

Trends in the Tokyo Office Real Estate Market

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In Tokyo's office real estate market, the economic recovery has combined with low but stable rents to drive demand and reduce vacancy rates. Furthermore, rents in premium office buildings appear to be bottoming out.

However, since growth in demand is not expected to significantly outpace new supply, we predict growing disparities in rents and vacancy rates based on location and quality of facilities.

1. Present Status of the Office Market

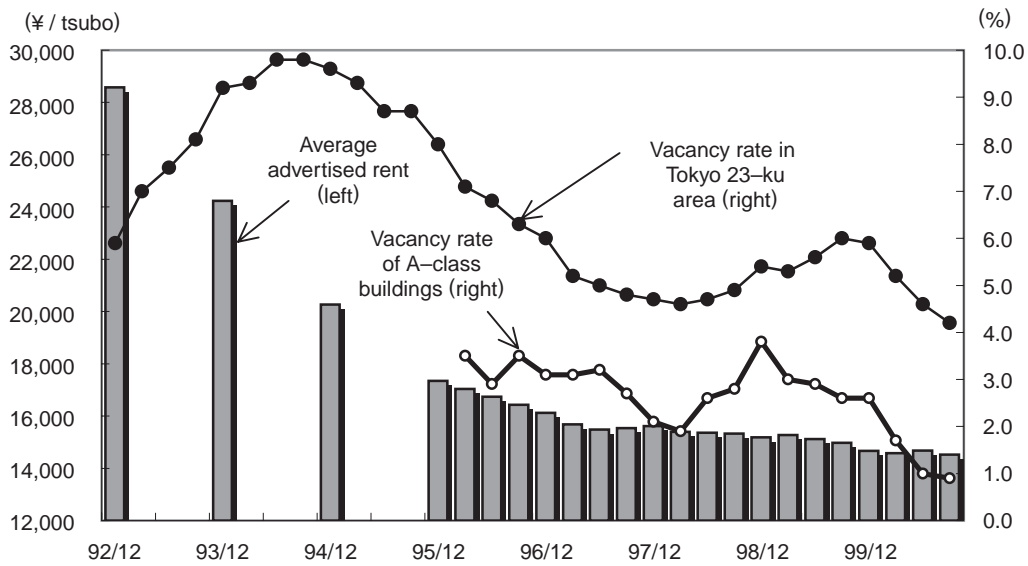
The vacancy rate in Tokyo's 23-ku (ward) area, which had risen since Q1 1998, peaked out in Q3 1999, falling to 4.2% in Q3 2000, the lowest level since 1992.

In addition, the recovery in the office real estate market is also corroborated by the record low vacancy rate of 0.9% for A-class buildings.

However, average office rents are at their lowest since 1992, and continue to hover near all-time lows despite the recent improvement in vacancy rate (Figure 1).

These apparently conflicting trends emerge from aggregated data that mask differences due to location and quality. Because of the market's diversification, specific trends such as the declining vacancy rate of A-class buildings are becoming increasingly difficult to identify from aggregated data.

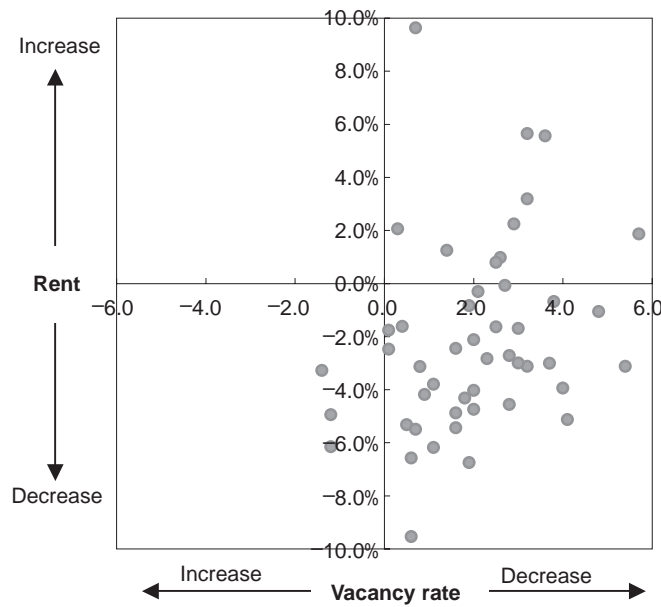
Figure 1 Vacancy Rate and Average Advertised Rent in Tokyo's 23-ku Area



Notes: There are 47 A-class buildings. The definition includes having at least 10,000 *tsubo* (33,000 sq. meters) of total floor space, at least 200 *tsubo* (660 sq. meters) per floor, and a construction date no earlier than 1982.
 Source: Ikoma/CB Richard Ellis

A clearer picture emerges from the changes in advertised rents and vacancy rates for 53 office areas in the one year period from September 1999. Of the 48 areas in which vacancy rates fell, advertised rents also declined in all but 10 areas (Figure 2).

Figure 2 Change in Advertised Rent and Vacancy Rate for 53 Office Areas (Sept. 1999 to Sept. 2000)



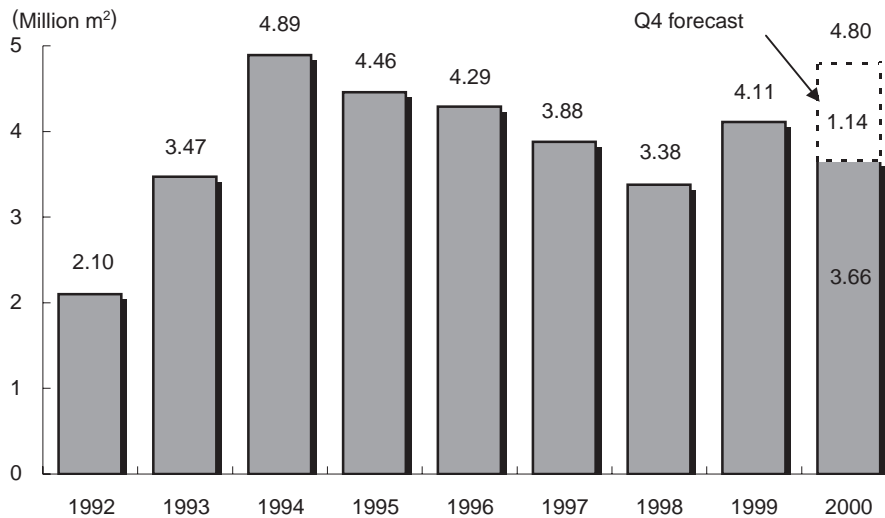
Source: Ikoma/CB Richard Ellis

Furthermore, fewer new lease contracts are offering free lease periods, indicating that rents in the more competitive buildings may already have stopped declining and begun to bottom out.

The increase in leased floor space has also been remarkable, growing 17% in the first half of 2000 and on pace to match the record high of 1994. In that year, the expansion in leased space resulted when the glut in new office supply after the bubble's collapse pushed down rents in new buildings, prompting companies intent on restructuring and cutting costs to move into leased offices.

In contrast, the present increase conveys a strong sense that the office market is recovering. The economic recovery and stable low rents have led to growth in new office demand among foreign financial institutions and IT related firms (Figure 3).

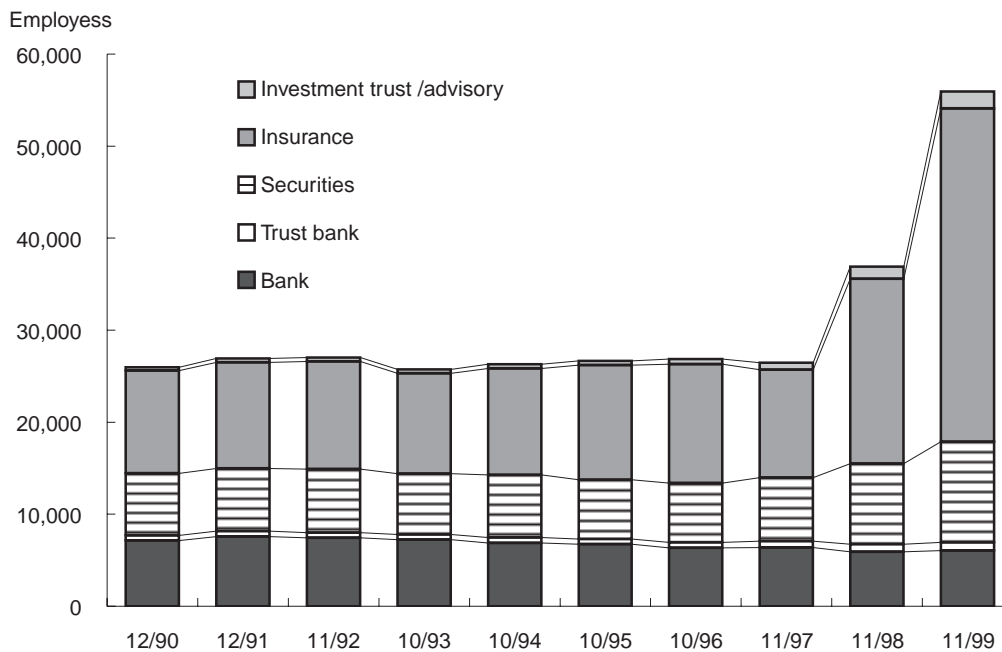
Figure 3 Floor Space Under Lease in Tokyo's 23-ku Area



Note: Leased floor space in the Oct.-Dec. 2000 quarter is a prediction.
Source: Office Building Research Institute

The number of employees at the Tokyo offices of foreign financial firms (banks, trust banks, securities companies, insurance companies, and investment trusts & advisories) rose from 37,000 in November 1998 to 56,000 in November 1999, an increase of over 50% (Figure 4).

Figure 4 No. of Employees at Foreign Financial Firms



Notes: Counts companies with local headquarters in Tokyo. When the current employee count is not known, the most recent data is used instead.

Source: Toyo Keizai Shinposha, *Handbook of Foreign Companies*.

While much of this growth came from absorbing employees at failed Japanese companies, foreign financial firms have also increased their employment due to expanding business opportunities amid the restructuring in the banking and insurance industries.

Foreign financial firms prefer large office buildings with excellent location and facilities, and their ability to pay premium rents makes them price leaders among large customers in the A-class office market.

Meanwhile, growth in IT related industries is driving office demand among both “new economy” Internet ventures and traditional “old economy” companies. IT related industries have sprung up anew in office districts such as Shibuya and Nishi Shinjuku, where rents are less expensive than in Tokyo’s mature office districts, and where large concentrations of young people abound. Because the new supply of office space in these areas is small, the market is tight.

Moreover, as the IT develops, the shift from suburban computing centers to Internet Data Centers (IDC) is causing office demand to shift to the central city.¹

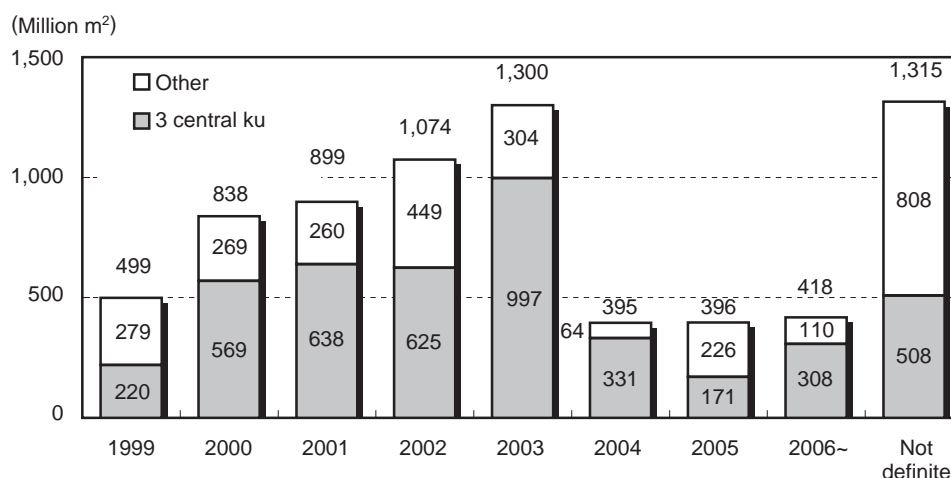
2. Office Construction Plans

The construction of large office buildings (including both leased and owner-occupied buildings with at least 5,000 m² of floor space) bottomed out in 1999 and is on the rise. In 2003, construction of 1.3 million square meters of office space is planned (Figure 5).

While this pace may seem unimpressive compared to that of the late 1980s and early 1990s (two to three million square meters per year), a sizeable proportion of the construction will consist of large buildings, and at least 70% will be concentrated in the three central wards. In particular, 390,000 m² is planned in Marunouchi, 280,000 m² in Tameike and east of Shinagawa Station, and 430,000 m² in Akasaka and Roppongi. Thus over the next five years, the new supply coming on line in each of the three areas will be equivalent to 13 to 25% of the present total leased space (Figure 6).

Compared to the construction boom of the late 1980s and early 1990s, many of the large buildings planned for these areas are of premium quality in terms of location and state of the art facilities for electricity, air conditioning and communications. Thus demand is almost assured given the right price.

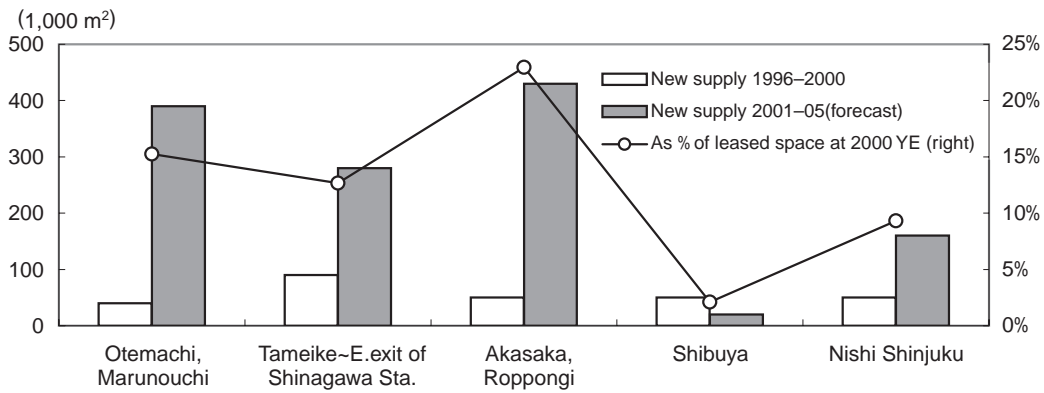
Figure 5 Planned Construction of Large Office Buildings in Tokyo's 23 Wards (5,000 m² or more)



Notes: Includes both leased and owner-occupied buildings. Office floor space is estimated from overall floor space figures.

Source: Compiled from various sources.

Figure 6 New Supply of Leased Office Space by District (excl. owner-occupied)



Total leased space		1995	2000		2005		Increase ②-①/①	Land area
			96-00 supply	①	01-05 supply (f)	②		
Central districts	Otemachi, Marunouchi	2,492	37	2,529	385	2,914	15%	1,297
	Tameike~E. exit Shinagawa Sta.	2,114	90	2,204	279	2,483	13%	6,041
	Akasaka, Roppongi	1,808	54	1,862	427	2,290	23%	3,252
Secondary districts	Shibuya	841	51	892	19	911	2%	1,582
	Nishi Shinjuku	1,659	46	1,705	159	1,863	9%	1,509

Notes: Districts are defined as follows: Otemachi / Marunouchi (Otemachi, Marunouchi, Yurakucho), Tameike / Shinagawa Station east side (Shimbashi, Hamatsucho, Shiba Koen, Shibaura, Kaigan, Minato Minami), Akasaka / Roppongi (Akasaka, Roppongi, Toranomom), Shibuya (Shibuya, Jinnan, Udagawacho, Dogenzaka), Nishi Shinjuku (West Shinjuku).

Source: Ikoma/CB Richard Ellis; forecasts are by NLI Research Institute.

Figure 7 Planned Construction of Large Office Buildings by District (50,000 m² or more)

2001	2002	2003	2004	2005
Otemachi / Marunouchi				
* Pacific Century Place Marunouchi	* Marunouchi Building		* Eiraku Bldg. / Nihon Kogyo Club reconstr.	* Site of former JNR headquarters * Meiji Life Bldg. reconstr.
Tameike / Shinagawa Station east side				
	* Shiba 3-chome Higashi area * Dentsu HQ	* Tameike AM Tower * Nippon Television HQ * Tameike Kajima Bldg. * Tameike Media Tower * Mitsubishi Heavy Industries HQ bldg. * Mitsubishi Motors HQ bldg. * Mitsubishi Corp. HQ bldg. * Nippon Express HQ bldg. * Canon Sales HQ bldg. * Taiyo Life HQ bldg. * Daito Trust Constuction. * HQ bldg.	* Shinagawa Station East Exit Bldg. * Tameike block no. 4	
Akasaka / Roppongi				
* Atago Green Hills	* Roppongi 1-chome	* Roppongi Hills	* Kyowa Fudosan Bldg. * Roppongi 3-chome Bldg.	
Shibuya				
Cerulean Tower				
Nishi Shinjuku				
	* Nishi Shinjuku 6-chome Minami area		* Nishi Shinjuku 8-chome Naruko area	

Note: See Figure 6 note for description of districts.
Source: Compiled from various sources.

3. Forecast for the Office Market

1. Office Demand

The market outlook gives little reason to be optimistic that demand growth will significantly outpace supply in the future.

On the positive side, if the economy continues to recover, office demand will keep expanding around IT industries and foreign financial firms. However, negative factors include restructuring among banks and life insurers, which causes further office consolidation and personnel downsizing, and downsizing of back office departments in all industries due to efficiency improvements from IT and a growing

emphasis on return on assets and office productivity.

Although IDCs are creating office demand in the central city, their impact on the urban office market is limited due to the scarcity of office buildings that can meet their rigorous technical specifications, and the viability of less expensive suburban locations. Moreover, IDCs provide server hosting services that companies can substitute for office space currently occupied by in-house servers.

However, because of the constant advances in office information networks, companies demand ever higher standards for building facilities and are becoming increasingly selective about the buildings they occupy. As a result, office demand for premium buildings satisfying stringent IT specifications will likely exceed new supply.

On the other hand, buildings with poor earthquake resistance and mediocre specifications will find it difficult to find tenants even with substantial rent reductions. Without significant new investments to upgrade facilities, they risk being plagued by constant vacancies.

2. Forecast for Office Rents

Despite the economy's present recovery, office rent increases will be restrained because companies are increasingly vigilant about improving their profit margins and return on assets.

Starting rents in premium buildings appear to have bottomed out and are likely to continue firming. However, the alleviation of location restraints allowed by information technology, the declining supremacy of the central city, and competition among office districts will help define an upper limit to rents, helping to moderate rent increases.

Moreover, since demand growth is not likely to outpace supply in the overall market, office rents are not likely to rise across the board. Instead, disparities are predicted to increase based on location and building quality (Figure 8).

Figure 8 Factors Affecting Future Office Demand and Rents

	Positive factors	Negative factors
No. of office workers	<ul style="list-style-type: none"> * Increase in employees due to economic recovery * Increased employment at foreign financial firms amid financial sector restructuring 	<ul style="list-style-type: none"> * Ongoing office consolidation & personnel cuts due to financial sector restructuring * Improved efficiency of operations due to advances in IT * Downsizing of back offices due to focus on return of assets and office productivity
Floor space per worker	<ul style="list-style-type: none"> * More space needed to accommodate increase in IT equipment * Increase in office demand of foreign firms, who have larger space requirements 	<ul style="list-style-type: none"> * Growth restrained by downsizing of IT equipment and outsourcing to IDCs.
Other demand	<ul style="list-style-type: none"> * Growing demand for call centers and IDCs * Increase in non-office demand for restaurants, stores, and substitutes for financial offices 	
Office rent	<ul style="list-style-type: none"> * Premium building rents are firm due to employment growth at foreign financial firms * Demand is concentrating in scarce premium buildings and locations 	<ul style="list-style-type: none"> * Competition between new and old office districts restricts max. rents * IT loosens office location restrictions, and superiority of central city locations is declining * Increase in leaseholds, longer lease contract periods at new premium buildings keep rents fixed * IT spending on equipment leasing fees increase, restraining office rents * Low inflation makes rent increases difficult

Note

1. Internet data centers provide customers with hosting, co-location, connectivity and managed services. IDC buildings must have good earthquake resistance, floors that withstand as much as 1,000 kilograms of weight, ceilings that are three meters high, and a power supply of 1 KVA per square meter. In addition, they need high quality cooling, security, and backup functions. As the growth of the Internet continues to drive demand for IDC facilities, a wide range of companies have entered the IDC business including communications carriers, providers, computer and electrical makers, and information system companies.