

Office Market Report

Tokyo | Q3 2018

November 7, 2018

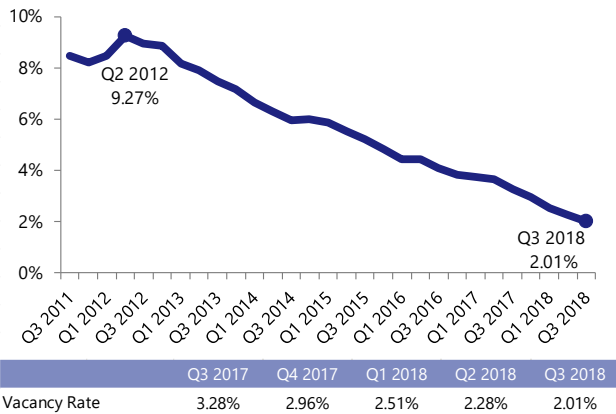


Summary

(1 tsubo = 3.3 sqm)

- In the July–September 2018 quarter, the Tokyo 23 Wards' office market saw a continued drop in the vacancy rate on the back of robust demand as companies required office space to secure personnel. There were active inquiries for vacancies, as evidenced by vacancies being filled before going on the market and vacancy information being met with a flood of applicants. New contract rent has risen sharply as a result.
- The **vacancy rate** was 2.01%, down 0.27 points from the previous quarter. The **Decrease in Vacant Space** exceeded **Increase**, with vacant space decreasing by 252,000 tsubo and increasing by 223,000 tsubo. The rise in the **Vacancy Turnover Ratio** (the ratio of vacant space leased during the quarter to the overall vacancy stock) continued to accelerate at 46.1%.
- The **New Contract Rent Index** (the level of new lease rent) was 122, up 9 points. The rising trend, which had been mild up to now, seems to be gathering pace. The **Contract Rent Diffusion Index**, calculated by subtracting the percentage of buildings with a rent decrease from that of buildings with a rent increase, remained above zero for the fourteenth consecutive quarter at +23.
- The **Paying Rent Index** (the level of new lease rent and that of existing lease rent combined) was unchanged at 91.
- **Average Free Rent Months of Lease with Free Rent** was 2.9 months, down 0.2 months. Granting of free rent dropped further due to a lessors' market, with a 4.2% ratio of free rent granted for six months or more.

Figure 1: Vacancy Rate



Vacancy

Figure 1 is the **vacancy rate** in Tokyo 23 Wards since 2011. The vacancy rate in Q3 2018 dropped 0.27 points quarter on quarter to 2.01%. The rate has been declining consistently since Q3 2012.

Companies are still hiring actively and there is strong demand for office expansion in preparation for a rise in headcount. Companies, regardless of size, are also focusing on creating a comfortable office environment to secure personnel, giving rise to demand for high-quality office buildings.

Figure 2: Increase and Decrease in Vacant Space

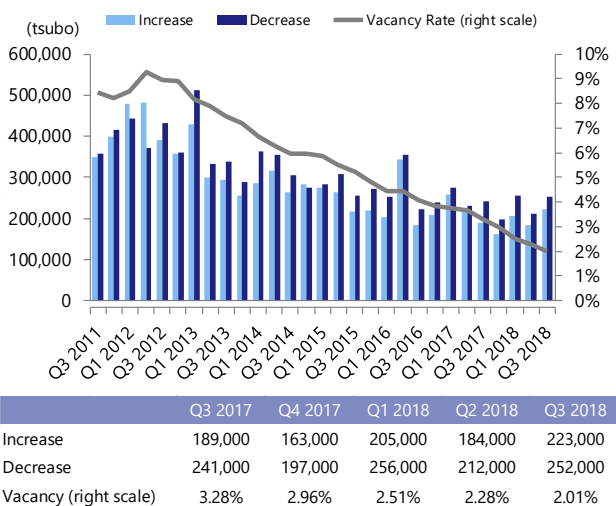


Figure 2 shows the quarterly **Increase and Decrease in Vacant Space**. The increase was 223,000 tsubo and the decrease was 252,000 tsubo. Decrease has exceeded increase for 15 consecutive quarters since Q1 2015, contributing to the constant decline in the vacancy rate.

There was a supply of multiple large properties in Q3 2018, roughly all of which were fully occupied at the time of completion due to strong demand. Formerly-occupied spaces were often filled from within the building before they went on the market. Therefore, the shortage of existing vacancies has not been alleviated, resulting in continued excess of decrease in vacant space over increase.

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

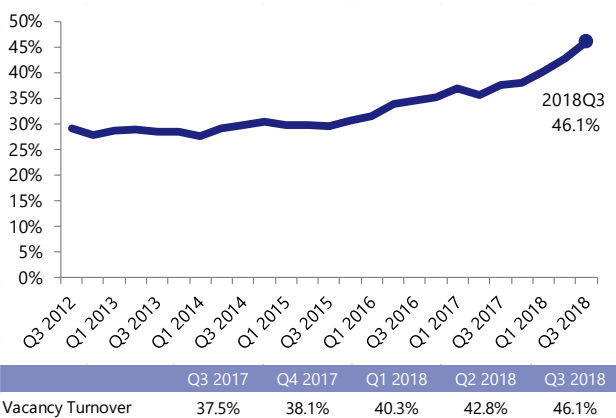


Figure 3 shows the **Vacancy Turnover Ratio** (four-quarter moving average), which is the ratio of vacant spaces leased to tenants during the quarter to all the vacant office stock (vacancy at the start of the quarter + vacancy added during the quarter).

The ratio in Q3 2018 was 46.1%, a rise for the sixth consecutive quarter. Vacant spaces are being leased up by tenants at an accelerating pace due to strains in supply and demand in the office market, where there continues to be more demand than supply.

Figure 4: New Contract Rent Index



New Contract Rent

Figure 4 shows the **New Contract Rent Index**, the index of new lease rent levels. The index for Q3 2018 was 122, a hefty 9-point rise from 113 in the previous quarter. We believe that the escalation of the shortage of vacant space resulted in tighter supply and demand, which has led to an accelerated rise in new contract rent following a mild rising trend after bottoming out in Q2 2012.

Figure 5 is the new contract rent index **by Size of Building**. The index for both small & medium buildings with a gross floor area (GFA) of less than 5,000 tsubo and large buildings with a GFA of 5,000 tsubo or more rose from the previous quarter to 124. Office buildings of all sizes are attracting the attention of tenants since there is a clear sense of scarcity in vacancies in the current Tokyo 23 Wards office market overall. Inquiries for vacancies have been active, with vacancy information being met with a flood of applicants, leading to a rise in contract rent levels regardless of size of the building.

Figure 5: New Contract Rent Index by Size of Building

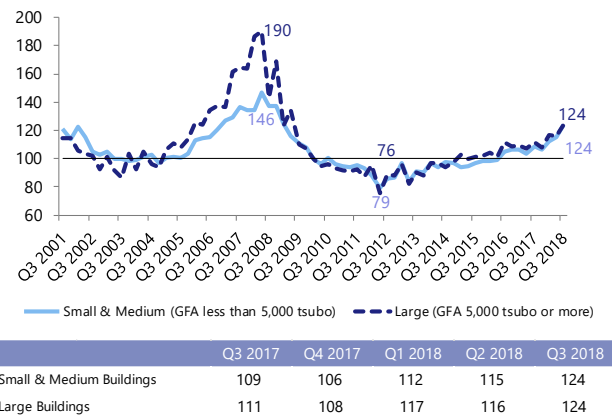


Figure 6: Contract Rent DI

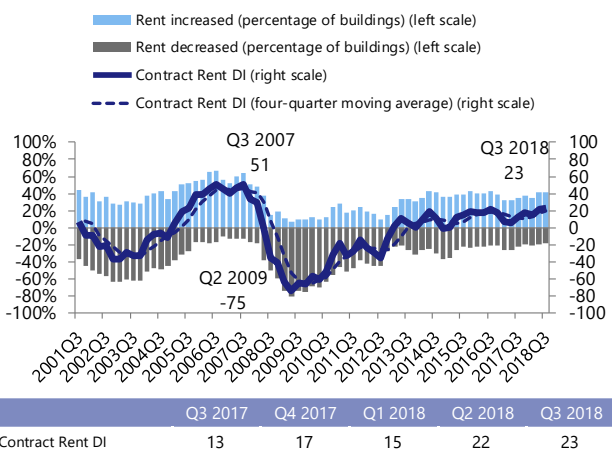
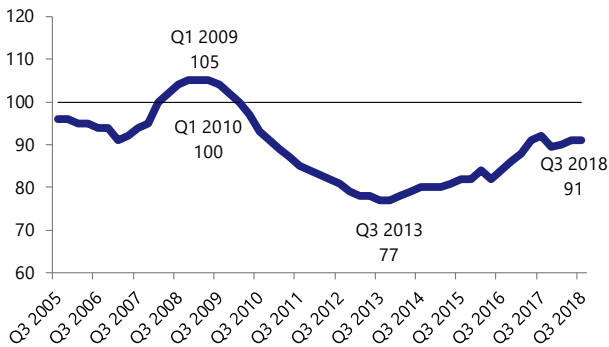


Figure 6 shows the **Contract Rent Diffusion Index (DI)**, which indicates the direction of changes in new lease rents. The DI in Q3 2018 rose 1 point over the quarter to +23. The quarter marked the fourteenth consecutive above-zero DI, which means the number of buildings with a rent increase exceeded those with a rent decrease.

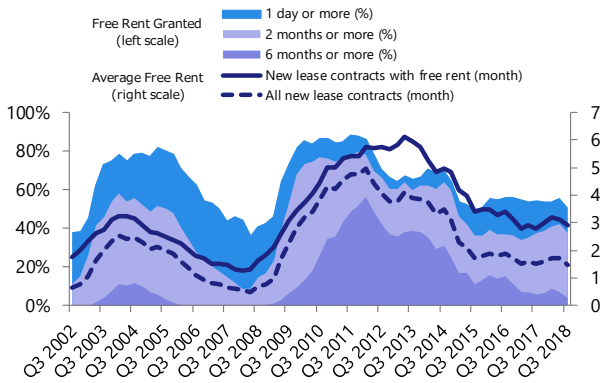
Although there has been a large supply of new office buildings in 2018, companies' strong demand is rising further, and it is expected that the tight office market will continue for some time. While a certain number of companies assume a wait-and-see stance until the Tokyo Olympics, there have been many cases where buildings scheduled for completion in 2019 are fully occupied at a high rent.

Figure 7: Paying Rent Index



	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018
Paying Rent Index	92	89	90	91	91

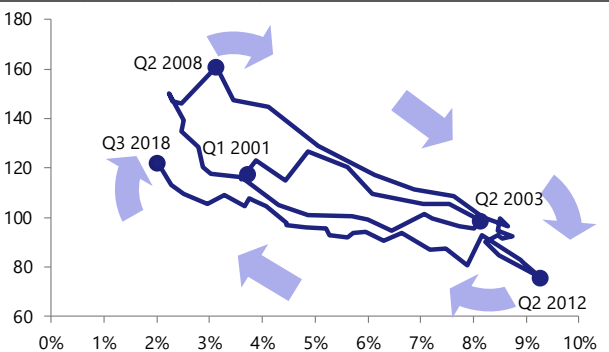
Figure 8: Free Rent



		Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018
Ratio of Free Rent Granted	1 day +	54.2%	53.6%	53.8%	55.2%	50.8%
	2 mon. +	37.3%	38.4%	40.7%	42.1%	37.5%
	6 mon. +	5.9%	6.3%	8.4%	6.7%	4.2%
Average Free Rent Months	All	1.5	1.6	1.7	1.7	1.5
	w/ FR	2.8	3.0	3.2	3.1	2.9

Note: Figures for the last three years (from Q1 2015) have been revised due to the addition of new data sources in the previous quarter.

Figure 9: Market Cycle



	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018
Vacancy Rate	3.28%	2.96%	2.51%	2.28%	2.01%
New Contract Rent Index	109	106	109	113	122

Note: Vacancy rates before March 2011 are based on data by a major leasing agent.

Paying Rent

Figure 7 shows changes in the **Paying Rent Index**, which covers both new lease rents and existing lease rents. The index in Q3 2018 was unchanged at 91. Since the paying rent index includes ongoing rent, its trend is milder than the new contract rent index, which is a timelier reflection of market trends.

Free Rent

Figure 8 indicates the trend of the ratio of new lease contracts with free rent to all new lease contracts (**Ratio of Free Rent Granted**) and the average free rent period (**Average Free Rent Month**). In Q3 2018, the average free rent month was 2.9 months for leases with free rent and 1.5 months for all new leases, both a decrease by 0.2 months over the quarter.

The ratio of free rent granted long-term (six months or more) dropped even further from the previous quarter to 4.2%, falling below 5% for the first time since Q2 2009. On the other hand, there remains to be a certain amount of short-term free rents, even though their ratio has dropped.

Note: Figures for the last three years (from Q1 2015) have been revised due to the addition of new data sources in the previous quarter.

Market Cycle

Figure 9 plots vacancy rates on the horizontal axis and the New Contract Rent Index on the vertical axis on a quarterly basis. It shows the cyclicity of the market, with the chart trending to the lower right in 2001 (vacancy up, rent down), remaining static in 2003–2004, then trending to the upper left in 2005 (vacancy down, rent up) and to the lower right again in 2008 (vacancy up, rent down).

The market entered a recovery phase in 2013, with the trend continuing in 2018. During Q3 2018, the chart moved to the upper left at an accelerated pace due to a drop in the vacancy rate and a surge in rent.

Reference

Figure 10: Major Building Completions (Q3 2018)

Name	Floors Above Ground / Below Ground	Ward	Address	Completion	Total floor area (tsubo)
OVOL Nihonbashi Building	15 / 3	Chuo	3-4-4 Nihonbashi Muromachi	2018/06	8,621
Otemachi PLACE (West Tower & East Tower)	35 / 3	Chiyoda	2-3-2 Otemachi	2018/08	107,085
Shibuya Stream	35 / 4	Shibuya	3-21-3 Shibuya	2018/08	35,090
Nippon Life Hamamatsucho Crea Tower	29 / 3	Minato	2-3-1 Hamamatsucho	2018/08	30,031

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

Figure 11: Major Office Relocations (Q3 2018)

Company	From	To	Month Year	Purpose	Size (tsubo)
Toshiba Memory	Hamamatsucho Building <i>Minato Ward</i>	msb Tamachi Tamachi Station Tower S <i>Minato Ward</i>	Jan 2019	Expansion	2,500
Tokai Tokyo Financial Holdings	Nihonbashi Front <i>Chuo Ward</i>	Nihonbashi Takashimaya Mitsui Building <i>Chuo Ward</i>	Jan 2019	Greater productivity, BCP measures	2,800
Sinanen Holdings	Head Office building <i>Minato Ward</i>	Sumitomo Fudosan Mita Twin Building West Wing <i>Minato Ward</i>	Jan 2019	Consolidation, better efficiency	780
Toyo Construction	Aomi Frontier Building <i>Koto Ward</i>	Jimbocho Mitsui Building <i>Chiyoda Ward</i>	Feb 2019	Better efficiency	1,300
NIPPON STEEL Chemical & Material	Akihabara UDX <i>Chiyoda Ward</i> Nittetsu Kobiki Building <i>Chuo Ward</i>	Nittetsu Nihonbashi Building <i>Chuo Ward</i>	May–Jun 2019	Company integration	1,500
Sekisui Chemical	Toranomon 2-chome Tower <i>Minato Ward</i>	The Okura Tokyo Prestige Tower <i>Minato Ward</i>	Oct–Dec 2019	Expansion, better efficiency	3,440

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

The sizes of office space are estimates.

Survey Overview				
	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			
Market	Tokyo 23 Wards			
Building Size	All	All	All	All / Large / Small & Medium
Release	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	32,744 buildings	16,418 contracts	16,418 contracts	745 contracts
How to Calculate	<ul style="list-style-type: none"> • 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. <p>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.</p>	<ul style="list-style-type: none"> • 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 <p>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.</p>	<ul style="list-style-type: none"> • 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". • Vacancy Turnover Ratio: 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" 	<ol style="list-style-type: none"> 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). <p>This model shows changes in new contract rents after removing property-specific variables.</p>

	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		
Market	Tokyo 23 Wards		
Building Size	All	All	All
Release	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	1,122 contracts	3,711 contracts	240 contracts
How to Calculate	<ol style="list-style-type: none"> 1) Compare the data of new contract rent per subso 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). 	<ol style="list-style-type: none"> 1) Calculate the rent per subso 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). <p>With this method, influences from replacement of sample data and deterioration of buildings over age are removed from the result.</p>	<ul style="list-style-type: none"> • 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. <p>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.</p>

Appendix

Xymax REI Research Updates August 2018 – October 2018

Office Space per Person 2018 September 27, 2018

- Office space per person in the Tokyo 23 Wards was 3.85 tsubo in 2018.
- The office space per person for new tenants was 3.82 tsubo, smaller than 3.87 tsubo for existing tenants.

Building Owner Survey 2018 October 25, 2018

1. Profile of building owners

- More than 60% of the business managers are aged 60 or older. 70% of the building owners own one or two properties.

2. The current building lease business

- To more than 80% of owners, the attractiveness of the building lease business is stable income.
- Of the various measures in the building lease business, a large percentage of owners place importance on and implement “responding to tenants’ requests” and “refurbishment or renovation of building.” While they place importance on “preparing a medium- to long-term repair plan” and “renovating existing non-conforming buildings,” not a lot of them implement them.

3. The future building lease business

- Short-term (around three years) outlook: 40% are optimistic, exceeding pessimistic views of 17%.
Medium- to long-term (five to ten years) outlook: 36% are pessimistic, exceeding optimistic views of 23%.
- Interest in future changes in society: “Decreases in the population and the number of workers” accounted for 73%, far exceeding other items.

4. Building owners who are conscious of planned maintenance

- Building owners with a medium- to long-term repair plan implement all measures such as “refurbishment or renovation of building” and “responding to tenants’ requests” at a greater rate than building owners without a repair plan and are more optimistic about the outlook.

5. Efforts made in order to be chosen by tenants

- Examples of efforts to overcome challenges and concerns in the future building business were obtained from the interviews.

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