

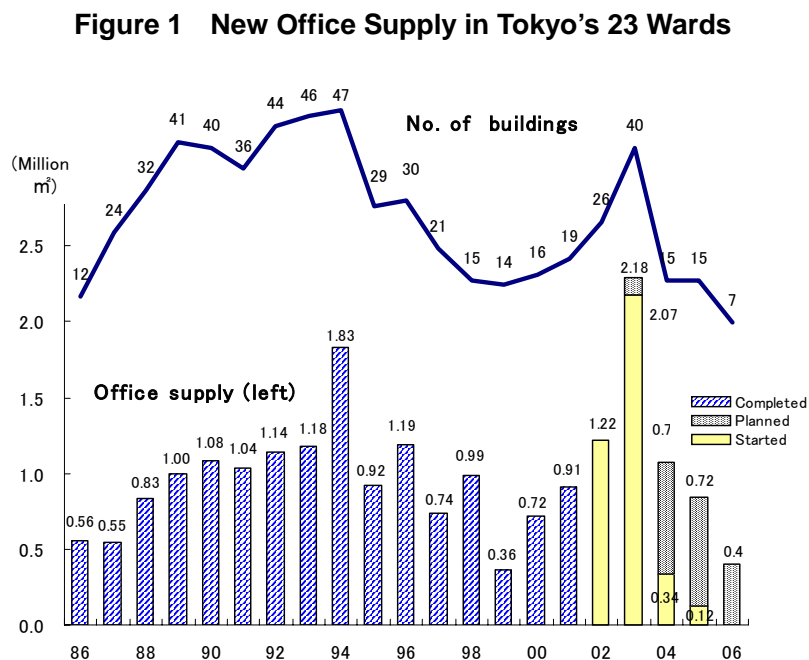
Trends in the Tokyo Office Market—Implications of the 2003 Peak in Supply of High-Grade Buildings

by Toshihiko Yamakata
Social Development Research Group

1. Rising Vacancy Rates

The Tokyo office market's "2003 problem" refers to the potentially rent destabilizing effect of the massive supply of new, large, high-grade buildings in prime locations arriving at a time when office demand is waning.

In Tokyo's 23-ward area, 40 new buildings with at least 10,000 square meters of floor space will be completed, supplying a total of 2.18 million square meters in new floor space. This new supply is unprecedented in size, exceeding even the bubble era's peak year of 1994 (Figure 1).



Notes: Shows only office space; excludes residential, hotel and retail space. Counts only buildings with at least 10,000 square meters of floor space.

Source: Mori Building Corp., *Survey of Market Trends for Large-Scale Office Buildings in Tokyo's 23 Wards*.

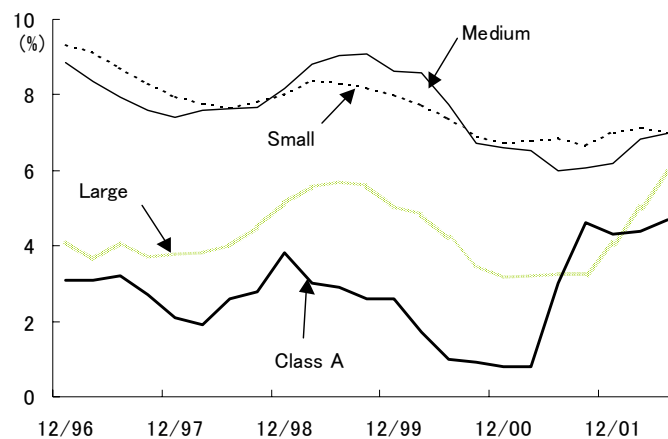
The vacancy rate of the overall market already started declining in December 2001. This decline is attributed not to the direct impact of the 2003 supply peak, but to weak office

demand stemming from the sluggish economy.

If demand continues to stagnate, the massive new supply arriving in 2003 is certain to destabilize market conditions. According to some forecasts, the vacancy rate of large buildings could exceed 10%.¹

By building size, vacancy rates of large buildings and Class A buildings, which in the past were quite low compared to small and medium sized buildings, began surging in the second half of last year. As a result, size-based differences in vacancy rates have shrunk significantly (Figure 2).

Figure 2 Vacancy Rate by Size of Building



Notes: Covers Tokyo's five central wards. Small buildings have a standard floor space of less than 50 *tsubo* (165 sq. meters); medium buildings have 50-99 *tsubo* (165-327 sq. meters); and large buildings have 100+ *tsubo* (330 sq. meters). The Class A buildings consist of 64 buildings, mostly in the five-ward area, with at least 10,000 sq. meters of floor space, and constructed in 1982 or later.

Sources: Compiled using data from Miki Shoji Co. for small, medium, and large buildings, and Ikoma Data Service System for Class A buildings.

2. Office Demand Remains Sluggish

(1) Can Supply Continue to Lead Demand?

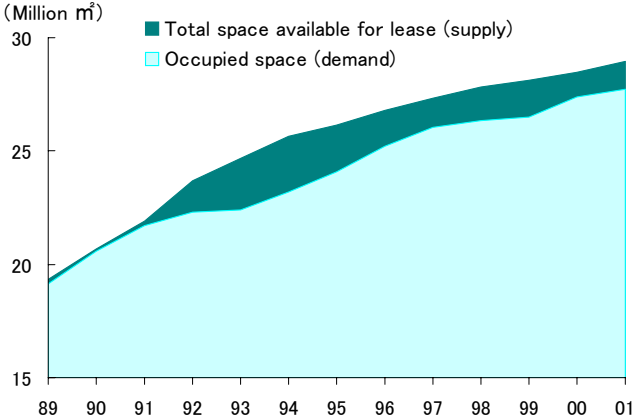
In the past, whenever supply had increased in the Tokyo office market, the market responded by absorbing the new supply with a surge in demand (Figure 3).

¹ The Commercial Property Research Institute's downside scenario predicts that the vacancy rate for large buildings could reach 7.21% in January 2003 and 11.42% in January 2004 (*Monthly Office Market Survey of the Tokyo Area*, digest edition, June 2002).

This pattern is attributed 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 economy. Companies continually needed more space as the proportion of office workers increased, work space per office worker grew, and IT equipment was upgraded. As a result, latent office demand consistently exceeded available supply, and quickly surfaced when the new supply appeared.

However, in recent years, office demand appears to have peaked out. Considering the condition of the economy, the recurrence of this type of latent office demand in 2003 is highly improbable.

Figure 3 Total Available and Occupied Floor Space

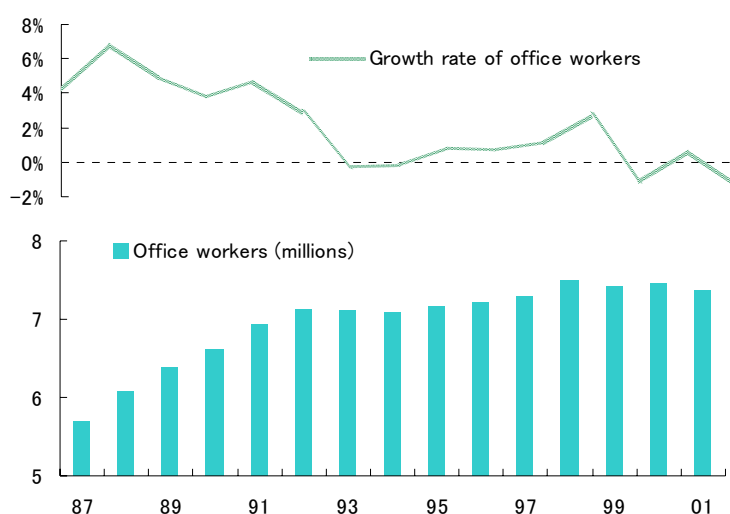


Source: Compiled using data from Ikoma Data Service System.

(2) Stagnant Growth of Office Workers

From 1987 to 1992, the number of office workers (specialized, technical, managerial, and administrative personnel) in the Tokyo area (Tokyo, Kanagawa, Saitama, and Chiba prefectures) grew by 3% to 7% per year. After dipping in 1993, the number reached 7.49 million in 1998, and has since hovered around 7.40 million (Figure 4).

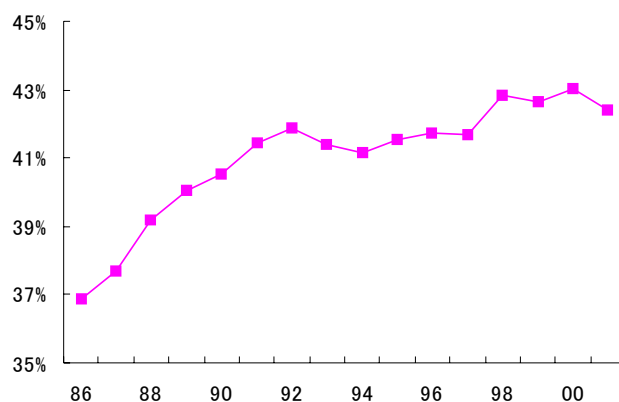
Figure 4 Number of Office Workers (Tokyo Area)



Notes: Tokyo area includes Tokyo, Kanagawa, Saitama, and Chiba prefectures. Shows annual averages.
 Source: Compiled from Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Labor Force Survey Report*.

The ratio of office workers to all employed persons, which had generally trended upward since 1986, has leveled off in recent years (Figure 5).

Figure 5 Ratio of Office Workers to All Employed Persons



Source: See Figure 4.

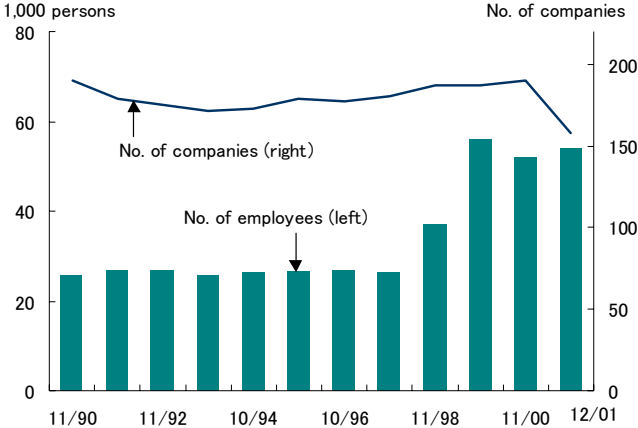
(3) Reduced Presence of Foreign Financial firms

Among foreign financial firms with a head or branch office in Tokyo, the number of employees has increased sharply since 1998, due in part to bailouts of failed domestic life insurers.² Along with technology companies, these firms drove office demand growth in 1999 and 2000.

² Foreign financial firms include banks, trust banks, securities firms, insurance companies, invest trusts and investment advisories with at least ¥50 million capitalization and foreign participation of at least 49%.

However, against the backdrop of Japan's ailing equity markets and weak earnings of parent firms in the U.S., foreign securities firms have been pulling out or scaling down operations in Japan since the second half of 2001. The number of firms declined by 32 to 158 firms, dampening growth in employment (Figure 6).

Figure 6 Foreign Financial Firms—No. of Companies and Employees

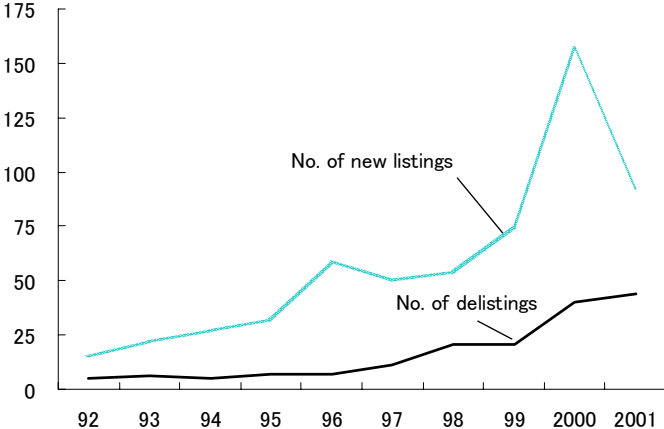


Note: Counts number of employees of foreign financial firms with head or branch office in Tokyo.
 Source: Compiled from Toyo Keizai Inc., *Foreign Companies in Japan*.

(4) Turnover of Listed Companies

New listings on the Tokyo Stock Exchange (including Mothers) have steadily grown, spiking to 157 companies during the IT boom of 2000 before dropping by 65 companies to 92 in 2001. Meanwhile, the number of delistings has also steadily risen, reaching 44 in 2001 (Figure 7).

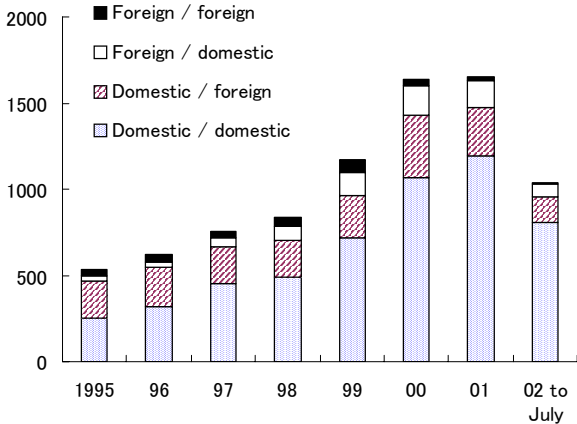
Figure 7 New Listings and Delistings (TSE)



Note: Shows total for TSE First Section, Second Section, and Mothers.
 Source: Compiled from Tokyo Stock Exchange, *Annual Securities Statistics*.

The number of mergers and acquisitions has also risen conspicuously (Figure 8).

Figure 8 M&A Activity



Note: Legend refers to nationality of primary and secondary firms in M&A.
 Source: RECOF Corp.

In general, while we expect growth in new venture companies to generate new office demand, business failures and delistings will obviously tend to reduce demand. And as M&A activity increases, companies will need to reduce employment and consolidate and move offices.

Since Japanese companies tend to emphasize job stability more than foreign firms, M&As among Japanese companies will produce fewer job cuts and office consolidations in the short term. However, in the long term, the effect of M&A activity on office demand will be persistently negative.

In any case, the turnover of companies is unmistakably on the increase. Under current conditions, even if demand deriving from office consolidation grows, overall office demand will not increase significantly.

(5) Growth in Office Space per Worker

Despite the decline in office workers, office demand can still grow if the floor space per person increases. According to a survey of tenants by Mori Building Corp., the office space per person (on a work space basis) has been expanding since 1992.³ While this trend is partly attributable to the increase in IT equipment, the inverse correlation between space per person and unit rent values is of great interest (Figure 9). That is, if lower rents have

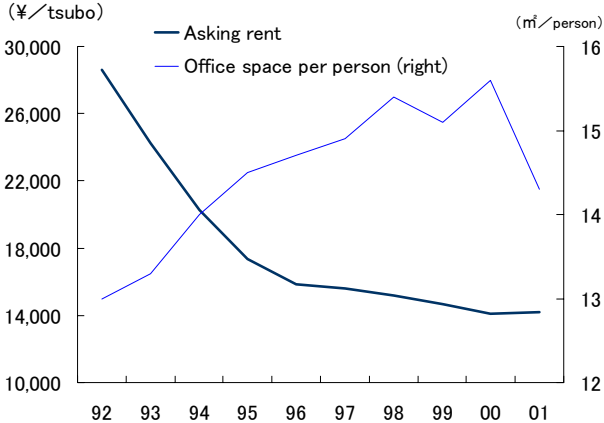
³ The 2001 survey recorded a decrease of 1.3m² from the previous year. Mori Building attributes this to an increase in employees while tenant-occupied space remained unchanged. Noting that some companies are postponing an office expansion in anticipation of the large supply arriving in 2003, Mori Building predicts that office space per person will recover in 2003.

induced tenants to lease more space and thereby increase the work space per person, further rent cuts appear necessary to help the sluggish office demand recover.

At many companies today, employees have access to their own personal computers, which are becoming increasingly compact and energy efficient. On the other hand, most office layouts still consist of island configurations in a large room with workers facing each other. Despite the emergence of free address offices (which have no fixed seating and allow people to freely share desks), there are few signs of a significant conversion to individual offices or variant layouts with much dead space.

Under current conditions, office space per person is thus unlikely to expand unless leasing costs decline.

Figure 9 Office Space per Person and Asking Rent



Note: Office space per person is ordinary work space divided by number of full-time employees. Ordinary work space excludes common areas, show rooms, etc.
 Source: Compiled using materials from Mori Building Corp. and Ikoma Data Service System.

3. Chain Reaction of Office Relocations

The architectural and facility standards of many of the high-grade buildings coming online in 2003 will surpass those of existing skyscrapers. Since rents will be at the high end for the locale, tenants will be limited to large companies and growth companies. According to some observers, while a zero sum competition will ensue among Class A buildings in 2003, smaller Class B and Class C buildings will not be seriously impacted. However, from 2003 to 2004, unless overall office demand expands, there is likely to be a chain reaction of office relocations that will migrate across building classifications.

As mentioned earlier, a dynamic office reorganization is occurring against the backdrop of

corporate mergers, business consolidations, and organizational streamlining centered around large companies. The need to consolidate scattered offices is greater than ever before.

Since office consolidation improves communication and operational efficiency, thereby enabling more efficient use of floor space, even if the rent increases, the total cost of leasing can remain unchanged or even decline.

For large companies that plan to consolidate offices, 2003 presents a golden opportunity to move into a higher-grade building. The supply of new high-grade office buildings provides an optimal destination for these office consolidations (Figure 10). Meanwhile, the Class A and B buildings that are vacated will begin actively recruiting new tenants.

Figure 10 Examples of Office Consolidation into Large New Buildings (2002-2003)

Company	Before consolidation	New building	Floor space
Dentsu	Dentsu Tsukiji HQ Bldg. (Chuo-ku) St. Luke's Tower (Chuo-ku) Dentsu Tsukiji Eto Bldg. (Chuo-ku) Dentsu Ginza Bldg. (Chuo-ku)	Shiodome A-block Dentsu Headquarters Building (Minato-ku)	219,000 m ²
Intelligence	Canadian Embassy (Minato-ku) Ginza Iwasaki Bldg. (Chuo-ku) Shinjuku Mitsui Bldg. (Shinjuku-ku)	Marunouchi Building (Chiyoda-ku)	160,000 m ²
Hitachi Software Engineering	Yokohama Onouecho Bldg. (Yokohama) Onouecho KN Bldg. (Yokohama) Queen's Tower (Yokohama) Yokohama Takashimacho Bldg. (Yokohama) Cosmo Kanasugibashi Bldg. (Minato-ku)	Shinagawa Seaside Forest Bldgs. A-1 & A-2 (Shinagawa-ku)	80,000 m ² (total)

Note: Some cases are still under consideration, and may renew lease.
Source: Compiled from *Nikkei Market Joho* and publicly available documents.

Existing Class A buildings, being large, are the likely destination for new office consolidations. However, older Class A buildings will need to thoroughly renovate their facilities or reduce rents to remain competitive.

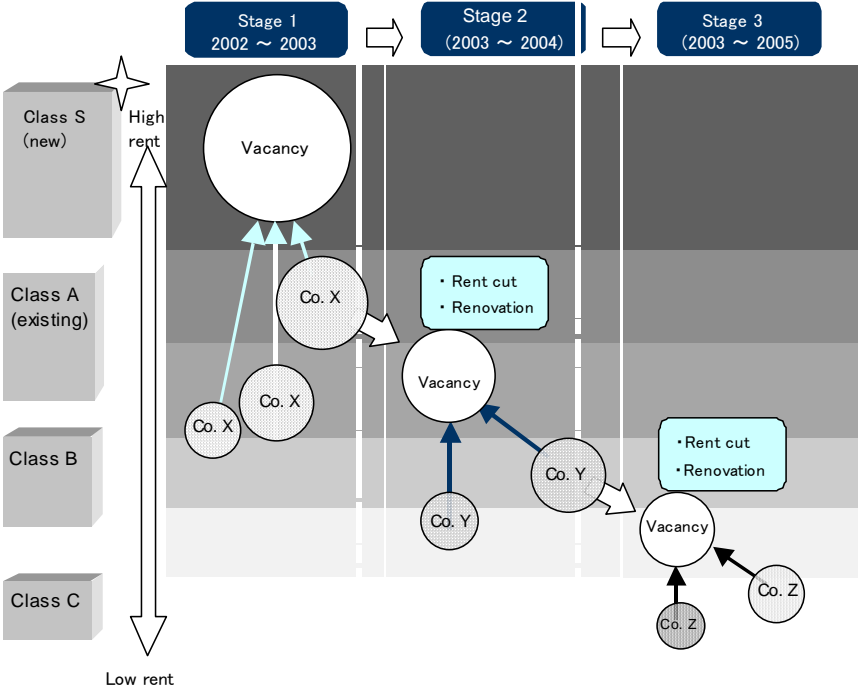
Next, Class B and C buildings, whose tenants will cancel leases in chain reaction, will start recruiting new tenants, heating up competition among the already large number of such buildings. Buildings that are poorly located or that do not renovate will struggle to find tenants even after slashing rents.

The only buildings that can avoid falling victim to the chain reaction are those that can differentiate themselves as data centers or by some other means.

If the outlook for recovery in office demand remains bleak, the consolidation and relocation of

offices into new high-grade buildings by some tenants is likely to trigger a chain reaction among other tenants. Over the next two to three years, tenants will migrate from existing Class A to Class B buildings, and from Class B to Class C buildings (Figure 11).

Figure 11 Chain Reaction of Office Relocations



Source: NLI Research Institute

4. The Coming Era of Fierce Competition

A breakdown of office construction starts over the past decade shows that the proportion of large buildings with a total floor space of at least 10,000 square meters is increasing (Figure 12).

From 2004 onward, due partly to urban redevelopment policies, the supply of office buildings will continue to grow centered around large-scale projects in central areas. Thus the stock of office buildings is also likely to grow larger in terms of building size.

By 2003, office buildings that are 15 years old or less and have at least 10,000 square meters of total floor space are predicted to comprise approximately one quarter of the total available space in Tokyo’s 23 wards (Figure 13).

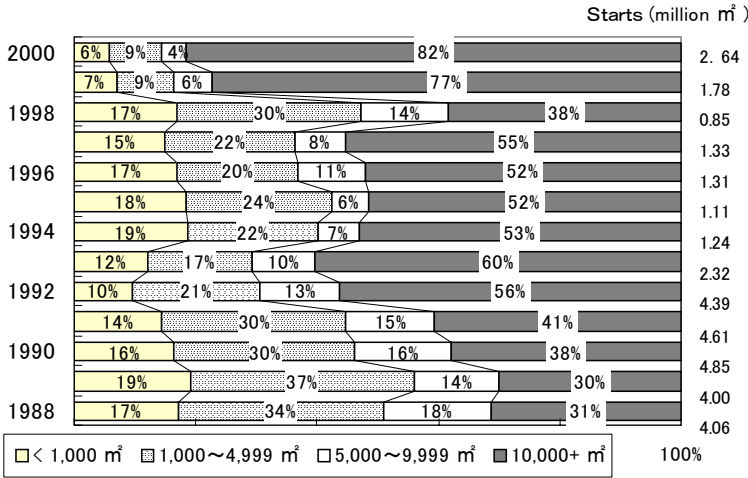
As office buildings grow in size, disparities among large buildings are widening with regard

to features such as location and facility standards. Newer Class A buildings tend to be at full occupancy more than older ones.⁴ Thus even Class A buildings, which are highly regarded overall for their prime location, newness, and large size, tend to lose their absolute advantage as time passes.

Just as skyscrapers have always been at the leading edge of technology and planning in each era, the buildings being completed around 2003 will boast the latest features in architectural and facility standards, Internet connection services, and security systems. However, a growing number of small and mid-sized new buildings have also incorporated superior features such as 2.7-meter ceilings, free access floors, 24-hour surveillance, and air-conditioning controls for individual rooms.

Meanwhile, to remain competitive, existing Class A buildings must strive to avoid physical deterioration and obsolescence by enhancing building management and facility functions. The era in which buildings only needed to be well located, new, and large is over. As buildings grow in size, a new era of fierce competition is about to begin.

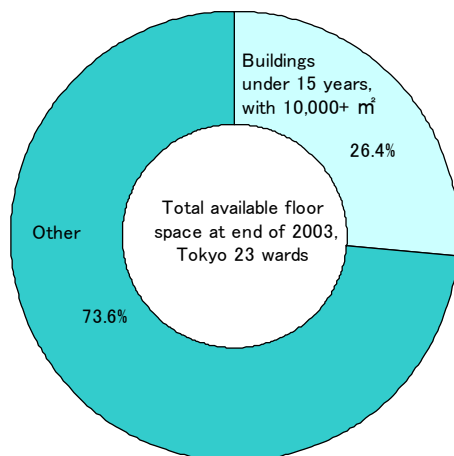
Figure 12 Construction Starts by Building Size (Tokyo’s 23 Wards)



Source: Compiled from Tokyo Metropolitan Government, *Construction Statistics*.

⁴ According to a survey by Ikoma Data Service System in the second quarter of 2002, approximately 58% of Class A buildings less than five years old had vacancies, compared to 73% of those five to ten years old, and 79% of those at least ten years old.

Figure 13 Ratio of Relatively New Large Buildings (Tokyo's 23 Wards)



Source: Compiled using data from Ikoma Data Service System and Mori Building Corp.