Status and Prospects for Regional Office Markets—Concentration in Tokyo May Cause a Contracting Equilibrium Elsewhere

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Introduction

The Tokyo office market's "2003 problem" arrived as expected this year: a massive supply of new large office buildings has flooded the market, competing for a limited demand crippled by the stagnant economy, and as a result further pushing vacancy rates upward and rents downward. However, looking beyond Tokyo's well publicized 2003 problem, we find even more dismal conditions in other major markets across Japan.

This paper analyzes the current status and prospects for regional office markets outside of Tokyo. We focus on six ordinance-designated cities to represent six major regions: Sapporo (Hokkaido), Sendai (Tohoku region), Nagoya (Tokai region), Osaka (Kinki region), Hiroshima (Chugoku region) and Fukuoka (Kyushu region).[1]

1. Office Market Concentration Continues in Tokyo

Since the late 1990s, population trend data for major metropolitan areas show that the population has continued to concentrate in the Tokyo area. Moreover, while the Nagoya area has remained stable with little increase or decrease, the Osaka area has continued to decline in population since the mid 1970s (Figure 1).

By prefecture, populations have continued to grow in Fukuoka prefecture since 1989, and in Tokyo and Aichi prefectures since 1997, with Tokyo's growth being overwhelming. On the other hand, Osaka, Hokkaido, and Hiroshima prefectures have persistently declined, and Miyagi prefecture also began declining in 2000 (Figure 2).[2]

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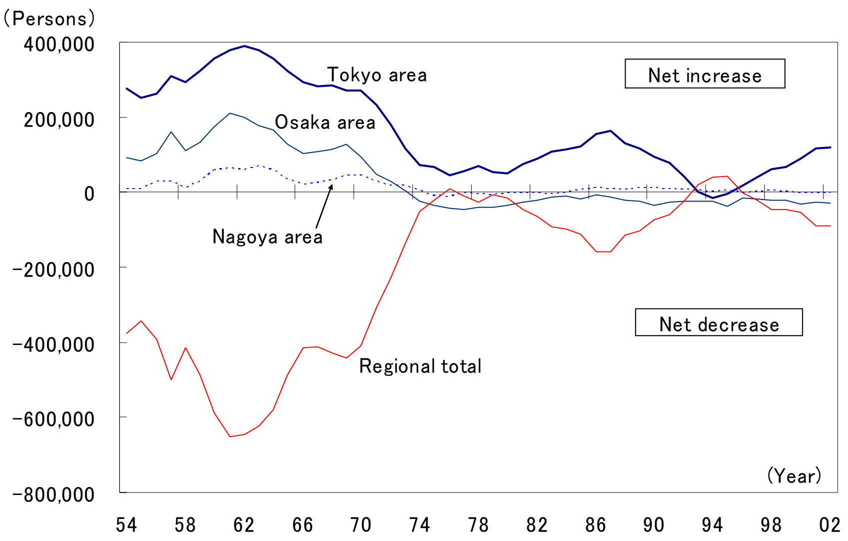
[1] Hokuriku, Koshinetsu, and Shikoku regions are excluded from our analysis because they are small in market size, and also have no ordinance-designated cities.

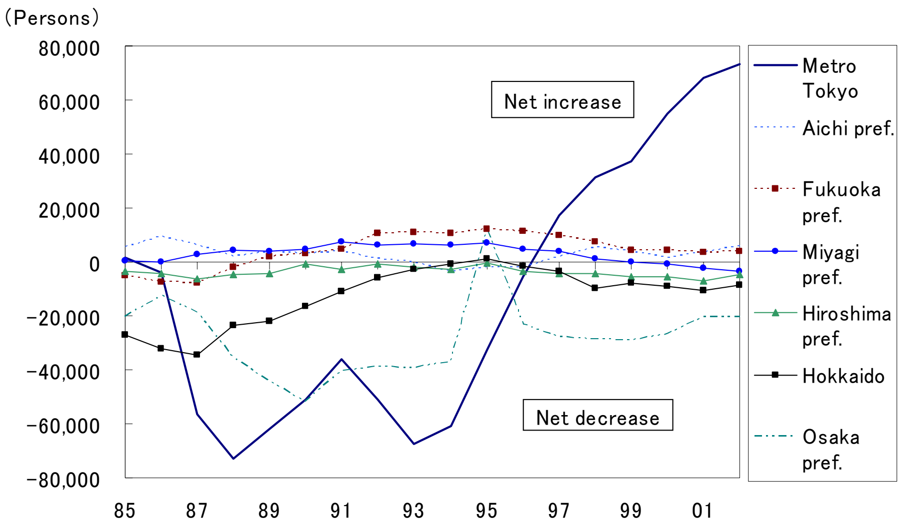
[2] The net population increase of Osaka prefecture in 1995 was temporary: a sudden inflow from neighboring Hyogo prefecture occurred after the Hanshin Awaji earthquake.

Figure 1　Population Trends of Major Metropolitan Areas



Note: Tokyo area consists of Tokyo, Kanagawa, Saitama, and Chiba prefectures; Osaka area consists of Osaka, Hyogo, Kyoto and Nara prefectures; Nagoya area consists of Aichi, Gifu, and Mie prefectures. Regional total is calculated as the negative value of the net increase for the three major metropolitan regions.
Source: Compiled from Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Report on the Internal Migration in Japan*..

Figure 2　Population Trends by Prefecture

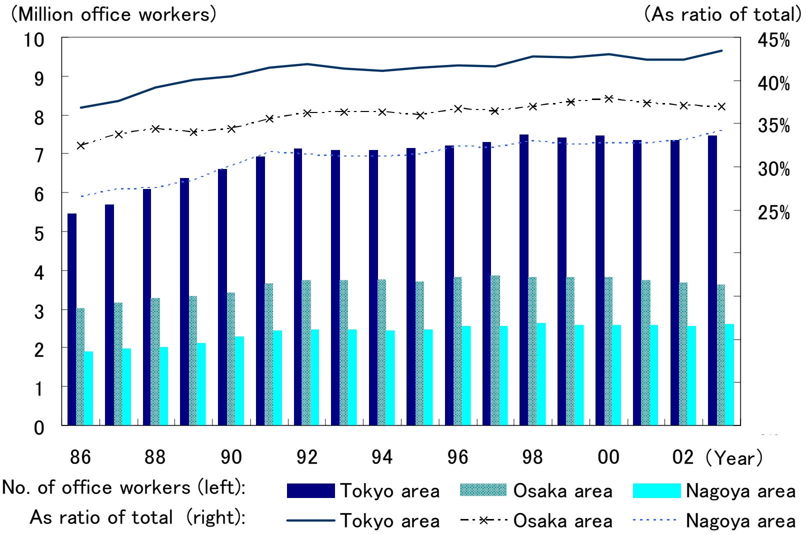


Source: Compiled from MPMHAPT, *Report on the Internal Migration in Japan.*

Of the three metropolitan areas, the Tokyo area has an overwhelmingly large number of office workers, and a high ratio of office workers to total employed persons.[3] Recently, office workers have been growing in Tokyo and Nagoya areas, but decreasing in the Osaka area (Figure 3).

[3] The *Labor Force Survey* does not provide data by prefecture.

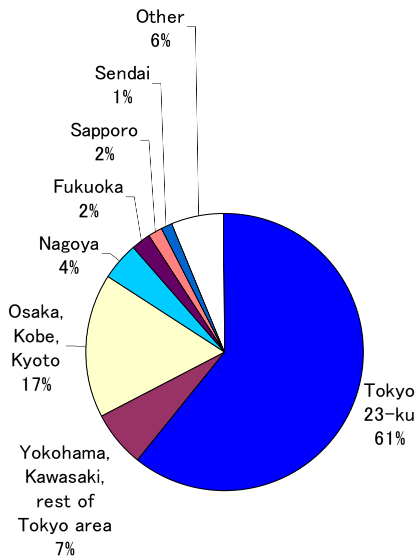
Figure 3　Office Worker Populations in the 3 Major Metropolitan Areas



Notes: Tokyo and Nagoya areas are the same as in Figure 1; Osaka area consists of Osaka, Hyogo, Kyoto, Nara, Shiga, and Wakayama prefectures. Shows January-March data for 2003.
Source: Compiled from MPMHAPT, *Labour Force Survey*.

In the office leasing market, the Tokyo 23-ku area (the 23 wards) comprises 61% of the total market. The Tokyo area, which includes three adjoining prefectures and the cities of Yokohama and Kawasaki, accounts for over two-thirds of the total market (Figure 4). The market share of the Tokyo 23-ku area, after peaking at 70% in the bubble era, plunged when the bubble collapsed because rents and vacancy rates deteriorated more than in other markets, but bottomed out at 59% in 1999, and has been growing since.

Figure 4　Office Market Share by Region



Note: Office leasing market size = Leased space x (1 – Vacancy rate) x Average annual real unit rent. Real rent is asking rent, and includes investment return on credit deposit.
Source: Compiled from Ikoma Data Service System, *2003 White Paper on Real Estate*.

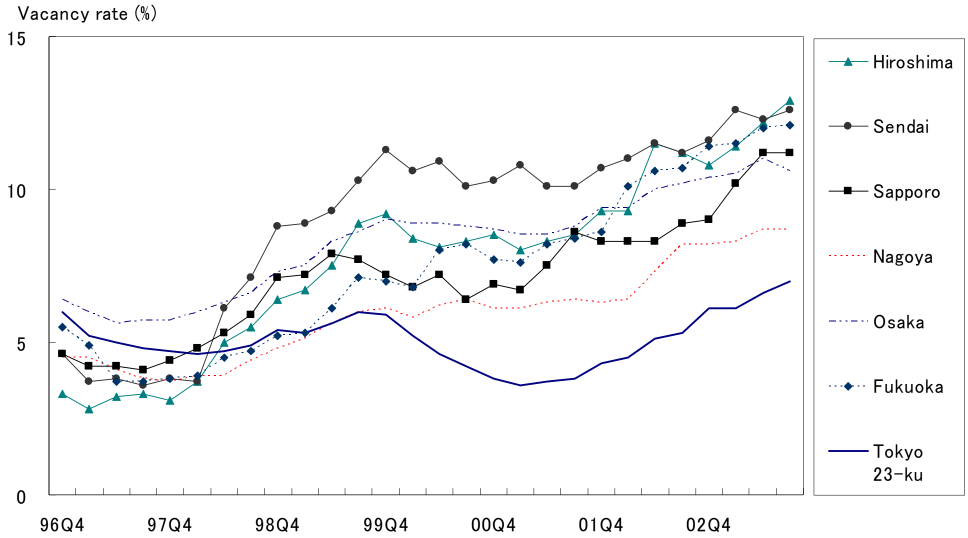
Clearly, the Tokyo 23-ku office leasing market surpasses all other regional markets by far.

Moreover, the already excessive level of concentration will continue to increase against the backdrop of long-term population growth in the Tokyo metropolitan area.

2. Nagoya Market is Firm, While Osaka Market Sags Markedly

Tokyo's (23-ku area) vacancy rate has steadily risen since 2001Q2, but still remains below that of all other major cities. Considering that all major cities except Osaka had lower vacancy rates than Tokyo until 1997Q4, it is apparent that office market conditions elsewhere have deteriorated even more than in Tokyo (Figure 5).

Figure 5 Vacancy Rate by City

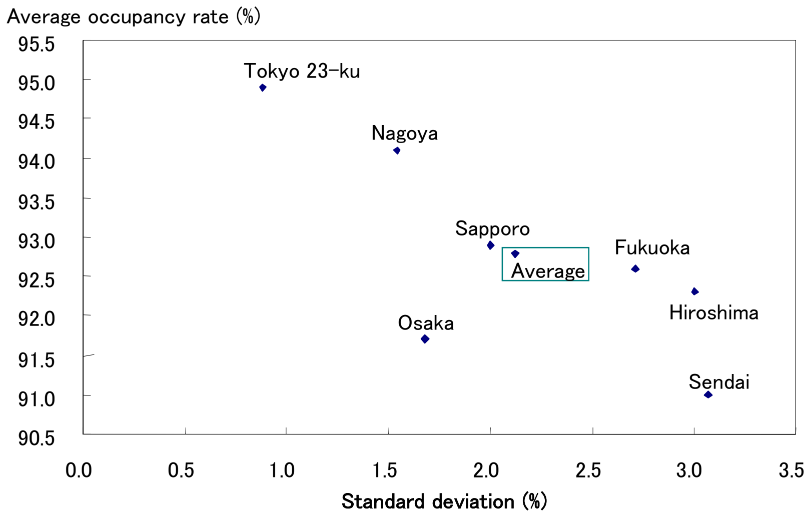


Source: Compiled from data supplied by Ikoma/CB Richard Ellis Corp.

From 1996Q4 to 2003Q3, the average occupancy rate (100 – vacancy rate) and its fluctuation range (standard deviation risk) is highest and most stable for Tokyo, followed by Nagoya. Osaka is next most stable after Nagoya, but has the second lowest occupancy rate. Sendai, the smallest of the seven markets, has the least stable and lowest occupancy rate of all (Figure 6).

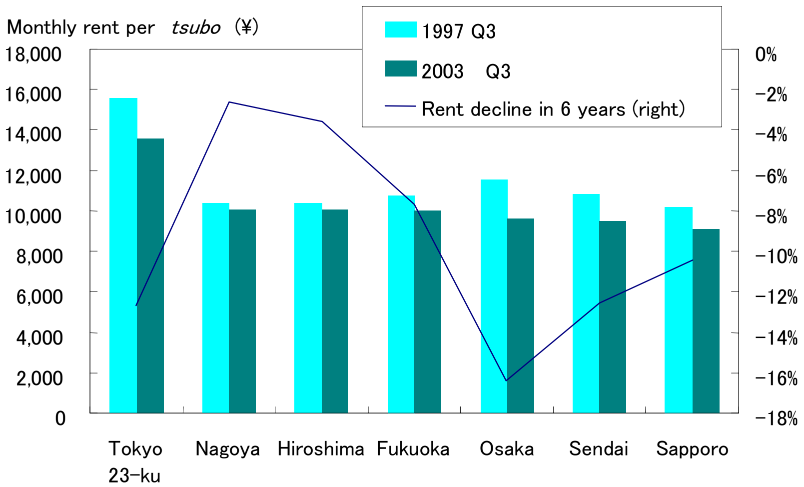
The average monthly office rent in Tokyo is in the mid ¥13,000 per *tsubo* (3.3 square meters), but only about ¥10,000 in all other cities. Osaka, which had the second highest rent in 1997, experienced the largest rent decline over the past six years, and now ranks fifth. Nagoya, which now ranks second in rent after Tokyo, had the smallest rent decline over the same period (Figure 7).

Figure 6　Average Occupancy Rate, and Standard Deviation



Notes: Shows data from 1996Q4 to 2003Q3. Average value refers to a simple average of the cities.
Source: Compiled from data supplied by Ikoma/CB Richard Ellis Corp.

Figure 7　Office Rent, and Change in Rent (1997-2003)

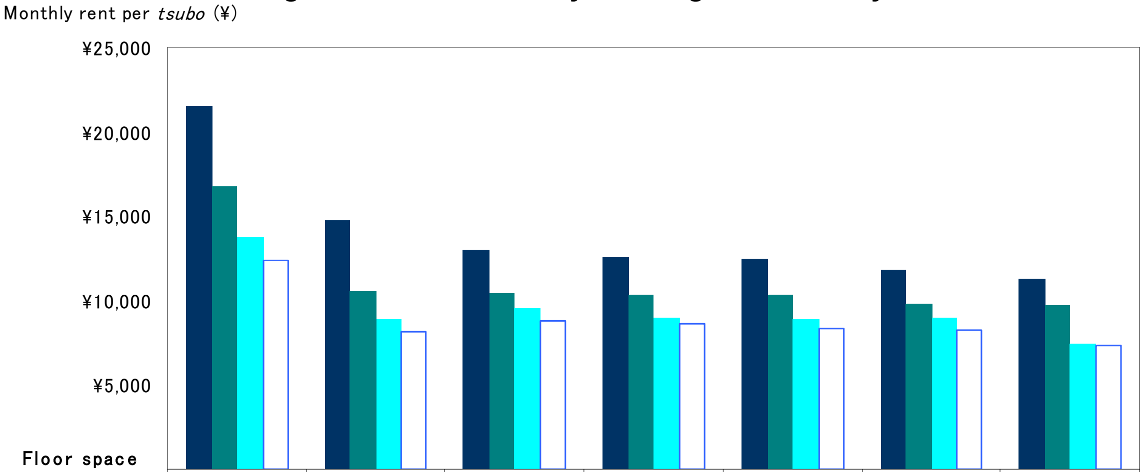


Note: Shows rent levels as of 2003Q3
Source: Compiled from data supplied by Ikoma/CB Richard Ellis Corp.

The rent data above, however, consists of simple average values that do not consider factors such as distribution of building size. Looking at office rent for buildings with at least 1,000 *tsubo* (3,300 sq. meters) of floor space, Tokyo's lead is followed by Osaka and Nagoya, with Sapporo trailing at seventh. However, for buildings with under 1,000 *tsubo* of floor space, Osaka drops to sixth place ahead of only Sapporo, while Nagoya moves up to second after Tokyo (Figure 8).

Also, the rent data is based on asking rents, which are generally higher than actual rents specified in contracts. The divergence between asking rents and contracted rents has been growing nationwide, implying that market conditions are actually even worse than the data indicates. The divergence is greatest in Osaka, followed by Sendai, Sapporo, Tokyo and Nagoya.[4]

Figure 8 Office Rent by Building Size and City



Floor space (*tsubo*)	Tokyo 23-ku	Osaka	Nagoya	Fukuoka	Hiroshima	Sendai	Sapporo
3,000+	¥21,520	¥14,740	¥12,960	¥12,530	¥12,470	¥11,810	¥11,250
1,000～3,000	¥16,800	¥10,560	¥10,410	¥10,310	¥10,340	¥9,840	¥9,750
500～1,000	¥13,700	¥8,840	¥9,510	¥8,970	¥8,880	¥8,930	¥7,460
＜ 500	¥12,370	¥8,160	¥8,770	¥8,630	¥8,330	¥8,240	¥7,350

Note: One *tsubo* is equal to 3.3 square meters.
Source: Compiled from data supplied by Ikoma/CB Richard Ellis Corp.

Amid the overall deterioration of market conditions, the relative stability of Nagoya contrasts sharply with the conspicuous descent of Osaka. The difference in vitality between the two cities is also corroborated by economic indicators such as unemployment rate and business confidence.

Based on total leased floor space, Osaka is still the nation's second largest office market at one-third the size of Tokyo but three times larger than Nagoya. But while corporate head offices and western regional offices are concentrated in Osaka, Osaka's office market has contracted conspicuously as the population and important economic functions continue to flow out of the area and relocate to Tokyo.

While regional office markets have been significantly impacted by the long-term slump in local economies, we cannot ignore the structural problem behind shrinking office demand in regional markets—the migration of people and businesses into the Tokyo area.

[4] According to a survey by the Commercial Property Research Institute, the divergence in January-June 2003 was 13.7% for Tokyo, 16.7% for Sapporo, 19.6% for Sendai, 11.1% for Nagoya, and 28.5% for Osaka. The calculation of divergence does not consider special concessions by the owner such as free rent or free interior remodeling. The survey excludes Hiroshima..

3. Increase in Intra-regional Concentration and Disparity

In most of the major cities, despite a long-term deterioration of market conditions, the equivalent of one to two percent of the total leased space is supplied each year as new office buildings are constructed. As a result, disparities are growing between areas and between buildings in each market, similar to Tokyo (Figure 9).

Figure 9 New Supply of Office Space by City

	Tokyo 23-ku	Sapporo	Sendai	Nagoya	Osaka	Hiroshima	Fukuoka
Total leased space (*tsubo*, end of 2000)	8,606,445	385,626	294,699	973,251	2,992,801	199,339	499,462
Average annual new supply (2000–2004)	173,256	6,787	1,002	11,181	31,634	1,948	9,298
New supply ratio	2.0 %	1.8 %	0.3 %	1.1 %	1.1 %	1.0 %	1.9 %

Note: Shows estimate for 2004.
Source: Compiled using data supplied by Ikoma/CB Richard Ellis Corp.

In regional markets, the largest office market usually belongs to the region's largest city because that is where corporate head offices and branch offices are concentrated. For example, the Sapporo market is approximately 14 times larger than Hakodate and Asahikawa combined, while Osaka is six times larger than Kobe and Kyoto, and Fukuoka is 11 times bigger than Kita Kyushu. The largest market in the region also has lower a vacancy rate and greater market stability.

Recently, against the backdrop of development of transportation networks and IT technology, the concentration of offices in major regional cities has intensified. For example, city banks have withdrawn from Otaru and concentrated offices in Sapporo. Businesses are relocating offices to Nagoya from Gifu and Yokkaichi, which are within 30 minutes commuting distance by train. Offices in Kyoto are being consolidated into those in Osaka.

Moreover, new large urban development projects near major train terminals in Sapporo, Nagoya, and Osaka have attracted a conspicuous number of tenants from conventional office locations, offering advantages such as convenient transportation and state-of-the-art facilities. The development projects satisfy a strong latent demand of the regional office market's core component—branch offices and local offices—for convenient locations near train terminals.

However, office relocations in all these cities share a common characteristic—businesses are aiming to reduce costs and consolidate offices against the backdrop of poor business conditions and the need to downsize, while dynamic business expansions are still the exception. Tokyo stands in contrast—the large supply of new office buildings has a negative impact on the overall market, but can also absorb demand for corporate head office functions and office consolidation of group companies.

Of course, while many relocations are motivated by downsizing, tenants still prefer buildings with standard features such as air-conditioning with individual controls, security systems with 24-hour entry and exit control, and free access floor systems. Meanwhile, older buildings are struggling to attract tenants.[5] In regional office markets, rents at many buildings are already below ¥10,000 because rent concessions such as reductions or free rent periods are no longer sufficient to attract tenants.[6]

4. Investment Opportunities in Regional Markets

Below we consider the office leasing markets in major regional cities from the perspective of investment markets.

Many real estate investment trusts (REITs) listed on the Tokyo Stock Exchange have real estate portfolios that are geographically diversified nationwide. Among REITs specializing in office buildings, Tokyo area properties represent 88% (by asset size) of Nippon Building Fund Inc.'s portfolio, and 73% of Japan Real Estate Investment Corp.'s portfolio. Both exceed the Tokyo area's average share of 68% in the national office leasing market.

Moreover, when the return and average price of NBF's properties are broken down by region, we find that the lowest return belongs to the three central wards of Tokyo (the risk premium added to the no-risk return is small), where the properties are large buildings.[7] This is followed in ascending order of return by the rest of Tokyo 23-ku, the rest of the Tokyo area, the cities of Osaka, Kobe, and Kyoto, and other regional cities (indicating an increasing risk premium), with buildings decreasing in size (Figure 10).

Seeking fund growth and long-term earnings stability, REITs tend to concentrate their holdings in the Tokyo area, where many high quality, large investment grade properties exist. Tokyo's earthquake risk is apparently a lesser concern than the economic and market risks in other regions. Osaka and Nagoya, however, being large and stable markets that offer many investment alternatives, receive larger allocations than other regional cities.

Regarding regional cities, the basic investment stance of REITs is to target ordinance-designated cities and carefully select prime properties with scarcity value.

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[5] Even in Nagoya, where the possibility of a major earthquake is an important concern, buildings with older earthquake resistance structures tend to be at a disadvantage in comparative assessments by prospective tenants, but relocations out of these buildings are not increasing based on earthquake risk concerns.

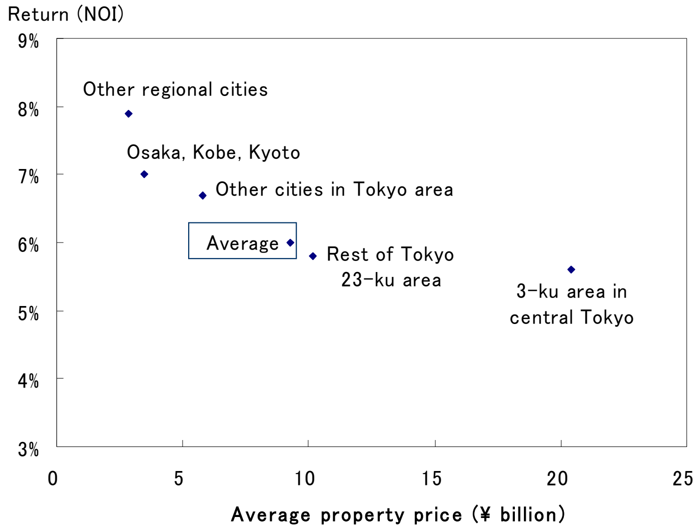
[6] Basically, rents in local cities are posted separately from common-service fees. However, fees are increasingly being included in rent negotiations on the instruction of head offices in Tokyo. Free rent stipulations have also been imported from Tokyo, while fixed-term lease contracts are still rare. Since final authority for both tenants and owners resides in Tokyo, contracts are taking longer to close.

[7] The return is calculated as net operating income (NOI) divided by property price. NOI is gross revenue (including rent) minus costs (management cost, taxes, insurance premiums, etc.); depreciation cost is not subtracted.

Most of the private real estate funds that seek capital gains from short-term investments invest in the Tokyo area—except for large foreign funds who can purchase the nationwide properties of failed life insurers.

Of course, regional cities may sometimes offer better investment opportunities than Tokyo, where players are numerous and competition for properties is intense. Needless to say, since economic conditions are worse and recovery prospects slimmer outside of Tokyo, investors will seek price discounts in regional cities so that additional risks are compensated by higher returns.

Figure 10 Investment Performance of NBF Properties by Region



Notes: Prices are appraised values at end of current period; rate of return of net operating income (NOI) is annualized. No properties are owned in Nagoya.
Source: Compiled from financial statements of Nippon Building Fund Inc. for the first half of 2003 (4th fiscal period, from January 1, 2003 to June 30, 2003).

5. Toward Revitalization of the Regional Markets

While short-term improvement in regional office market conditions will rely heavily on economic recovery, long-term improvement must address the structural problem of overconcentration of economic activity and population in Tokyo.

In the future, as the population ages and decreases, unless the structure of overconcentration in Tokyo changes, cities such as Osaka, Nagoya, Sapporo, and Fukuoka will increasingly be affected by downsizing and the transfer of important functions to Tokyo, and their office markets are likely to experience a contracting equilibrium as a result.

One background factor to the overconcentration in Tokyo is that business and investment opportunities are scarcer outside of Tokyo, and companies are confronting the limits of growth.

Under a uniform nationwide system of economic regulations and taxation, the Tokyo area enjoys an overwhelming edge in business and investment opportunities because of the convergence of foreign and domestic companies and information, and also has Japan's largest consumption market. Thus companies make the rational decision to locate their head office or business operations here. Moreover, even companies started up elsewhere are drawn by opportunities for growth offered by the large Tokyo market.

As a result, core functions such as management, R&D, and international operations tend to be located in Tokyo because of the convergence of people, goods, money and information, while business functions are relegated to regional cities.

As the overconcentration in Tokyo accelerates, Tokyo's so-called "2010 problem," which predicts a troubling decrease in office workers as baby boomers retire in large numbers, could be alleviated or even averted. However, since the competition among cities for office demand is a zero sum game, Tokyo's gain will come at the expense of a contracting equilibrium in regional office markets.

The full-fledged revitalization of regional office markets will depend on whether regional economies can offer business opportunities not available in Tokyo, attract leading companies and human resources, and nurture new industries.

But the revitalization of regional markets is impossible through conventional policies such as pork-barrel public works projects, protection of cottage industries, and present urban revitalization policies oriented around construction. What is needed are bold innovations that transcend the government's Special Zones for Structural Reform program, and enable regions to take the initiative in pursuing deregulation and attracting new industries.