The New Contract Rent Index is the rent estimated in the preceding step based on Q1 2010 as the base point (=100). This model shows changes in new contract rents after removing property-specific variables.

	Contract Rent DI	Paying Rent Index	Free Rent Granted (%) & Average Free Rent (Month)
Description	Index of changes in new contract rents. Calculated by counting and comparing the buildings where rent has increased and those where rent has decreased.	Index of changes in paying rents (new and existing contract rents).	Distribution of free rent and average length of free rent period. Free rent is the time lag between the start of the contract and the start of the rent payment.
Main Point	Direction of contract rent trends	Level of rents paid by tenants	Market trends that are not reflected in contract rents
Sector	Office Building	Office Building	Office Building
Market	Tokyo 23 Wards / Tokyo Central 3 Wards	Tokyo 23 Wards	Tokyo 23 Wards
Building Size	All	All	All
Release	Every Quarter	Every Quarter	Every Quarter
Data Source	Data of new contract rents including CAM charge. Independently collected by Xymax.	Data of new and existing contracts signed for buildings under management by Xymax.	Data of new contracts signed for buildings under management by Xymax.
Data Used in Recent Quarter	1,673 contracts	3,832 contracts	119 contracts
How to Calculate	1) Compare the data of new contract rent per tsubo with that in the 6-month prior period in the same building. Each contract was counted separately into three categories: buildings with "rent increase", "no change" or "rent decrease" 2) Calculate the percentage of buildings with "rent decrease" and buildings with "rent increase". 3) Subtract the percentage of buildings with "rent decrease" from the percentage of buildings with "rent increase". This outcome is the Contract Rent Diffusion Index (DI).	1) Calculate the rent per tsubo of each tenant from the data of new and existing lease contracts and memorandums. 2) Develop a rolling hedonic model (overlapping period: five quarters) based on the rents calculated in the preceding step (the "paying rent") with property-specific factors as variables (location, building size, building age, facilities, date of signing of lease, etc.). 3) Estimate a quarterly contract rent by assigning the values of a typical building to the model developed in the preceding step. 4) The Paying Rent Index is the rent estimated in the preceding step based on Q1 2010 as the base point (=100). With this method, influences from replacement of sample data and deterioration of buildings over age are removed from the result.	• Free Rent Period The period between the start of the contract and the start of the rent, shown in number of days. • Ratio of Free Rent Granted The ratio of contracts with free rent in all the new contracts (excl. contracts for expansion within the building and recontracts) • Average Free Rent (Month) of All the Contracts The simple average of the free rent period including lease contracts with no free rent. • Average Free Rent (Month) of Contracts with Free Rent The simple average of the free rent period of lease contracts with free rent. In some cases, the rent agreed in a lease contract includes CAM charge, and then, for a certain period of time, the rent is reduced to the CAM charge equivalent or closer level, but such contracts are excluded from this research.

Appendix
Xymax REI Research Updates April – June 2017

Use of Properties Changed over Time **April 17, 2017**

- Properties are used for different purposes and such purposes are changing year after year influenced by various factors including economic changes. Changes are seen on each property. Examples are the buildings that are constructed after former buildings were torn down, the buildings that are converted to suit to different use, and the new buildings that are constructed on vacant land. People also noticed that the street views have changed, but few studies visualized the changes with particular data.
- The city of Osaka provided the land use survey for this study. The focused area is the central part of the city (Umeda, Yodoyabashi-Honmachi and Shinsaibashi-Namba) where large-scale developments increased rapidly responding to the growing demand related to tourists from abroad. The changes in stock of buildings and the use of buildings constructed after former buildings were analyzed. The study found the following trends: buildings are becoming larger than before and more buildings are now used for purposes other than office.

New Ways of Working and New Types of Offices **April 13, 2017**

- Concerns on labor shortage from aging population and declining working-age population made companies to take initiative more seriously to change how people work in order to keep workforce and improve work efficiency.
- Xymax Real Estate Institute, last year, conducted two surveys on how to work. This report summarizes the latest trends on changes in how to work and the relation between how to work and where to work (current situation, challenges, future, etc.) from the viewpoint of both companies and office workers.

Contact

Xymax Real Estate Institute
Phone: +81 3 3596 1477
Fax: +81 3 3596 1478
Email: info-rei@xymax.co.jp