Xymax Real Estate Institute

Office Market Report

Tokyo | Q4 2018

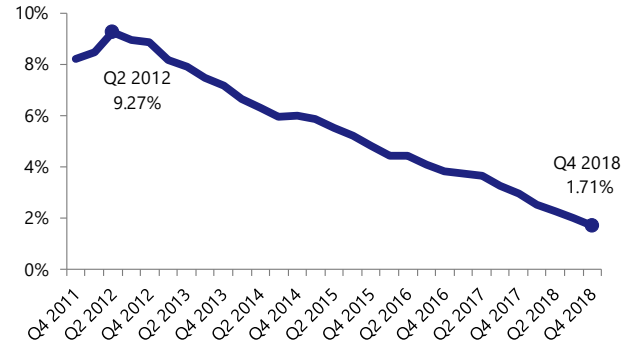
February 6, 2019

Summary

(1 tsubo = 3.3 sqm)

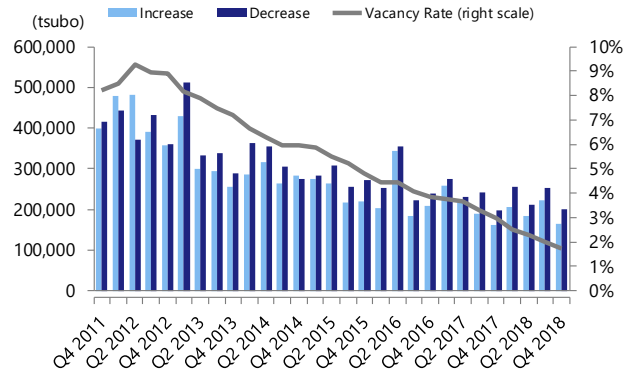
- In the October–December 2018 quarter, the Tokyo 23 Ward's office market saw a continued drop in the vacancy rate on the back of tight supply and demand as many companies sought office space as part of their efforts to strengthen recruitment. Tenants' demand for offices was strong, with vacancies that arose when companies relocated being filled before going on the market. New contract rent has remained on a rising trend accordingly.
- The **vacancy rate** was 1.71%, down 0.30 points from the previous quarter. The **decrease in vacant space** continued to exceed the **increase**, with vacant space decreasing by 201,000 tsubo and increasing by 165,000 tsubo. The **vacancy turnover ratio**, which is the percentage of vacant space leased during the quarter to the overall vacancy stock, rose by 3.6 points to 49.7%, a rise for the seventh consecutive quarter and indicating an acceleration in the pace at which vacancies are filled.
- The **new contract rent index**, the level of new lease rent, rose by 1 point quarter on quarter to 123. Although the rise has moderated compared to Q3, the index is still on a rising trend. 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 fifteenth consecutive quarter at +23.
- The **paying rent index**, which is the level of new lease rent and that of existing lease rent combined, was unchanged from the previous quarter at 91.
- The **average free rent months of lease with free rent** was 1.5 months, and the **ratio of free rent granted** was 51.0%, accounting for a majority, indicating that free rent has become common in the market.

Figure 1: Vacancy Rate



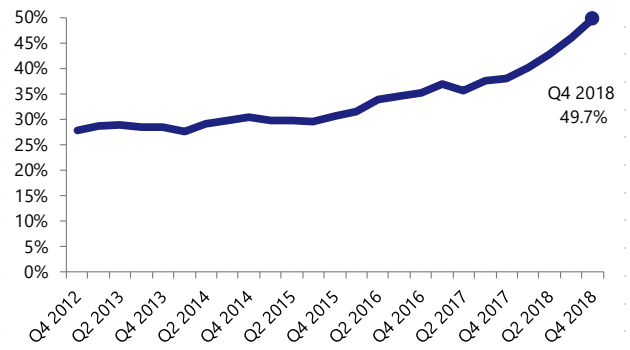
	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
Vacancy Rate	2.96%	2.51%	2.28%	2.01%	1.71%

Figure 2: Increase and Decrease in Vacant Space



	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
Increase	163,000	205,000	184,000	223,000	165,000
Decrease	197,000	256,000	212,000	252,000	201,000
Vacancy (right scale)	2.96%	2.51%	2.28%	2.01%	1.71%

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



	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
Vacancy Turnover	38.1%	40.3%	42.8%	46.1%	49.7%

Vacancy

Figure 1 shows the **vacancy rate** in the Tokyo 23 Wards since 2011. The rate in Q4 2018 dropped 0.30 points from Q3 to 1.71%, a record low.

Companies are still hiring actively and attempts to secure office space in preparation for a rise in headcount are intensifying. More companies are consolidating multiple offices that are dispersed into an office building with a large typical floor area for more active communication and better efficiency. While nearly 40% of companies feel that their office is too small,[*1] some have given up relocating as they failed to find vacancies of the desired size and changed the office layout or established a sub-office instead. We believe the need for relocation or an increase in floor space will remain high.

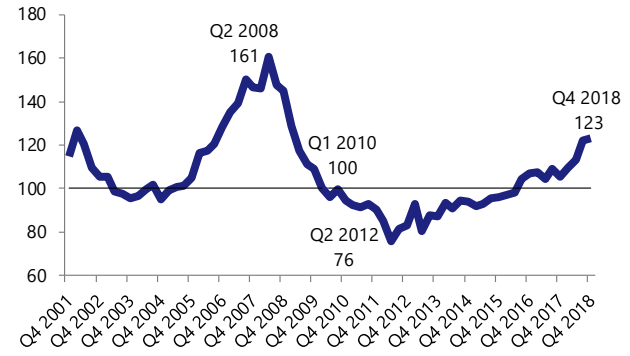
*1 *Metropolitan Areas Office Demand Survey Autumn 2018*, released December 18, 2018
https://www.xymax.co.jp/english/news_research/?type=research

Figure 2 is the **increase and decrease of vacant space**. The increase was 165,000 tsubo and the decrease was 201,000 tsubo. Decrease has exceeded increase for 16 consecutive quarters since Q1 2015, resulting in the constant decline in the vacancy rate.

Although there was a supply of a large property in Q4 2018, it was nearly fully occupied at completion due to strong demand for office expansion. Formerly occupied spaces were often filled from within the building by existing tenants increasing floor space.

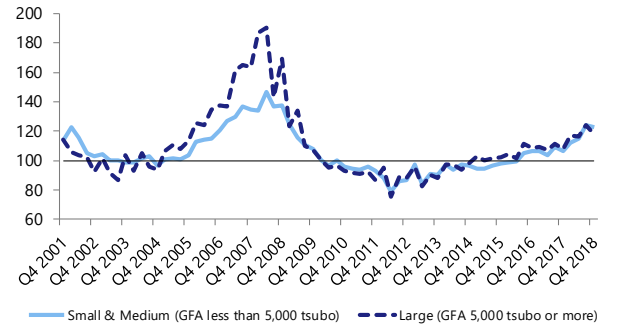
Figure 3 shows the **vacancy turnover ratio (four-quarter moving average)**, the ratio of vacant spaces leased to tenants during the quarter to all the vacant office stock (vacancy at the start of the quarter + vacancy added during the quarter). The ratio in Q4 2018 was 49.7%, a rise for the seventh consecutive quarter, indicating that vacant spaces are being taken by tenants at an accelerating pace.

Figure 4: New Contract Rent Index



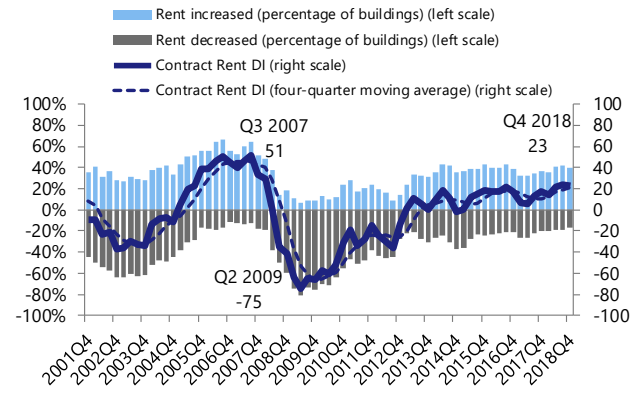
	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
New Contract Rent Index	106	109	113	122	123

Figure 5: New Contract Rent Index by Size of Building



	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
Large Buildings	108	117	116	124	118
Small & Medium Buildings	106	112	115	124	123

Figure 6: Contract Rent DI



	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
Contract Rent DI	17	15	22	23	23

New Contract Rent

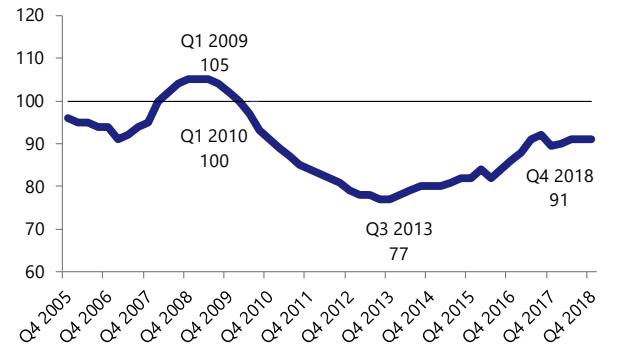
Figure 4 shows the **new contract rent index**, the index of new lease rent levels. The index for Q4 2018 was 123, a 1-point rise from 122 in Q3. While the rise has shrunk compared to that of Q3 (9 points), it is a rise of 17 points from Q4 2017, indicating that new rent is still on an upward trend. There is a clear sense of scarcity of vacancies in general, regardless of the age, size, and location of buildings, on the back of active relocation for expansion and improvement of work efficiency.

Figure 5 indicates the new contract rent index by **size of building**. Although the rent for both small & medium buildings and large buildings dropped as a reaction to the surge in Q3, the rising trend has continued over the past year.

Figure 6 is the **contract rent diffusion index (DI)**, which indicates the direction of changes in new lease rents. The DI in Q4 2018 was unchanged from the previous quarter at +23. The quarter marked the fifteenth consecutive above-zero DI, which means the number of buildings with a rent increase exceeded those with a rent decrease. We believe this to be due to companies' strong demand for office space expansion, despite new supply of more than 200,000 tsubo of office buildings in 2018.*2 Although new supply of approximately 160,000 tsubo is planned in 2019, many of them have already been leased up by tenants. It is likely that rents will continue to rise due to the scarcity of vacancies.

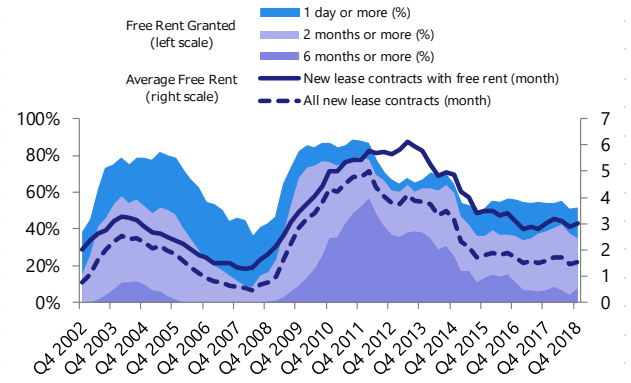
*2 *TOKYO 23 WARDS | Supply of New Office Space 2019*, released December 12, 2018
https://www.xymax.co.jp/english/news_research/?type=research

Figure 7: Paying Rent Index



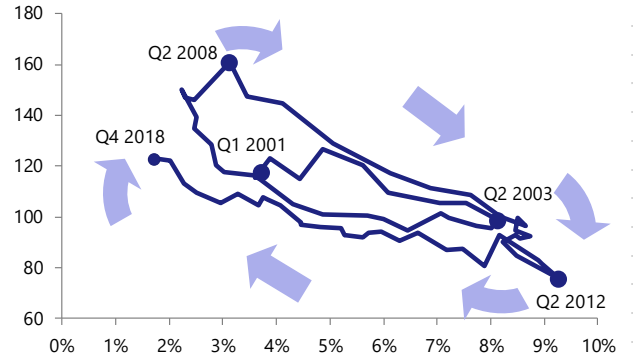
	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
Paying Rent Index	89	90	91	91	91

Figure 8: Free Rent



		Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
Ratio of Free Rent Granted	1 day +	53.6%	53.8%	55.2%	50.8%	51.0%
	2 mon. +	38.4%	40.7%	42.1%	37.5%	35.3%
	6 mon. +	6.3%	8.4%	6.7%	4.2%	7.9%
Average Free Rent Months	All	1.6	1.7	1.7	1.5	1.5
	w/ FR	3.0	3.2	3.1	2.9	3.0

Figure 9: Market Cycle



	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
Vacancy Rate	2.96%	2.51%	2.28%	2.01%	1.71%
New Contract Rent Index	106	109	113	122	123

Note: The vacancy rate before March 2011 is 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 Q4 2018 was unchanged from Q3 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 percentage 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 Q4 2018, the average free rent month was 3.0 months for leases with free rent, a slight increase of 0.1 months from Q3, and 1.5 months for all new leases, unchanged from Q3.

Although the vacancy rate has dropped in the past several years and the market has recovered, there is still a certain amount of long-term and short-term free rents, unlike in around 2008 before the financial crisis. We believe that free rent has become a custom in the market to reduce the initial cost of tenants in consideration of their relocation costs.

Market Cycle

Figure 9 plots the vacancy rate on the horizontal axis and the new contract rent index on the vertical axis on a quarterly basis. It shows the cyclicality 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 Q4 2018, the chart moved to the upper left due to a drop in the vacancy rate and a slight rise in rent.

Reference

Figure 10: Major Building Completions (Q4 2018)

Name	Floors Above Ground / Below Ground	Ward	Address	Completion	Total floor area (tsubo)
Marunouchi Nijubashi Building	30/ 4	Chiyoda	3-2-3 Marunouchi	2018/10	52,651
Sumitomo Fudosan Fukuoka Hanzomon Building	7 / 1	Chiyoda	1-12-1 Kojimachi	2018/10	3,531
Tokyu Yotsuya Building	9 / 2	Chiyoda	6-6 Kojimachi	2018/10	3,393
Sumitomo Fudosan Akihabara North Building	10 / 0	Taito	5-2-1 Ueno	2018/11	3,532

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

Figure 11: Major Office Relocations (Q4 2018)

Company	From	To	Month Year	Purpose	Size (tsubo)
mediba	Shibuya Hikarie *Shibuya Ward*	Sumitomo Fudosan Roppongi Grand Tower *Minato Ward*	Jan 2019	Better efficiency	770
ALBERT	Shinjuku Nomura Building *Shinjuku Ward*	Shinjuku Front Tower *Shinjuku Ward*	Jan 2019	Expansion	511
San-ai Oil	Obbli Uni Building *Shinagawa Ward*	Otemachi PLACE East Tower *Chiyoda Ward*	Apr 2019	Consolidation, better efficiency	883
Nippon Light Metal	Tennoz Yusen Building *Shinagawa Ward*	Urbannet Uchisaiwai-cho Building *Minato Ward*	H2 2019	Better efficiency	3,630
Sumitomo Chemical	Tokyo Sumitomo Twin Building (East) *Chuo Ward*	Tokyo Nihonbashi Tower *Chuo Ward*	H2 2021	Better efficiency	5,000
Sumitomo Life Insurance	Kowa Sumisei Tsukiji Building *Chuo Ward*	Yaesu 2-chome North District Category I Urban Redevelopment Project A-1 Block *Chuo Ward*	2022	Better efficiency	5,600

Source: Complied 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	33,052 buildings	15,083 contracts	15,083 contracts	939 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		
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	1,387 contracts	3,798 contracts	241 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 (November 2018 – January 2019)

Fact-Finding Study on Real Estate Strategies of Commercial Outlets 2018 November 29, 2018

- Xymax REI conducted an analysis of the real estate strategies for commercial outlets by operators that operate or control multiple outlets. The report summarizes the details, changes, and issues of operators' real estate strategies.

Fact-Finding Study on Information Management of Commercial Outlets 2018 November 29, 2018

- This report summarizes the reality of operators' information management, including how they actually manage information and the challenges involved when they formulate and implement real estate strategies of outlets.

Analysis of Length of Occupancy of Office Tenants in Tokyo 23 Wards (2018) December 7, 2018

- The estimated average occupancy period of office tenants, including ongoing tenants, was 9.6 years.
- The estimated percentage of tenants continuing to stay in a building for over two years was 93.8%

TOKYO 23 WARDS | Supply of New Office Space 2019 December 12, 2018

- The average annual new supply in 2019–2022 is expected to be 138,000 tsubo, falling below 172,000 tsubo, the annual average annual of the past 10 years.

OSAKA CITY | Supply of New Office Space 2019 December 12, 2018

- The average annual new supply in 2019–2022 is expected to be 9,000 tsubo. This is less than a third of 29,000 tsubo, the average annual volume of the past 10 years.

Metropolitan Areas Office Demand Survey Autumn 2018 December 18, 2018

- Since autumn 2016, Xymax REI has been conducting surveys on companies' use of offices and workstyles on a semi-annual basis and has analyzed their relationship between office demand. This report covers the results of the fifth survey.

TOKYO 23 WARDS | Office Stock Pyramid 2019 January 23, 2019

- Office stock at end of 2019 is expected to be 12.81 million tsubo on a rentable area basis, with small & medium-sized buildings and large buildings accounting for roughly the same amount: 6.05 million tsubo (47%) and 6.76 million tsubo (53%), respectively.

OSAKA CITY | Office Stock Pyramid 2019 January 23, 2019

- Office stock at end of 2019 is expected to be 2.79 million tsubo on a rentable area basis, with small & medium-sized buildings and large buildings accounting for roughly the same amount: 1.39 million tsubo and 1.40 million tsubo, respectively.

Please contact below for inquiries on this report

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