

The Tokyo Office Market's “2010 Problem” —A Net Decline in Office Demand Could Impair the Market From 2003

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Abstract

With no full-scale economic recovery in sight to trigger an expansion in office demand, the large supply of office space entering the market in 2003 will inevitably increase vacancy rates and lower rents. Although competition to attract tenants is expected to result in a zero-sum game, both new and old large-scale buildings stand to benefit from the rising trend in corporate mergers and consolidation of operations. Competition will also intensify among medium-scale buildings as businesses cancel leases to consolidate offices; however, the risk of cancellations and rent decreases will be relatively low for buildings that are appropriately managed. For property managers and J-REITs, the 2003 over-supply problem represents a unique opportunity to show resistance in a faltering market and gain the confidence of investors.

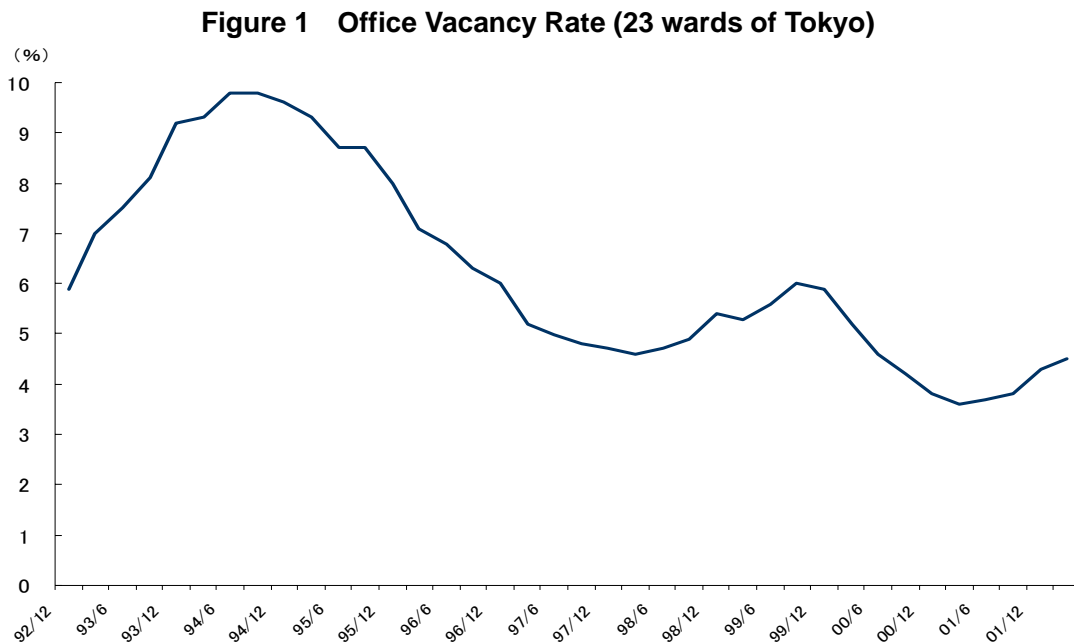
During the decade from 2000 to 2010, the number of office workers in the 23 wards of Tokyo is expected to decrease by 5%. In the worst case, this would mean the disappearance from the market of 3.7 million square meters of office demand, or 23 times the size of the Marunouchi Building. Moreover, we predict that the decline could be exacerbated around 2007 to 2009 by a wave of retirement among the baby boom generation, and culminate in what we call the “2010 problem.” Market participants will need to devise long-term strategies that deal with the predicted decline in office demand, something they have never experienced before.

Since declining demand is forecast for the Tokyo office market, in which supply has always tended to create demand in the past, an increase in the development of outstanding properties will lead to greater disparities among projects and areas, and could potentially give rise to a large amount of dead stock. As such, urban development policy needs to shift from a supply-side orientation to one that emphasizes stock adjustment and the inducement of demand.

1. Trends in the Tokyo Office Market: Outlook for 2003

(1) Growing Imbalance of Supply and Demand

The vacancy rate in the 23 wards of Tokyo rose sharply in the fourth quarter of 2001 after the September 11 terrorist attacks, and continued rising to 4.5% in the first quarter of 2002 (Figure 1).¹



Source: Ikoma Data Service System

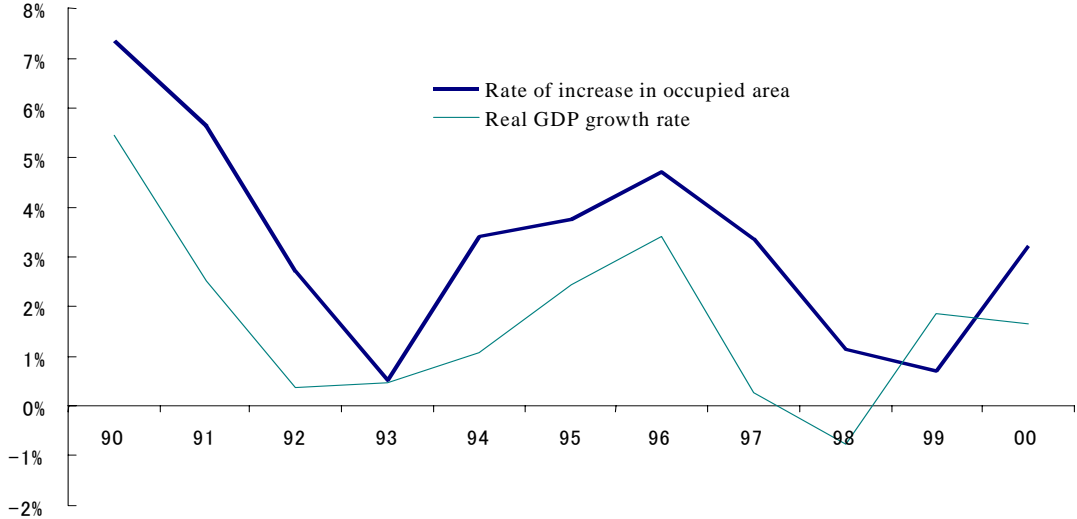
At present, some improvement is being seen in economic indicators, but progress is slow in the disposal of bad debt by financial institutions, restructuring of enterprises, and reorganization of industry, and the future of the economy remains unclear. Among foreign financial institutions, who are regarded as price leaders in the large-scale office market, demand based on office expansion has failed to recover, and there are no growth companies to replace this loss. Being closely correlated to economic growth, office demand cannot be expected to expand under the present conditions in which no full-scale economic recovery is foreseen (Figure 2).

Under these circumstances, 2.18 million square meters of office space in large-scale, high-grade buildings in the most prestigious parts of central Tokyo will come onto the

¹ Here, we have used data from Ikoma Data Service System. However, according to monthly data from Miki Shoji, the vacancy rate in the business districts of Tokyo had risen to 5.25% by May 2002.

market in 2003.² Because of this, further increases in the vacancy rate and decreases in rent levels are unavoidable.

Figure 2 Office Demand and Economic Growth



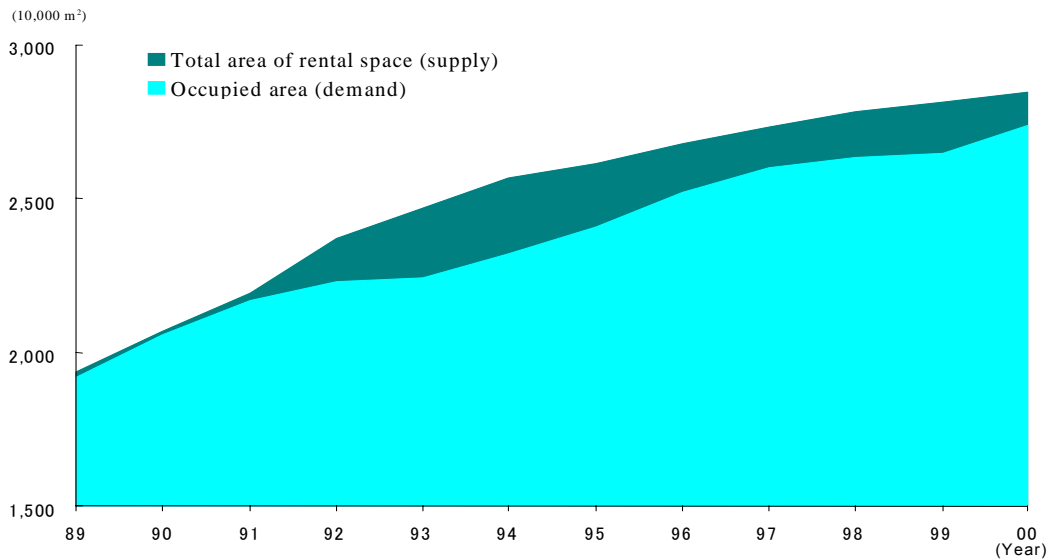
Source: Prepared by NLI Research Institute, based on materials from Ikoma Data Service System and other sources.

In the past, whenever supply increased in the Tokyo office market, demand followed as if to catch up with the supply (Figure 3). In fact, office demand consistently exceeded supply due to long-term trends such as the transfer of head office and R&D functions to Tokyo, entry of new businesses, and growth of the service-oriented economy. As a result, not only did the proportion of office workers rise, but the work space per person increased, while companies also needed more space to upgrade information systems. This latent demand surfaced as new supply came onto the market.

When a large supply of office space entered the market in 1994, rents fell sharply, especially in new, large-scale buildings. However, the effect of this price decrease was to stimulate even more office demand. The vacancy rate, which had risen to nearly 10%, declined sharply. Unfortunately, since then, rent levels have adjusted significantly, leaving little leeway for further rent reductions that could boost demand.

² Based on a survey by Mori Building (December 2001). This refers to office buildings with total floor area of at least 10,000 square meters, excluding applications other than office use.

Figure 3 Office Supply and Demand (23 wards of Tokyo)



Source: Prepared by NLI Research Institute, based on materials from Ikoma Data Service System.

(2) Zero-Sum Game Predicted in the Office Leasing Market

Since a large supply of new, large-scale buildings will enter the market at a time when office demand cannot be expected to expand, competition to attract tenants is expected to result in a zero-sum game, especially among large-scale buildings. Most efforts to attract tenants in new leased buildings will be focused on drawing tenants away from existing buildings, and when companies construct their own buildings, new tenants will be sought for the vacated space.

A dynamic reorganization movement is now underway especially at large companies to effect operational streamlining, business consolidation, and corporate mergers. With the exception of some foreign businesses, who are opting for decentralization because of concerns about terrorism, there has been an unprecedented trend to consolidate offices that had been excessively scattered. When a business consolidates offices, it can lease a smaller total area by using floor space more efficiently. Thus even if the unit rent increases somewhat, total costs may remain the same or even decrease.³ This creates ample incentive to relocate to a new building despite the higher rent, and as a result large-scale new buildings are becoming a popular destination for this kind of office consolidation. Existing large-scale buildings also have significant potential to become a new destination for office consolidation if their facilities are upgraded appropriately and measures such as rent reduction are taken.

³ When scattered offices are consolidated, less office space is devoted to reception desks and reception rooms, and floors can be used more efficiently for work space. Thus the total amount of office floor space tends to decrease.

Meanwhile, as office consolidation leads to lease cancellations at medium-scale buildings, these buildings will begin to aggressively seek tenants, causing competition to heat up in this category as well. Since there are so many competing buildings in this category, buildings with outdated facility specifications or poor earthquake resistance will be at a disadvantage.

Small-scale buildings in desirable locations are less likely to become embroiled in competition to attract tenants away from other buildings—they tend to have their own well-established tenants, few of their tenants would need to expand or consolidate offices, and rents are much lower compared to higher-grade buildings.

Caution is advisable in areas that have large concentrations of older, small to medium-size buildings, vacancy rates already exceeding the market average and still rising, and are located near office districts where large amounts of new office space will be supplied such as the Otemachi-Marunouchi area and Shiodome area.

Still, even buildings that are lacking in terms of size, facilities or location will face less risk of lease cancellations and rent reductions if properly managed. In fact, if property managers and J-REITs who manage buildings are able to demonstrate resistance in the midst of a faltering market, this can become a unique opportunity to gain the confidence of investors.

2. Risk of a Net Decrease in Demand: The Office Market's "2010 Problem"

(1) Decline in Tokyo's Office Workers

The 2003 problem refers to the large supply of new buildings coming online at a time when office demand is not expanding. As large-scale redevelopment continues in 2005 and thereafter, especially in central Tokyo, the predicted decline in office demand will become a major problem (Figure 4).

Table 4 Major Office Buildings Planned for 2005 and Later (23 wards of Tokyo)

Scheduled Year of Completion	Building and Development Name	Developer	Location	Total Floor Area (10,000m ²)
2005	Marunouchi 1-chome No. 1 Block Redevelopment	Mitsubishi Estate, Nippon Life Insurance Company and Others	Marunouchi, Chiyoda Word	20
	Meiji Life Insurance Building Block Redevelopment	Meiji Life Insurance	Marunouchi, Chiyoda Word	15
	Muromachi Mitsui-Shinkan	Mitsui Fudosan and Seshoya	Nihombashi-Muromachi, Chuo Word	13
	Mita-Miyako Hotel Demolished Site Redevelopment	Sumitomo Realty & Development	Mita, Minato Word	10
	Akasaka 1-chome Project	Kowa Fudosan	Akasaka, Minato Word	7
	Taihei 4-chome - Kinshicho Redevelopment	Tokyo Tatemono	Taihei, Sumida Word	7
	Shirogane 1-chome East Block Redevelopment	Redevelopment Association	Shirogane, Minato Word	5
	Akasaka Yakken-Zaka North Block Redevelopment	Redevelopment Preparation Association	Akasaka, Minato Word	5
	Akihabara 10-1 Block Redevelopment	Fuji Soft, ABC	Soto-Kanda, Chiyoda Word	4
	JR Tokai Shinagawa Building	East Japan Railway	Konan, Minato Word	4
	Higashi-Ikebukuro 4-chome Redevelopment	Redevelopment Association	Higashi-Ikebukuro, Toshima Word	4
	Nihombashi-Hamacho 3-chome Redevelopment	Yasuda Fudosan	Nihombashi-Hamacho, Chuo Word	3
	Suntory Head Office Building	Suntory	Daiba, Minato Word	3
2006	Tokyo Building Reconstruction	Mitsubishi-Estate and The Bank of Tokyo-Mitsubishi	Marunouchi, Chiyoda Word	15
	Akihabara No. 3 Block Redevelopment	NTT Urban Development and Kajima Corp.	Soto-Kanda, Chiyoda Word	14
	Yurakucho Station Front Area Redevelopment	Redevelopment Preparation Association	Yurakucho, Chiyoda Word	8
	Osaki Station East Side No. 3 Block Redevelopment	Redevelopment Preparation Association	Higashi-Gotanda, Shinagawa Word	8
	Nishi-Shinjuku 6-chome No. 6 Block Redevelopment	Redevelopment Preparation Association	Nishi-Shinjuku, Shinjuku Word	8
	Kita-Shinjuku Block Redevelopment	Tokyo Metropolitan Government and Others	Kita-Shinjuku, Shinjuku Word	6
After 2007	Defence Agency Facilities Demolished Site Redevelopment	Mitsui Fudosan, Yasuda Life Insurance and Others	Akasaka, Minato Word	35
	Tokyo Station Yaesu Side Redevelopment	East Japan Railway, Mitsui Fudosan and Others	Marunouchi, Chiyoda Word	34
	Ministry of Education, Science and Technology and Board of Audit of Japan Reconstruction Project	PFI System	Kasumigaseki Chiyoda Word	24
	Kanjo No. 2 Route Redevelopment	Tokyo Metropolitan Government	Toranomon, Minato Word	20
	TBS Building Redevelopment	TBS	Akasaka, Minato Word	17
	Mitsubishi Corp. Marunouchi New Head Office Building	Mitsubishi Corp. and Mitsubishi Estate	Marunouchi, Chiyoda Word	6
	Tokyo Metropolitan Government Office Demolished Site Redevelopment	Tokyo Metropolitan Government	Yurakucho, Chiyoda Word	—

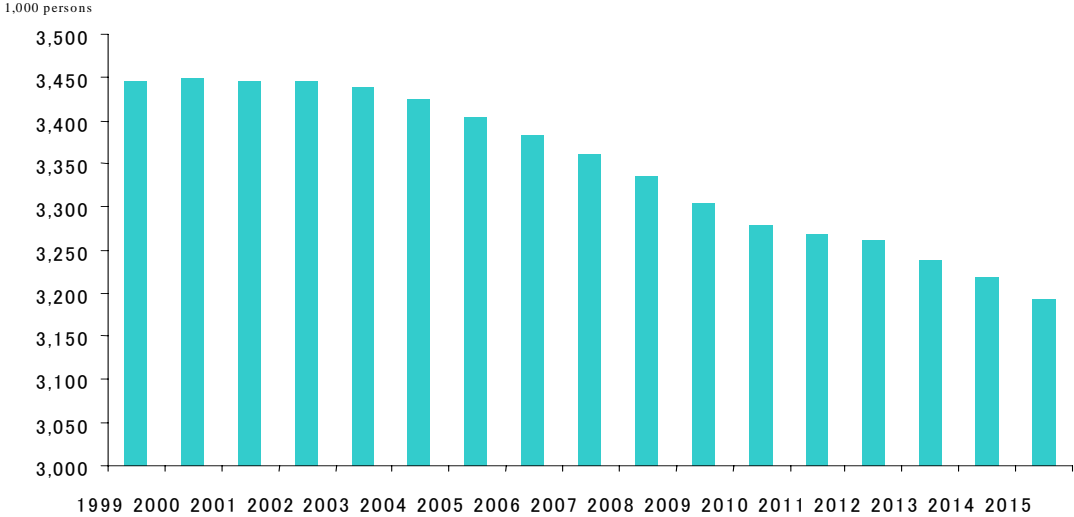
Note: Total floor space may include area for non-office uses in some cases.

Source: Prepared by NLI Research Institute, based on published materials by Mori Building and other sources.

Attractors Lab predicts that the number of office workers in the 23 wards of Tokyo will decline by 127,000 persons from 2005 to 2010. This is nearly triple the decline in office workers of 44,000 persons from 2000 to 2005. The number of office workers is predicted to

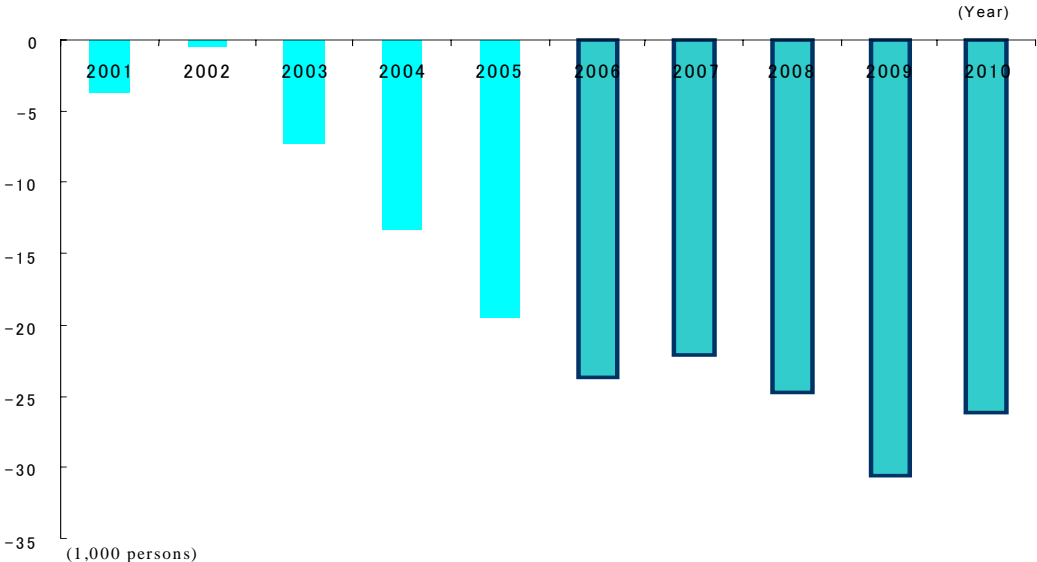
drop by 5% over the ten-year period from 2000 to 2010. If the amount of floor space per worker is 21.4 square meters,⁴ this corresponds to the disappearance from the market of 3.7 million square meters of office demand (including company-owned buildings), or 23 times the size of the Marunouchi Building (Figures 5 and 6).⁵

Figure 5 Predicted Decline in Office Workers (23 wards of Tokyo)



Source: Prepared by NLI Research Institute, based on estimates by Attractors Lab. (Year)

Figure 6 Annual Decrease in Office Workers (23 wards of Tokyo)



Source: Prepared by NLI Research Institute, based on estimates by Attractors Lab. (Year)

⁴ According to a survey by Mori Building, the average work area per person (not including common portions, showrooms, etc.) is about 15 square meters. Assuming that the work area accounts for 70% of the total floor area, the total floor area per person is 21.4 square meters (15/0.7).

⁵ The total floor area of the Marunouchi Building after rebuilding is 160,000 square meters.

Of course, in the case of a leased building, if the occupied floor space per person increases by 5% because of lower rent levels, this would compensate for the reduction in office workers. Thus even if the leasing market were to shrink on a value basis, office demand itself would not decrease. Also, more positive results can be expected if there is a large increase in foreign businesses, who are financially strong and can afford to use more work space than Japanese companies. Another plausible scenario is for companies, whose dilemma will no longer be excess labor but labor shortages, to retain employees past the age of 60 and recruit more foreign office workers,⁶ thereby mitigating the decline in number of office workers (Figure 7).

Table 7 Factors Affecting Office Demand

Factors that Increase Office Demand	Factors that Decrease Office Demand
<ul style="list-style-type: none"> ■ Increases in the number of office workers <ul style="list-style-type: none"> • Hiring more office workers (additional staff in the areas of data communications and software development; entry of foreign financial institutions into the market due to activation of securities markets; new business expansion by other enterprises; increased hiring of women and foreign workers, etc.) • Raising the retirement age of office workers • Reassigning office workers (from the provinces to Tokyo; from production to clerical work and software development) • Increasing the proportion of office workers (shrinking production functions and expanding service functions) 	<ul style="list-style-type: none"> ■ Decreases in the number of office workers <ul style="list-style-type: none"> • Unemployment of office workers (due to business failure, industry reorganization, restructuring, etc.) • Restricted hiring of office workers • Retirement of office workers • Reassigning office workers (from Tokyo to the provinces; from clerical work and software development to production) • Decreasing the proportion of office workers (expanding production functions and shrinking service functions — however, this is highly unlikely)
<ul style="list-style-type: none"> ■ Increases in the amount of floor space per person <ul style="list-style-type: none"> • Lowering rent levels • Adding more IT equipment • Increasing number of foreign companies and other businesses with higher space standards 	<ul style="list-style-type: none"> ■ Decreases in the amount of floor space per person <ul style="list-style-type: none"> • Raising rent levels • Downsizing IT equipment and outsourcing to Internet data centers (IDC)
<ul style="list-style-type: none"> ■ Increases in new types of office demand <ul style="list-style-type: none"> • Call centers • Internet data centers (IDC) • Building demand other than office use, including restaurants and retail stores 	<ul style="list-style-type: none"> ■ Consolidation of scattered offices due to corporate mergers and office reorganization <ul style="list-style-type: none"> • Increases in new types of office demand • Use of condominiums as offices

Source: NLI Research Institute

Since many factors are involved, it is particularly difficult to forecast office demand. However, we believe that the loss of 3.7 million square meters in office demand over a decade represents something close to the worst-case scenario. In particular, since a major decline is expected around 2007 to 2009 as the baby boom generation reaches retirement age, attention

⁶ These predictions on the number of office workers incorporate an increase in the percentage of women between the ages of 25 and 34 who are in the work force.

should be drawn to the 2010 problem of the office market.⁷ Also, since the population of Japan as a whole will peak in 2005 and then enter a period of decline,⁸ it is clear that the market crisis will not end in 2010.

In any case, it will certainly be important for persons involved in the market to formulate long-term strategies that address the predicted decline in office demand, something they have never experienced before. At the very least, in the natural selection of the future, survival will depend on the quality of management.

(2) A Demand-Inducement Model for Urban Development

At present, a great variety of programs and concepts related to urban renewal have emerged. However, most of these programs and measures are still based on a supply-oriented approach, aimed at promoting development projects in the private sector (Figure 8).

Table 8 Recent Trends Related to Urban Renewal (2002)

	Trend	Details
National government:	<ul style="list-style-type: none"> Establishment of the Law on Special Measures for Urban Renewal (April 2002) Revision of the Building Standards Law (June 2002) Relaxation of conditions on rebuilding of condominiums (FY 2002) 	<ul style="list-style-type: none"> This is administered by local governments, which designate districts in urgent need of action for urban renewal and special urban renewal districts as exceptions in urban planning. Limited-time legislation for ten years. The upper limit on the floor area ratio is increased from 1,000% to 1,300%. Simplification of general design program procedures. Relaxation of setback restrictions. Revision of divided ownership law to promote condominium rebuilding.
Council on Economic and Fiscal Policy, etc.:	<ul style="list-style-type: none"> Special zone concept (May 2002) 	<ul style="list-style-type: none"> Major relaxation of regulations, including preferential tax measures in certain designated areas. Seven fields, including IT, biotechnology, international exchange, harbors, and recycling industry revitalization. There is also a plan for special zones of regulatory reform by the General Council on Regulatory Reform.
Tokyo Metropolitan Government	<ul style="list-style-type: none"> Revision of urban planning (May 2002) 	<ul style="list-style-type: none"> Otemachi, Marunouchi, and Yurakucho are designated as areas subject to special floor area ratio regulations. Unused floor area ratio portions can be transferred within the designated areas, promoting advanced and multifunctional land use.

⁷ Under the heading "2010-nen Mondai" (2010 Problem), the official web site of Seiichi Takarabe states that Nissan Motor Co. is conducting an internal study on how to deal with the problem of a labor shortage which will be caused by the retirement of many workers of the baby boom generation (April 19, 2002). <http://www.takarabe-hrj.co.jp/takarabe/>

⁸ Population estimate by Attractors Lab.

	Trend	Details
	<ul style="list-style-type: none"> Relaxation of environmental assessment standards (June 2002) Attracting private sector activity to rebuild municipal housing (May 2002) 	<ul style="list-style-type: none"> The size subject to environmental assessment is increased by about 1.5 times. For districts in urgent need of action for urban renewal, the procedures are simplified and time periods are cut by half or more. It was decided that Mitsui Real Estate and other private sector groups would participate in rebuilding a municipally operated housing complex in Minami-Aoyama 1-chome.
Chiyoda-ku:	<ul style="list-style-type: none"> Assistance program to help family households raising children, etc. to live closer to parents (April 2002) 	<ul style="list-style-type: none"> Rent assistance is provided for a certain period of time to family households and newlywed households who have parents living in Chiyoda-ku and wish to move into the ward.
Sumida-ku:	<ul style="list-style-type: none"> Study on authorization of condominiums that are supportive to child-raising (Planned for October 2002) 	<ul style="list-style-type: none"> Study on providing support such as assistance for condominium building in order to stem the population outflow. Study on a program to assist home buyers.
National government:	<ul style="list-style-type: none"> Establishment of Law on Soil Pollution Countermeasures (May 2002) 	<ul style="list-style-type: none"> Requires landowners to conduct a soil survey if homes, parks, etc. will be built on land formerly occupied by a business that handled toxic substances.
Toshima-ku:	<ul style="list-style-type: none"> Plan to restrict construction of one-room condominiums (January 2002) 	<ul style="list-style-type: none"> New taxation plan for one-room condominiums.
Koto-ku:	<ul style="list-style-type: none"> Restriction of condominium construction (April 2002) 	<ul style="list-style-type: none"> Asking condominium developers to freeze new starts. Sweeping revision of guidelines to allow collection of funds to support public facility improvement.
Ota-ku:	<ul style="list-style-type: none"> Plan to restrict condominium construction (May 2002) 	<ul style="list-style-type: none"> Plan to revise development guidelines to condominium builders in industrial areas, for explanation of construction plans to factory administrators near the planned lot.
Ruling party:	<ul style="list-style-type: none"> Proposal of the establishment of a council for discussion on relocating functions of the nation's capital (May 2002) 	<ul style="list-style-type: none"> Suspension of work to unify relocation candidate sites, which originally had a deadline of May 2002; and postponement of the relocation of capital functions.

Note: The shaded portions represent the liberalization of regulations.
Source: NLI Research Institute

The supply-oriented approach relies on deregulation to attract private sector activity and redevelop areas with large concentrations of old buildings. According to this approach, the resulting construction demand would help revitalize local economies while enhancing disaster preparedness. However, with demand predicted to decline in the Tokyo office market, and supply no longer able to generate new demand as in the past, an increase in the redevelopment of large-scale, outstanding properties would lead to greater disparities among projects and areas, and potentially give rise to a large amount of dead stock. Urban development policies thus need to shift from a supply-oriented approach to one that emphasizes stock adjustment and the inducement of demand.

For instance, the growth of office stock could be controlled by promoting rebuilding and large-scale renovation to upgrade building performance, and by promoting the conversion of office buildings to residential use to serve the population returning to live in central Tokyo. Another conceivable measure would be to place stricter controls on land use and manage areas for advanced uses while restricting development in other areas. Possible means of inducing demand would be to develop housing closer to the places people work; to encourage more women to join the work force by establishing day-care centers; to promote employment of the elderly; and to reduce or abolish taxes on places of business. However, the most important measure to induce demand will be to resolutely implement structural reforms in order to pull the Japanese economy out of its long recession.

As a final point of emphasis, we should note that Japan's urban development policy itself is approaching a major turning point as Tokyo's sustained population inflow mitigates the decline in office demand compared to other cities, where the outlook is more grim.