Tokyo Office Market Trends—Cloudy Outlook for Leasing, While Investment Heats Up

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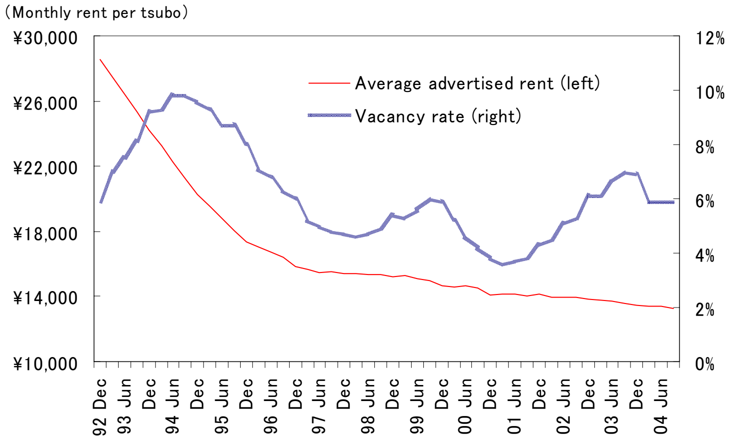
1. Leasing Market Outlook Turns Cloudy

Several indicators suggest a outlook for Tokyo's office leasing market. The vacancy rate in Tokyo's 23-ku area, which peaked in the third quarter of 2003, flattened for three straight quarters, while the average advertised rent has continued to decline (Figure 1). Another troubling sign is that the secular growth in leased office space per person has started to decrease.

Figure 1 Office Rent and Vacancy Rate in the Tokyo 23-Ku Area



Source: Ikoma Data Service System.

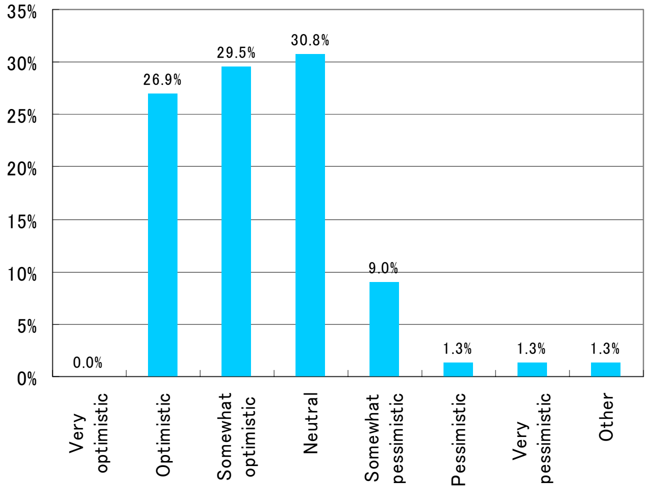
According to our latest market outlook survey, market participants are also growing more cautious.[1] As many as 30.8% of respondents have a neutral outlook that the office leasing market will maintain status quo over the next year (Figure 2).

This response is followed by a "somewhat optimistic" outlook (29.5%) in which the vacancy rate will decrease, but actual rents will remain flat. Thus the majority of market participants predict that actual rents will not rise in the next year. However, we should note this also includes respondents who predict that even though rent may not be rising, the falling vacancy rate will

[1] *The Office Market Outlook Survey of Businesspersons and Professionals* (October 2004) covers a sample of 150 market participants involved in real estate, construction, finance, insurance, securities, brokerages, building management, J-REIT, private funds, credit rating, investment advisories, and consulting. We sent out questionnaires by e-mail on October 4, 2004, and collected 79 responses in the next twelve days (52% response rate).

give landlords a slight edge in negotiating better terms, such as reducing the free-rent period.

Figure 2　Outlook for the Tokyo Office Leasing Market (1 Year Ahead)



Definitions:
1. Very optimistic—Average vacancy rate improves further, and actual rent rises in most areas and buildings.
2. Optimistic—Average vacancy rate improves further, and actual rent rises in some areas and buildings.
3. Somewhat optimistic—Average vacancy rate improves further, but actual rent remains flat.
4. Neutral—Average vacancy rate stays unchanged, and actual rent also remains flat.
5. Somewhat pessimistic—Average vacancy rate stays unchanged, and actual rent decreases further.
6. Pessimistic—Average vacancy rate deteriorates, and actual rent decreases in some areas and buildings.
7. Very pessimistic—Average vacancy rate deteriorates, and actual rent decreases in most areas and buildings.
8. Other

Source: NLI Research Institute

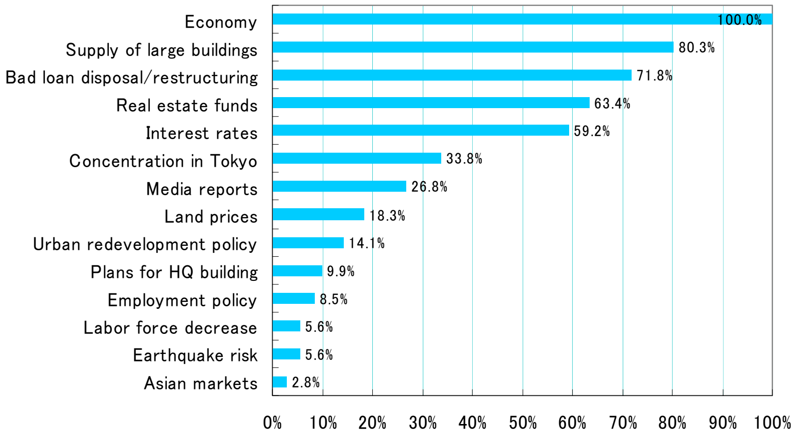
While none are "very optimistic" about a general increase in actual rent, the third most common view is "optimistic" about a limited increase in actual rent, such as for large buildings located in central areas.

Since Tokyo's office leasing market successfully overcame the "year 2003 problem"—an oversupply of new office buildings—only a small fraction of participants are pessimistic. The general mood remains one of caution.[2]

Respondents predict that the following factors will impact the office market in the next year, in order of importance: business conditions, new supply of large buildings, progress in the disposal of nonperforming loans and corporate restructuring, real estate funds, and interest rate trends (Figure 3).

[2] This view is echoed in the *Survey of Building Management Trends* (July 2004) by the Tokyo Building Association, an organization of building owners, which predicts that rent levels will decline in the next three months.

Figure 3　Factors That Will Affect Tokyo's Office Leasing Market in the Next Year



Source: NLI Research Institute

These results indicate that the slightly cautious outlook of respondents can be attributed to economic uncertainty, ongoing new supply of large buildings, and continuing disposal of nonperforming loans and corporate restructuring.

In assessing the impact of real estate funds, respondents weighed two opposing factors: while building owners will be hurt by development projects that increase the supply of new buildings, a vigorous investment market will stimulate the economy and thereby boost office demand.

We also note that media reports rank seventh on the list. This reflects the impact of publicity regarding the year 2003 problem, which depressed rents by giving tenants a negotiating edge over skittish landlords.

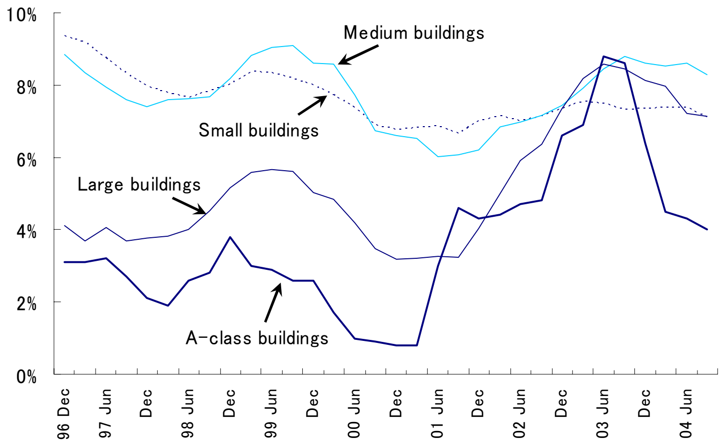
2.　The Stratified Market

The overall outlook for the office leasing market can be misleading due to the market's stratified structure. We thus need to examine specific market segments by building size and location. For example, while rent is predicted to recover among large buildings in central Tokyo, small and medium buildings in other areas face grim long-term prospects because they are less able to satisfy demands for ever-rising standards.

Looking at vacancy rates in central Tokyo by building size, we find that overall averages mask the completely different trends for A-class buildings and small buildings (Figure 4).

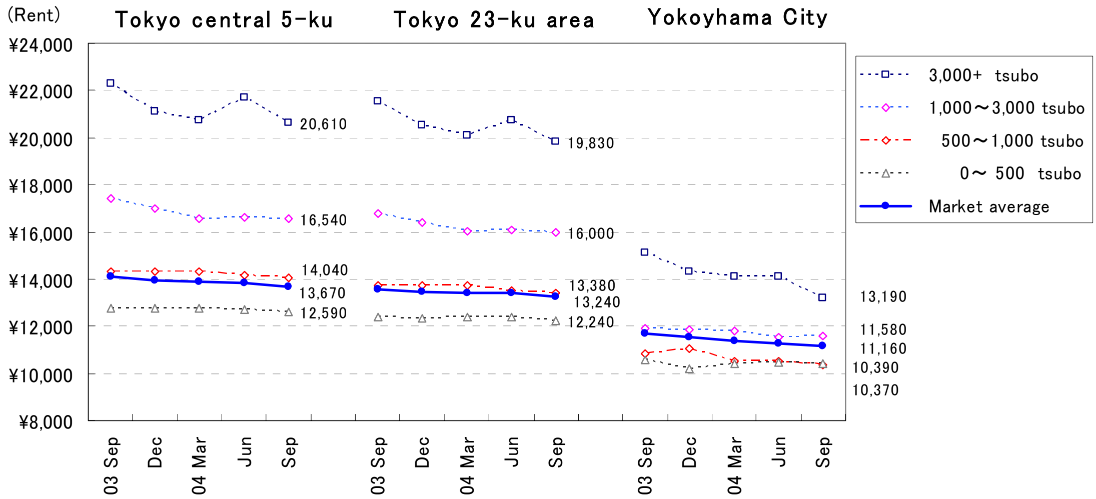
In addition, rent data by location and building size shows that large buildings in the 5-ku central Tokyo area occupy the top tier of the stratified market structure (Figure 5).

Figure 4　Vacancy Rate in Central Tokyo by Building Size



Notes: Large buildings have a standard floor space per floor of at least 100 *tsubo* (330 square meters), medium buildings have 50 to 99 *tsubo*, and small buildings have less than 50 *tsubo*. A-class buildings are located in central Tokyo (Chiyoda-ku, Chuo-ku, Minato-ku, Shibuya-ku, and Shinjuku-ku) or other area with similar potential. In addition, they have total floor space of at least 10,000 *tsubo*, at least 200 *tsubo* per floor, 2.6-meter or higher ceiling, and electric power supply of 30VA per square meter.
Source: Compiled using materials from Miki Shoji Co. and Ikoma CB Richard Ellis.

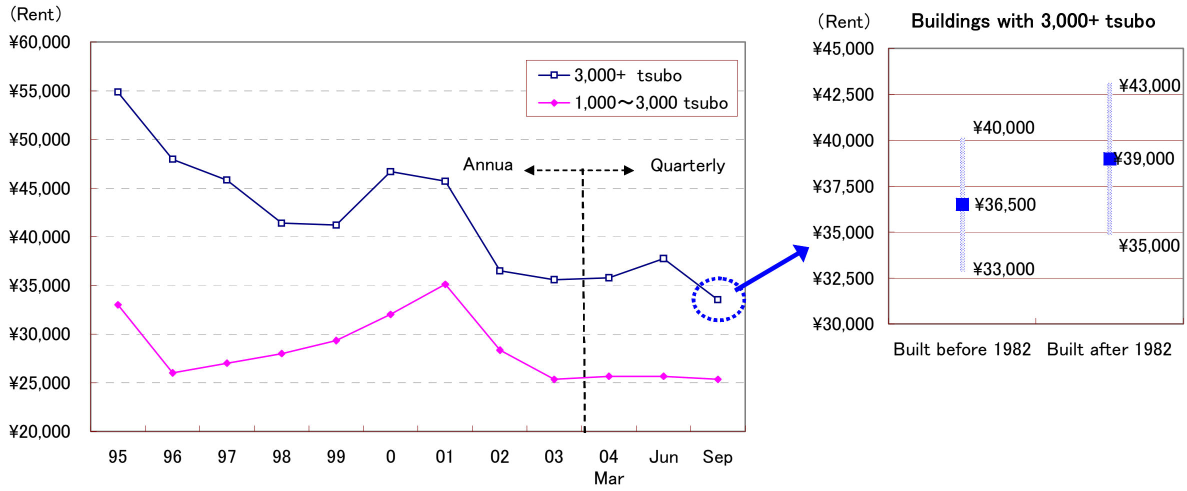
Figure 5　Tokyo Office Rent by Area and Building Size (monthly rent per *tsubo*)



Source: Compiled using materials from Ikoma Data Service System, IDSS-CREIS online service.

Moreover, in the highest rent districts of Marunouchi, Otemachi and Yurakucho in central Tokyo, rent by building size and age shows that large new buildings (constructed after the new earthquake resistance standards of 1982) have higher rents (Figure 6).

Figure 6 Office Rent in Marunouchi, Otemachi and Yurakucho by Building Size and Age (monthly rent per *tsubo*)

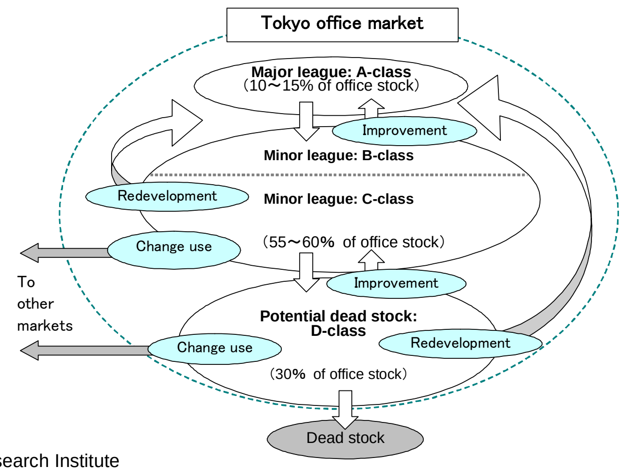


Source: Compiled from Ikoma Data Service System, IDSS-CREIS online data service..

In another survey, the satisfaction of current tenants regarding facilities and functions of office buildings was found to be highest in relatively new buildings constructed since 1996.[3]

In assessing office buildings, a prominent approach used in the U.S. reflects the stratified market structure by classifying buildings into A-class (the "major league"), B-class and C-class (the "minor league"), and D-class (potential dead stock; Figure 7).[4]

Figure 7 Stratification of the Office Market



Source: NLI Research Institute

Potential dead stock refers to buildings deemed non-competitive and highly likely to be rejected by the market in the future. These buildings may be economically or socially obsolete due to poor structure or facilities, severe safety flaws, or a mismatch in location and purpose. Moreover,

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[3] *Nikkei Real Estate Market Data Survey* (1993).

[4] In the U.S., lease brokers and market data service providers classify properties into three groups (A, B, and C-class) based on their own overall assessment of location, building and facility grade, and rent and price level.

repair or renovation work cannot enhance their market value, and additional investment may be unrecoverable.[5]

At present, central Tokyo has few vacant buildings that could develop into slums. But there are many buildings that could soon turn into dead stock as demand mismatches alienate tenants.

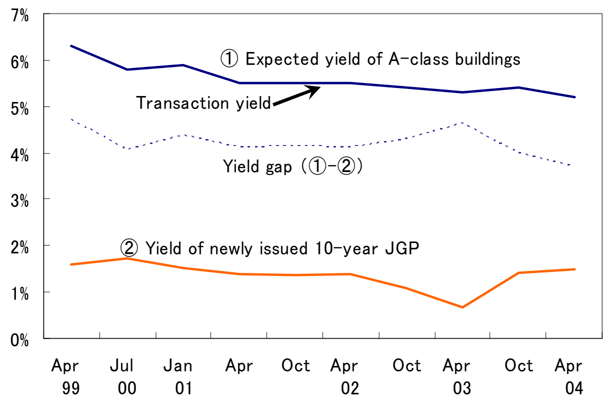
However, we must note that these conditions will not necessarily remain fixed in the future. Real estate is a renewable asset, and potential dead stock properties of today could be rebuilt or redeveloped into top-grade properties. On the other hand, A-class properties could also degenerate into lesser properties unless properly managed.

3. Vigorous Investment Market Stands in Sharp Contrast

In contrast to the slumping office leasing market, the real estate investment market is active particularly in leased office buildings, and shows signs of heating up into a "fund bubble."

Large amounts of funds are flowing into the investment market. Against the backdrop of ultra-low interest rates and relatively high rent income, investors are taking advantage of the yield gap (the difference between real estate yield and loan interest rate) using leveraged equity investment opportunities (Figure 8).

Figure 8 Expected Investment Yield of A-Class Buildings (Marunouchi and Otemachi)



Note: Expected yield is the capitalization rate used in determining investment value. Transaction yield is the actual market return.
Source: Compiled from Japan Real Estate Institute, *Survey of Real Estate Investors*, and other publicly available materials.

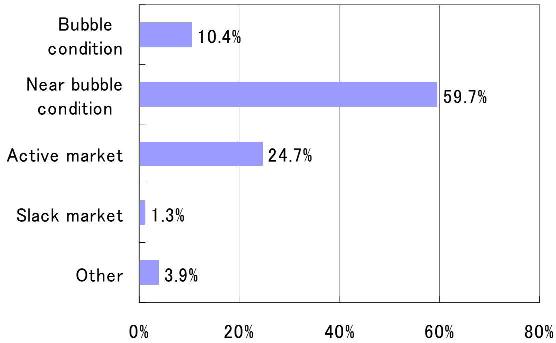
In addition, the expanding real estate securitization market has reduced the risk premium of real

[5] About one-third of the office stock is thought to have flaws in earthquake resistance. As more tenants become sensitive to disaster risk, these buildings could suddenly turn into dead stock. No real estate investor with a medium to long-term perspective would consider buying such a property without a plan to rebuild or enhance earthquake resistance.

estate (which raises prices) by enhancing the liquidity and transparency of real estate. Also, the pool of investors has grown beyond foreign investors to domestic institutional investors, causing expected returns to decline.

In our survey, the current market view of most participants is that a growing number of transaction prices defy understanding (59.7%). They are concerned that the cap rate[6] is decreasing without regard to individual property risk, decreasing returns for non-superior properties (Figure 9).

Figure 9　Views of the Current Real Estate Investment Market



Definitions:
1. Bubble condition—Most transaction prices defy understanding
2. Near-bubble condition—Increasing number of transaction prices defy understanding
3. Active market—Transaction prices are high but within reason
4. Slack market—Transaction prices are appropriate, with room to increase
5. Other

Source: NLI Research Institute

This is followed by the view that the present market is an active market in which most transaction prices are appropriate (24.7%), and the view that the market is experiencing a bubble in which most transaction prices defy understanding.

We thus found contrasting perceptions between optimism in the investment market and cautious outlook of the office leasing market. While most market participants are wary that the investment market will heat up, they also sense a need to participate with a bullish attitude for the time being.

Looking ahead, with the upcoming removal of the full deposit guarantee (lifting of the payoff ban) in April 2005, implementation of asset impairment accounting from the fiscal year ending in March 2006, and continued reliance on a loose monetary policy, the investment market may continue to heat up even if real estate investment yields decrease further.

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[6] The cap rate is used in making judgements on property assessment and investment value.