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Japan Real Estate Investment

REVIEW

NOMURA REAL ESTATE Development Co., Ltd

Summary

The present study examined new supply of large office buildings with a floor space over 1,000 *tsubo* in Tokyo's 23 wards over the next four years (2011~2014), as well as tenant relocation trends in Tokyo during 2010. We also looked at leasing market trends, supply trends by location and year of construction, and the characteristics of relocating companies, and based on these results we discuss demand and supply in Tokyo's major office market (five central wards) through 2014.

Leasing market trends in the five central wards (through 2010)

- Overall vacancy rates reached an all-time high in August 2010, but vacancy rates in newly constructed office buildings, which are considered to be a leading indicator, showed improvement.
- In 2010 the amount of office space lost to the market exceeded nominal new supply, and the total stock of leased office space fell slightly, however total vacant floor space increased.
- Reconstruction is the primary source of new supply in the 5 central wards, so the amount of space lost each year has been increasing. Annual losses reached the 138,000 *tsubo* level in 2010.

New supply trends in Tokyo's 23 wards

- There are concerns about how the market will be affected by the large amount of new supply scheduled for completion in 2012, however the total will only be about 78% of the record set in 2003.
- By ward, new supply will be highest in Chiyoda, followed in succession by Minato, Chuo, and Shinjuku.
- In Chiyoda, large volumes of new supply will be completed in or around Marunouchi in 2012 (210,000 *tsubo*), and 2014 (140,000 *tsubo*).
- In Minato, large-scale redevelopment projects will reduce the proportion of new supply generated through reconstruction of existing buildings to 38%; supply will peak in 2014 (100,000 *tsubo*).
- In Chuo, 81% of new supply will be from reconstruction projects, the highest percentage in the 23 wards; supply will peak in 2013 (100,000 *tsubo*).
- In Shinjuku most new supply will be from new developments in areas near established business districts. Reconstruction will account for only 16% of new supply.

Tenant relocation in the 23-ward area

- Tenant relocation in 2010 included a relatively high proportion of large-scale relocations.
- Most of these large-scale relocations were within the 5 central wards, with the most popular destinations being Marunouchi, Konan and Toyosu.

- Main reasons for relocation were ‘integration of facilities due to organizational restructuring’, ‘relocation due to reconstruction of former office building’ and ‘corporate merger or consolidation’.
- Large-scale relocations primarily involved companies in the Information/Communications/IT, and Finance/Insurance sectors.

Office demand and supply in the 5 central wards

- Net new office supply will be low, except in 2012 (130,000 *tsubo*). Even in 2012, net new supply will be only 43% of the level recorded in 2003.
- The annual increase in demand in the 5 central wards has averaged 70,000 *tsubo*/year over the last 10 years. This is equivalent to 1% of total leased office space in the 5-ward area.
- Conditions are in place for a recovery in demand, but this will depend largely on corporate sentiment.
- Average net new supply over the next 4 years will total 45,000 *tsubo*/year, less than two-thirds of the historical annual increase in leasing demand.
- The influence of supply side fluctuations on the market should be minimal. The future demand-supply balance could fluctuate significantly depending on the strength or weakness of demand.
- The average vacancy rate could reach even higher levels as uncompetitive office buildings are left empty.

The future direction of the office leasing market in Tokyo’s 5 central wards will be determined primarily by demand-side trends, and these demand trends will depend largely on corporate sentiment. Monetary easing carried out by the Bank of Japan since the end of 2010 has significantly boosted the value of the stock market and the J-REIT market. If this has the effect of improving business sentiment, the office leasing market could recover very rapidly, and this in turn could generate a positive growth cycle that would revitalize the market for property sales.

However, global political and economic factors now have a much greater impact on Japanese domestic markets than ever before, and these factors are very difficult to predict. Under such conditions it will remain important to keep a close eye on trends in the global economy.

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Introduction

In August 2010 office vacancy rates (See Note) in Tokyo's 5 central wards (Chiyoda, Chuo, Minato, Shinjuku, Shibuya) reached an all-time high of 9.17%, exceeding even the levels seen after the massive influx of new supply that hit the market in 2003. Office demand has fallen for three years in a row, and since there will be a sharp surge in new supply in 2012, most forecasters have taken a rather pessimistic view of the future of the market. A number of media reports have gone so far as to claim that, "New supply in 2012 will reach all-time highs, exceeding even the level recorded in 2003," but the facts have remained unclear.

(Note: According to data published by Miki Shoji)

To get a true picture of market conditions we must subtract the amount of office space lost to the market from nominal new supply. In other words, we need to look at net new supply. This is particularly important in Tokyo's 5 central wards, where in recent years reconstruction projects have accounted for an increasing proportion of new office space. In these areas, the amount of office space removed from the market each year has reached levels that can't be ignored. For this reason we should keep in mind that it is impossible to compare 2003 and 2012 simply in terms of the volume of nominal new supply.

From the demand viewpoint, corporate earnings improved in 2010, to the extent that many companies are posting record-breaking profits. Moreover, a large number of firms reduced or deferred plans to expand their offices after the Lehman shock, and it is likely that many of these companies are starting to feel pinched for space. However, businesses are still wary of expanding or relocating their offices, particularly in light of political and economic risk factors such as the emergence of the Greece debt crisis in May, and the subsequent rise in the value of the yen and the cost of various raw materials. Nevertheless, should political and economic prospects stabilize, companies will start to firm up their business strategies and demand for office space could grow rapidly as a result of mergers, organizational reforms and restructuring.

With these various factors in mind, the present survey examined new supply of office buildings with a floor space of at least 1,000 *tsubo* in Tokyo's 23 wards over the next four years (2011~2014), as well as tenant relocation trends from January~December 2010. After clarifying factors such as leasing market trends, new supply by location and year of construction, and the types of companies that relocated in 2010, we will turn our attention specifically to Tokyo's 5 central wards, and discuss the dynamics of demand and supply in this key business area through 2014.

Notes: In the present report office buildings are categorized as follows:

Large buildings (M Class) Floor space 1,000 *tsubo* ~ 2,999 *tsubo*

Large-scale buildings	(L Class) Floor space 3,000 <i>tsubo</i> ~ 8,999 <i>tsubo</i>
Very large-scale buildings	(LL Class) Floor space 9,000 <i>tsubo</i> ~ 17,999 <i>tsubo</i>
	(XL Class) Floor space ≥ 18,000 <i>tsubo</i>

This survey of new supply covered large buildings located in Tokyo's 23 wards and used primarily as offices, with standard floors of at least 100 *tsubo* (330 m²), and total floor space of at least 1,000 *tsubo* (3,300 m²). Figures for new supply include only floor space devoted to office use, excluding retail, residential and hotel space. Data is accurate as of the end of December 2010, and was obtained by means of site surveys, published information, and interviews.

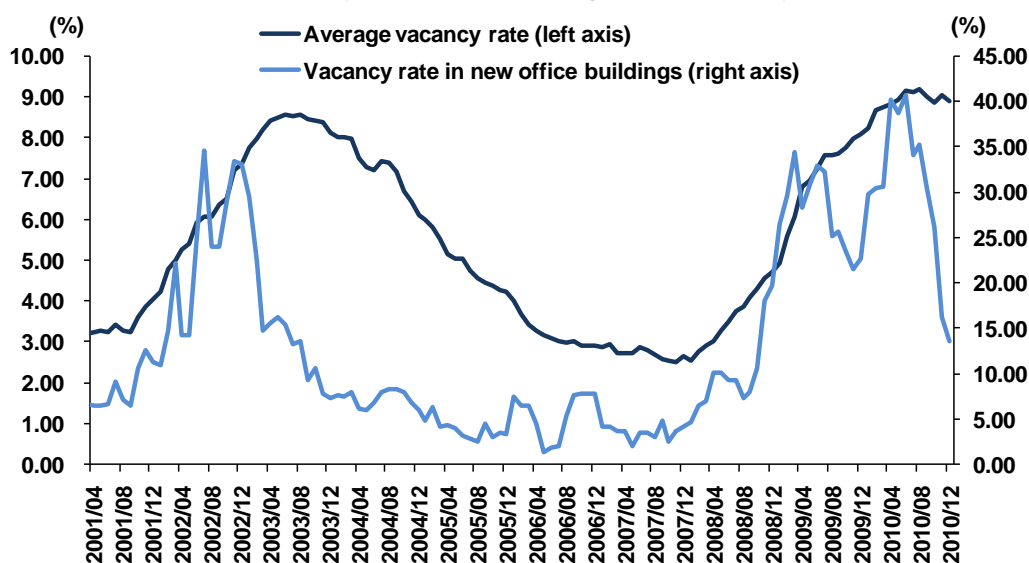
1. Office Leasing Market Trends in Tokyo's 5 Central Wards (through 2010)

1-1 Vacancy Rates

Overall vacancy rates reached an all-time high in August 2010, but showed signs of recovery in newly constructed buildings less than one year old

An examination of average vacancy rates in Tokyo's 5 central wards through 2010 showed that they peaked at 8.57% in the summer of 2003, then fell to a low of 2.49% in November 2007. Vacancies then began rising again and reached an all-time record high of 9.17% in August 2010, and currently remain at around that level. On the other hand, vacancy rates at new buildings less than one year old, a leading indicator of future market trends, had fallen to as low as 13.63% as of the end of 2010 (Fig. 1). Demand for newly constructed supply will be a key predictor of future vacancy rate trends.

Figure 1 Average office vacancy rates in Tokyo's 5 central wards, and vacancy rates in newly constructed buildings less than one year old

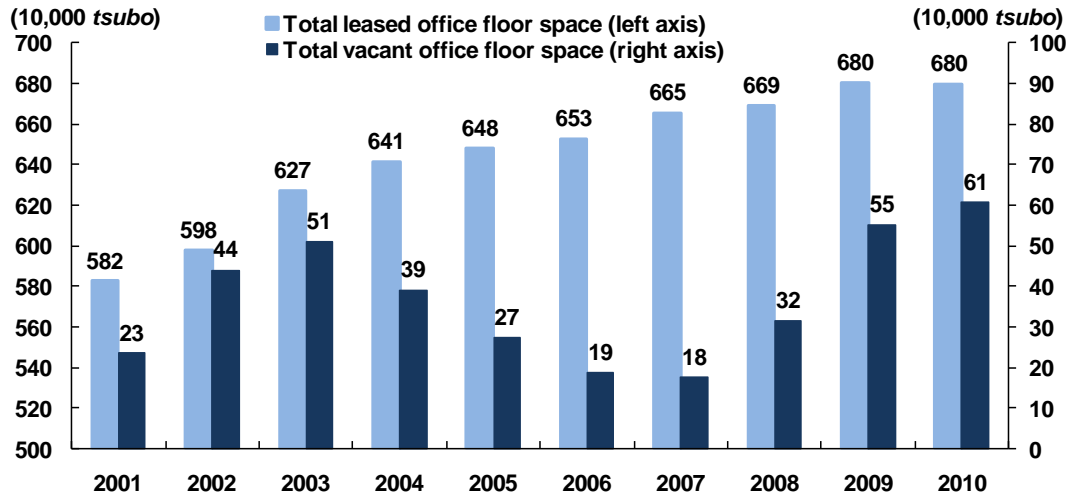


Source: NRE, based on data published by Miki Shoji.

Total stock of leased office space was unchanged in 2010, whereas the amount of vacant space increased

The total stock of leased office space in the 5 central wards, which had been growing every year, remained flat in 2010. In contrast, the amount of vacant office space rose by 60,000 *tsubo* in 2010, from 550,000 *tsubo* to 610,000 *tsubo*, clearly reflecting a decrease in demand (Fig. 2).

Figure 2 Office stocks and vacancy levels in Tokyo's 5 central wards



Source: NRE, based on data published by Miki Shoji

1-2 Nominal New Supply and Loss of Office Space

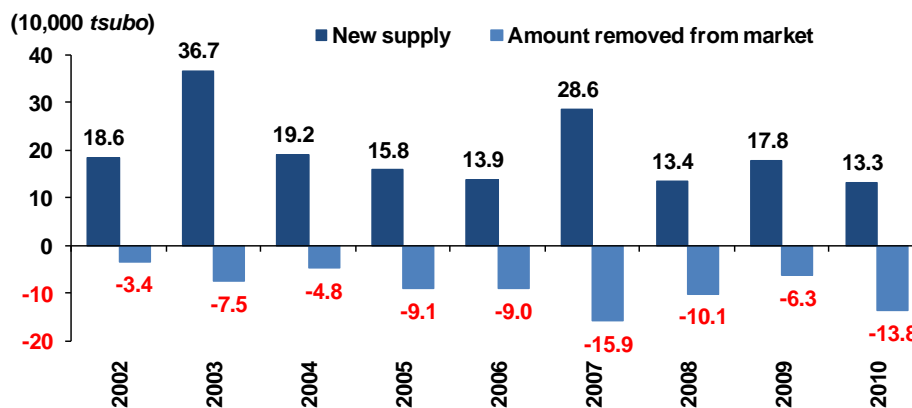
Office space removed from the market exceeded nominal new supply in 2010

Nominal new supply of leased office building space in Tokyo's 5 central wards totaled 133,000 *tsubo* in 2010. However, 138,000 *tsubo* was removed from the market during the same period, so for the first time the 5-ward area experienced a net loss of 5,000 *tsubo* of office space.

By way of comparison, during the previous peak in vacancy rates in 2003, nominal new supply was 367,000 *tsubo*, whereas losses totaled only 75,000 *tsubo*, for a net gain of 292,000 *tsubo*. As supply from reconstruction of obsolete office buildings has increased in recent years, the ratio of space removed from the market has grown. Between 2005~2010, the average amount of leased office space lost each year reached 107,000 *tsubo*.

Under these conditions, a simple comparison of nominal new supply will not give an adequate picture of how the market is changing.

Figure 3 Nominal new supply and loss of leased office space in Tokyo's 5 central wards



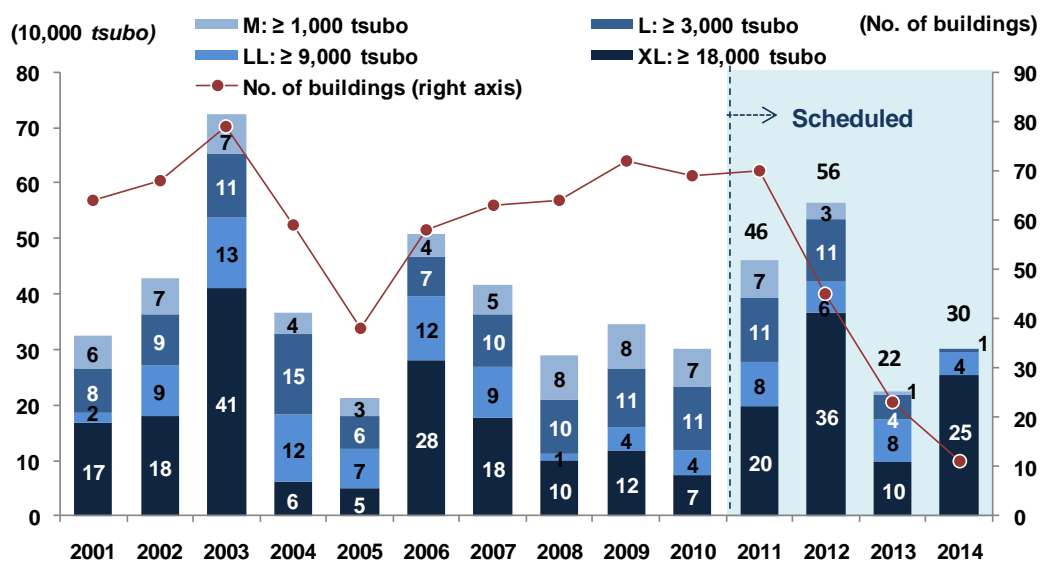
Source: NRE, based on data in materials published by Miki Shoji.

Most new supply is being created through reconstruction of older office buildings, especially in central Tokyo, so net increases in new supply are quite small. Therefore vacancy rates are being determined primarily by fluctuations in demand, rather than supply.

2. New Supply Trends in Tokyo's 23 Wards

2-1 Nominal New Supply

Figure 4 New supply of office buildings in Tokyo's 23 wards (floor space $\geq 1,000$ tsubo)



Note: This survey of new supply covered buildings used primarily as offices, with standard floors of at least 100 tsubo, and total floor space of at least 1,000 tsubo. Data was gathered from public sources, site surveys and interviews, and includes all buildings for which information was available as of the end of December 2010 (except those whose completion dates had not been decided). In the present report office buildings are categorized as M Class (floor space 1,000 tsubo ~ 2,999 tsubo), L Class (floor space 3,000 tsubo ~ 8,999 tsubo), LL Class (floor space 9,000 tsubo ~ 17,999 tsubo), and XL Class (floor space $\geq 18,000$ tsubo). The bar graph indicates supply, and shows total office floor space, excluding retail, residential and hotel space. The dashed line shows the number of buildings constructed in each year covered by the survey.

Source: NRE

New supply will be higher than average in 2011 and 2012, but will not reach 2003 levels

The volume of new office building supply in Tokyo's 23 wards (floor space $\geq 1,000$ tsubo) will total 460,000 tsubo in 2011, and 560,000 tsubo in 2012. These values are 18% and 44% higher, respectively, than the average annual amount for the last ten years (390,000 tsubo). Earlier estimates had suggested that new supply in 2012 might even exceed the amount recorded in 2003, but as a result of various delays and cancellations the final total for 2012 will

be only about 78% of the peak level reached in 2003 (Fig. 4). Specific characteristics of new supply from 2011 through 2014 are as follows.

[2011] Seventy new buildings are scheduled for completion, with a total floor space of 460,000 *tsubo*. Several projects were cancelled or delayed, but others that had been delayed in previous years finished construction, so our estimate of new supply remains unchanged from the previous survey.

[2012] New supply will consist of 45 buildings with a total floor space of 560,000 *tsubo*. About 75% of this total will enter the market during the first six months of the year. XL class buildings are expected to account for a high percentage (65%) of the overall total. Of a total of 16 XL class buildings included in this survey, 14 have already started construction. It is possible that the remaining two projects could be delayed.

[2013] New supply will be relatively low, consisting of 23 buildings with an aggregate floor space of 220,000 *tsubo*. XL class buildings will account for 43% of this total. Changes in the demand-supply balance could bring a number of delayed or temporarily shelved projects back to life.

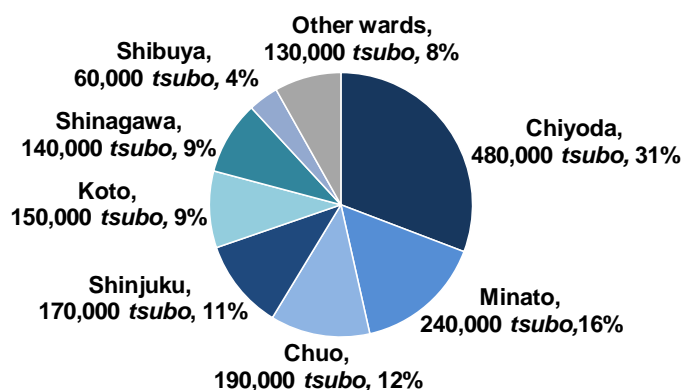
[2014] Eleven new office buildings will be completed, with a total office floor space of 300,000 *tsubo*. XL class buildings will account for an extremely high percentage (84%; 250,000 *tsubo*) of this total. Nearly all of this new supply is from urban redevelopment or building reconstruction projects which will go forward regardless of changes in the economy or market conditions.

2-2 Supply Trends from 2011~2014 by Location

Most new supply is in Chiyoda, followed by Minato, Chuo, and Shinjuku

Looking at new supply of office building space from 2011~2014 by ward, Chiyoda leads the way by far with 480,000 *tsubo* (31% of the overall total). Next comes Minato with 240,000 *tsubo* (16%), Chuo with 190,000 *tsubo* (12%), and Shinjuku with 170,000 *tsubo* (11%; Fig. 5). Koto, which has been a major source of new office supply for some time, has 150,000 *tsubo* scheduled for completion by 2012. Several projects have been put on hold in that area.

Figure 5 Distribution of new office supply in Tokyo's main wards (2011~2014)

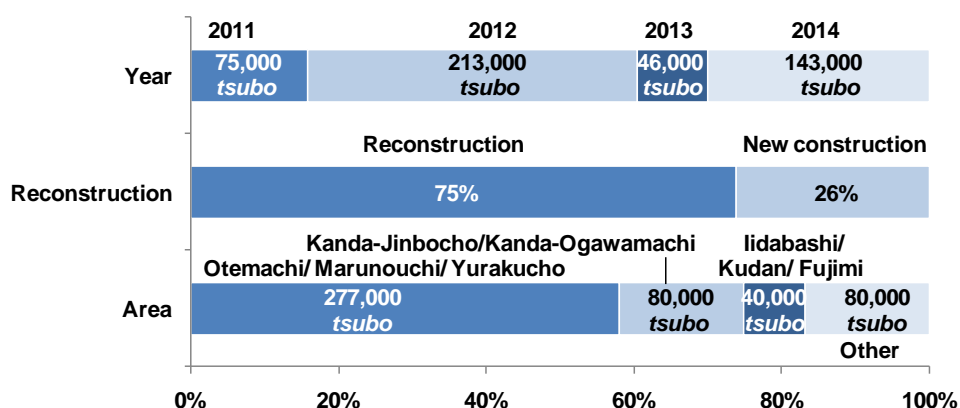


Source: NRE

[Chiyoda] New supply to total 210,000 *tsubo* in 2012, primarily in Marunouchi

Levels of new supply will be high in 2012 (210,000 *tsubo*), and 2014 (140,000 *tsubo*). Some 280,000 *tsubo* of this amount will be centered on the Marunouchi area, in projects such as the Palace Hotel hotel/office complex reconstruction project, the Marunouchi 1-4 project, the JP Tower building, and others. Next comes the Kanda-Jinbocho/Ogawamachi district, at 80,000 *tsubo*. Major projects there will include the Kanda Surugadai 4-6 Plan, and the Awajicho 2-Chome West Redevelopment Project. Third is the Iidabashi area, at 40,000 *tsubo*, in projects such as the Iidabashi Nishiguchi Redevelopment Project. Reconstruction will account for 74% of new supply.

Figure 6 New office supply in Chiyoda (2011~2014)

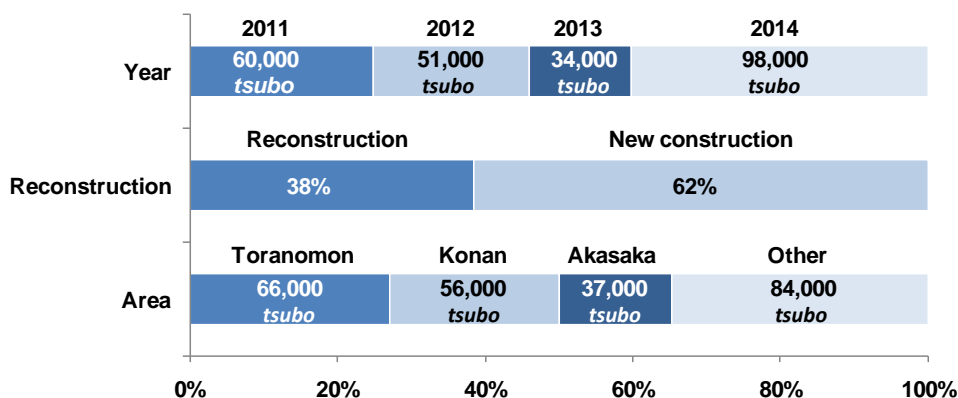


Source: NRE

[Minato] Most new supply will come from large-scale redevelopment projects

New supply will be highest in 2014 (98,000 *tsubo*). The largest amount (66,000 *tsubo*) will be generated in the Toranomon area (Loop line #2 redevelopment project, etc.), followed by Konan (56,000 *tsubo*; Shibaura Water Reclamation Center, etc.), and Akasaka (Akasaka K Tower, etc.). Urban redevelopment projects will be predominant during this period, so reconstruction will account for only 38% of new supply.

Figure 7 New office supply in Minato (2011~2014)

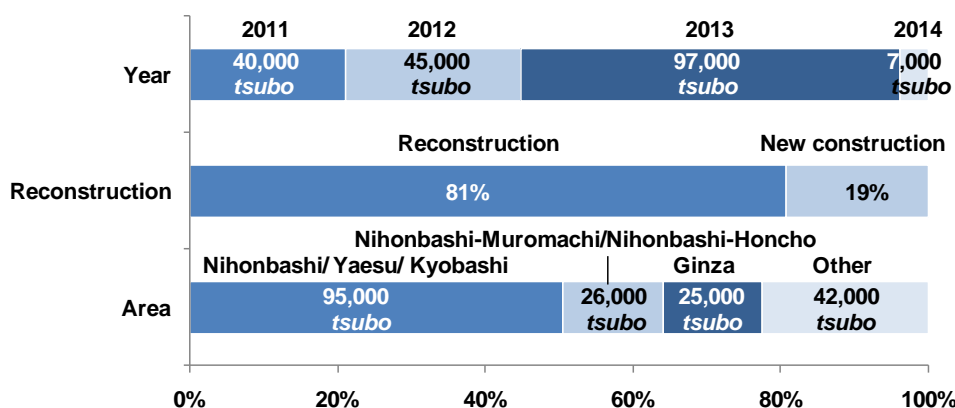


Source: NRE

[Chuo] New supply to reach 100,000 *tsubo* in 2013, with 80% from reconstruction

The largest amount of new supply (approximately 100,000 *tsubo*) will enter the market in 2013. Major sites will be Nihonbashi/ Yaesu/ Kyobashi at 100,000 *tsubo* (Kyobashi 3-1 Project, etc.), followed by Nihonbashi-Muromachi/ Nihonbashi-Honcho (Muromachi East District Development Project, Block 2-3, etc.), and Ginza (Kabukiza Redevelopment Project, etc.). Reconstruction will account for 81% of new supply, the highest ratio in the 23-ward area.

Figure 8 New office supply in Chuo (2011~2014)

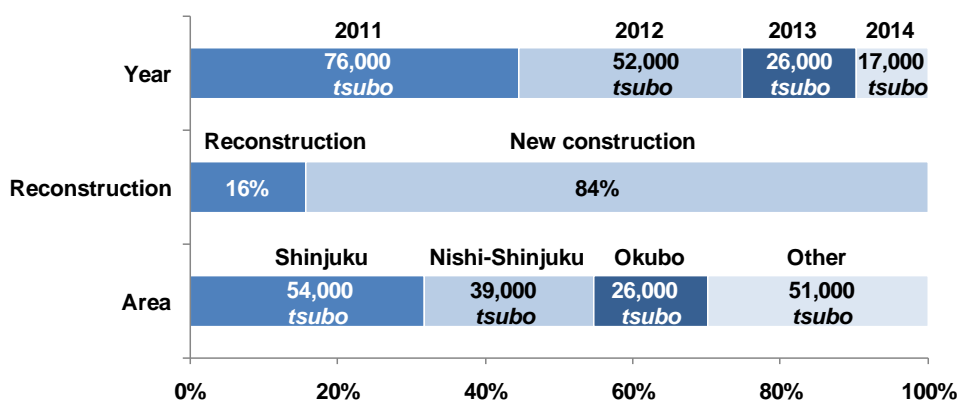


Source: NRE

[Shinjuku] Most New Supply to Come From New Construction Near Existing Business Districts

By year, the largest amount of new supply (76,000 *tsubo*) will come onto the market in 2011. By area, 54,000 *tsubo* will be created in Shinjuku proper (Shinjuku Eastside Square project, etc.), followed by 39,000 *tsubo* in Nishi-Shinjuku (Naruko Redevelopment Project, etc.), and Okubo (3-Chome West District Redevelopment Project, etc.). Most new supply will be generated by new construction in areas adjacent to well-established business districts. Reconstruction will account for only 16% of the total.

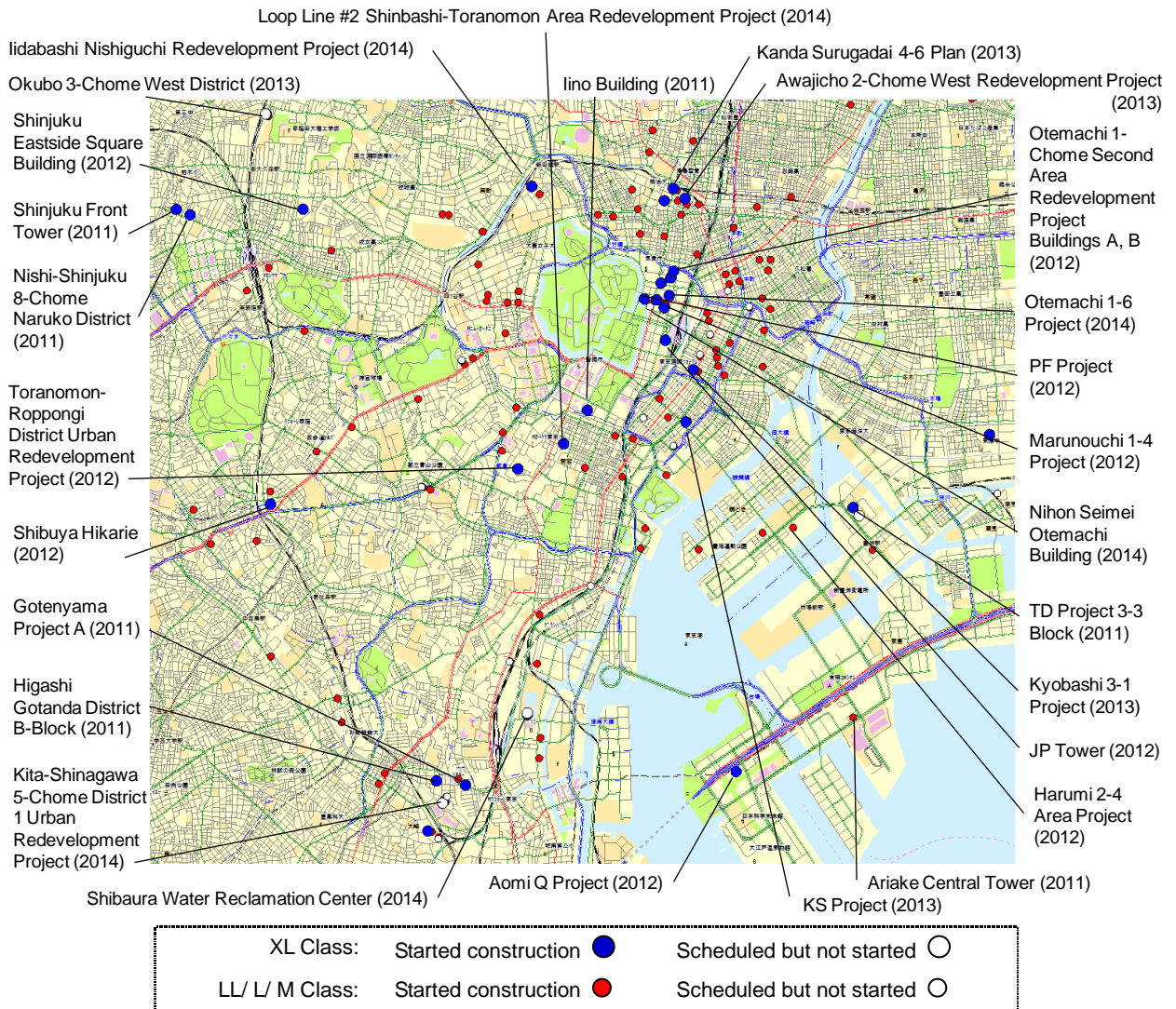
Figure 9 New office supply in Shinjuku (2011~2014)



Source: NRE

The map in Figure 10 shows the distribution of major office projects in the Tokyo area (as of December 31, 2010).

Figure 10 Major office projects in metropolitan Tokyo (2011~2014)



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Source: NRE

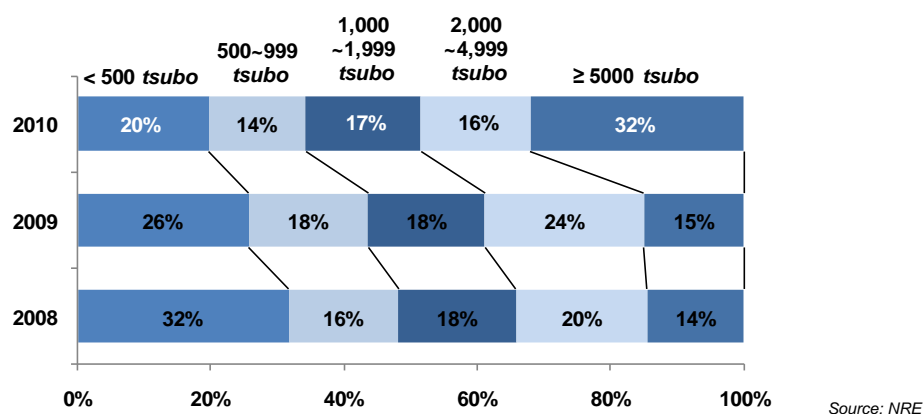
3. Tenant Relocation Trends in Tokyo's 23 wards

3-1 Tenant Relocation Trends in 2010

Ratio of large-scale relocations increased in 2010

Considering that tenant company trends are a key determinant of future office demand, we performed an analysis of corporate relocations in 2010. We determined the industry category of tenant companies, their reasons for relocation, and the areas they chose to relocate to. Figure 11 shows relocation trends for major tenants in terms of office size. In 2010, 32% of total contracted floor space in relocations was located in offices of 5,000 *tsubo* or larger, and offices of 1,000 *tsubo* or more accounted for 65% of the overall total. These figures are a clear indication that large-scale relocations are on the rise.

Figure 11 Tenant relocation by scale (floor space basis)

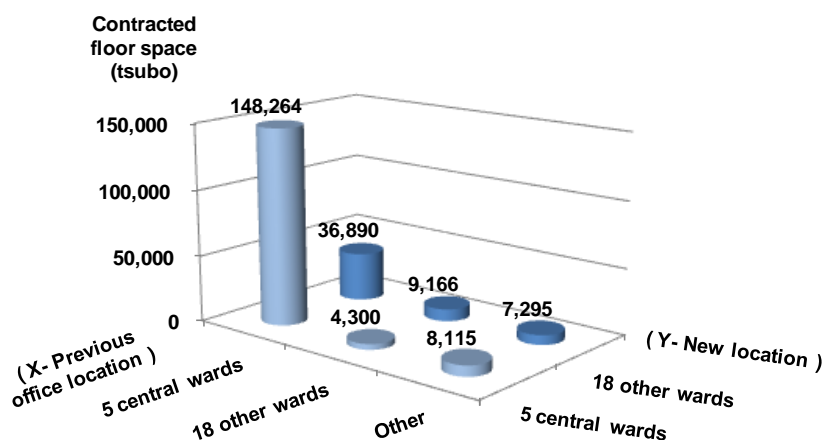


Most large-scale relocations were within the 5 central wards; top three areas were Marunouchi, Konan, and Toyosu

We looked at the previous and the new office locations for all large-scale relocations. A majority of the relocations took place within the 5 central wards (148,000 *tsubo*). Only 37,000 *tsubo* left the 5-ward area, and just 12,000 *tsubo* moved into the 5-ward area from other wards (Fig. 12-1). The most popular destination was the Otemachi/ Marunouchi/ Yurakucho district, followed by Konan (near the east entrance of Shinagawa Station), Toyosu/ Shinonome, Toranomom, and Toyochō/ Kiba (Fig. 12-2). Construction of new office buildings in peripheral areas such as Toyosu and Kiba spurred large-scale relocations to those districts. In contrast, some buildings in the central part of Tokyo were unable to adequately adjust their rents and other conditions to meet the needs of potential tenants.

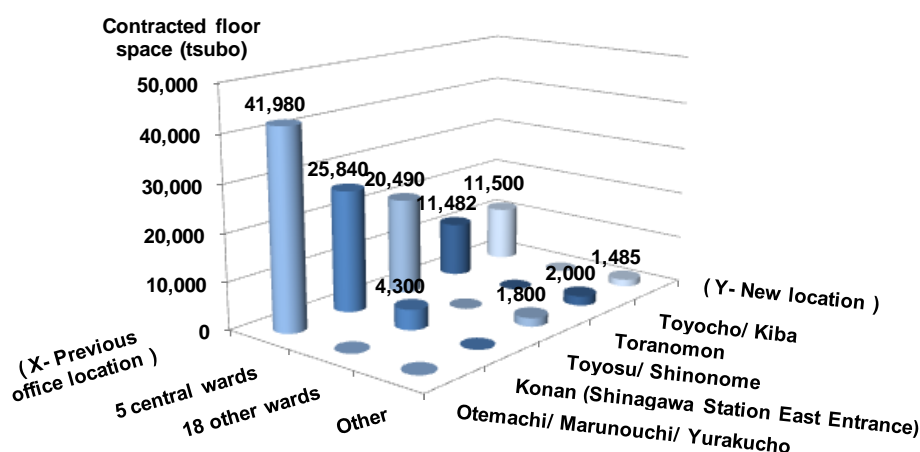
Figure 12 Relocation volume within metropolitan Tokyo
(Contracted floor space basis 2010)

1. Relocations to the central 5 wards and the remaining 18 wards



Source: NRE

2. Top 5 relocation sites



Source: NRE

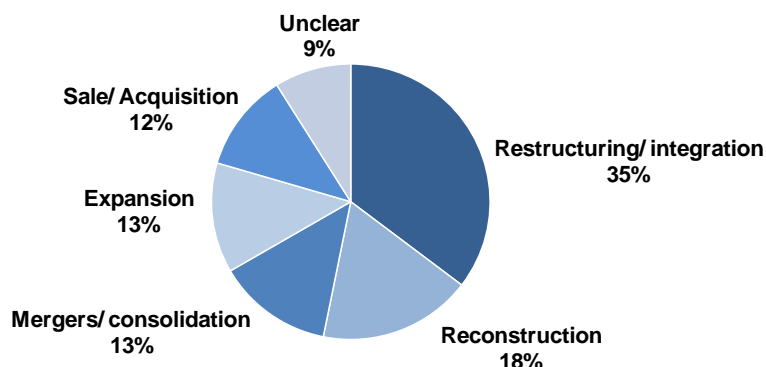
Major reasons for relocation were “integration of facilities due to restructuring”, “reconstruction of former office building”, “merger/ consolidation”

The most common reason given for large-scale relocations was “integration of facilities due to restructuring”, which accounted for 35% of the total, followed by “reconstruction” at 18%. Next came “merger/ consolidation” at 13%, “office expansion” at 13%, and “sale or purchase of office facilities” at 12% (Fig. 13). “Integration due to restructuring” and “merger/ consolidation” together accounted for 48% of the total. This result reflects the fact that companies are reviewing their existing business models and restructuring themselves to cope more dynamically with the demands of globalization. This trend can be expected to intensify and even accelerate going forward.

On the other hand, however, many buildings in central Tokyo were constructed according to outdated seismic resistance standards or have inferior specifications, and there is a shortage of high-spec large-scale office buildings that can meet the needs of rapidly evolving companies and organizations. As a result, despite the severity of current economic conditions,

reconstruction projects are going forward in order to take advantage of medium to long term demand.

Figure 13 Major reasons for office relocation (Floor space basis; 2010)

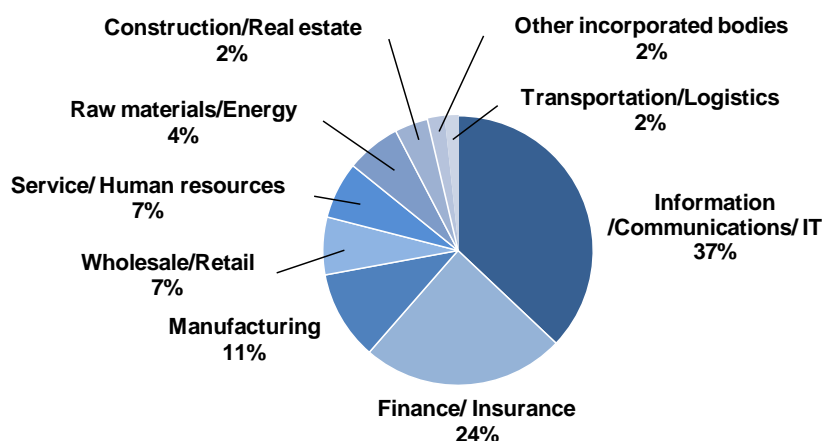


Source: NRE

Industry categories with most relocations were Information/Communications/IT, and Finance/Insurance

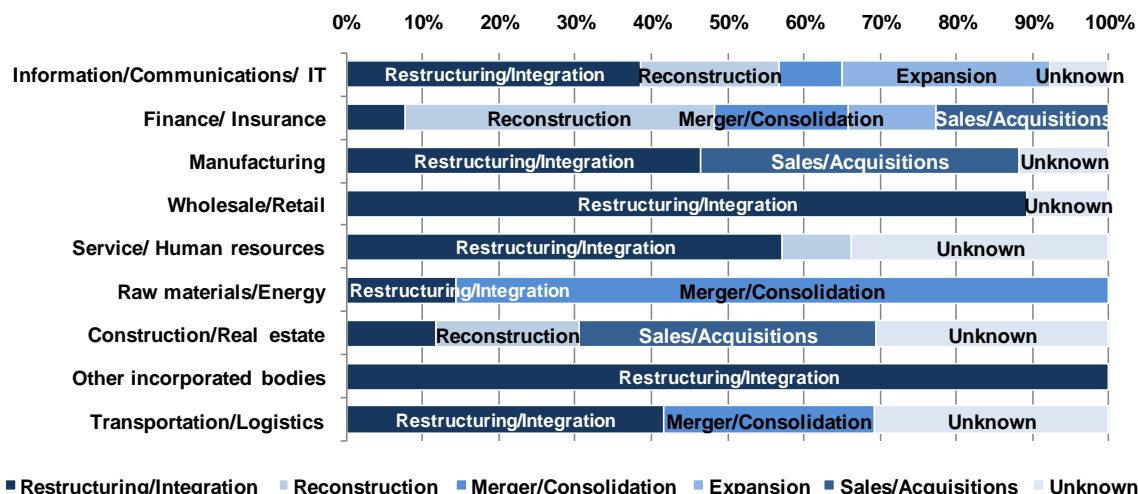
We investigated the industry categories of companies that relocated to offices with at least 1,000 *tsubo* of floor space during 2010. The industry category with the most such relocations was Information/Communications/ IT, which accounted for 37% of the overall total. This was followed by Finance/ Insurance at 24%, Manufacturing at 11%, Wholesale/Retail at 7%, and Service/ Human resources at 7% (Fig. 14). Among Information/Communications/ IT companies, the top three reasons given for relocation were restructuring/integration, expansion, and reconstruction. A large number of these companies are working to build more dynamic management structures while also trying to expand their businesses, and this is driving office demand. Among Finance/Insurance companies, in addition to mergers/consolidation, other notable factors were reconstruction and sales/acquisitions undertaken with relation to Business Continuity Planning (BCP) or Corporate Real Estate (CRE) planning (Fig. 15).

Figure 14 Office relocations by industry category in 2010 (floor space basis)



Source: NRE

Figure 15 Major reasons for relocation, by industry category (2010)



Source: NRE

Examples of Relocations Due to “Restructuring/Integration”

- IT company A moved to the Shinagawa Grand Central Building in the Konan area (12,000 *tsubo*)*
- IT company B moved to the B Company Group Head Office Building in Konan (5,300 *tsubo*)
- IT company C moved to the newly constructed Sumitomo Fudosan Iidabashi First Tower in Bunkyo (5,300 *tsubo*)
- Foundation D moved to the newly constructed Fukagawa Gatharia West No. 3 Building in Koto (4,200 *tsubo*)

Examples of Relocations Due to “Reconstruction”

- Financial company E moved from Hibiya to their newly constructed E Head Office Building in Marunouchi (15,000 *tsubo*)
- Information company F moved from Otemachi to the former Nissan Head Office Building in Chuo (8,000 *tsubo*)
- Financial company G moved from Yaesu to the Shinnihon Sekiyu Toranomom Building in Minato (5,400 *tsubo*)
- Information company H moved from Otemachi to the newly constructed Tokyu Capital Tower in Chiyoda (4,200 *tsubo*)

Examples of Relocations Due to “Mergers or Corporate Consolidation”

- Raw materials/Energy company I moved to the former Nippon Steel Head Office Building in Otemachi (12,000 *tsubo*)
- Insurance company J moved to the newly constructed Sumitomo Fudosan Shinjuku Central Park Building in Nishi Shinjuku (6,000 *tsubo*).
- Communications company K moved to the newly constructed SIA Toyosu Prime Square building in Koto (5,400 *tsubo*)

Examples of Relocations Due to “Expansion”

- IT company L moved from Harumi to the newly constructed Toyosu Front Building in Koto (10,000 *tsubo*)
- Financial company M moved from Otemachi to Roppongi Hills Mori Tower in Minato (3,500 *tsubo*)

Examples of Relocations Due to “Sales/Acquisitions”

- Financial company N moved from Otemachi to the newly constructed Fukagawa Gatharia West No. 2 Building in Kiba (7,300 *tsubo*)
- Manufacturing company O moved from Otemachi to the newly constructed Toyosu Front Building in Koto (4,600 *tsubo*)
- Financial company P moved from Uchisaiwaicho to the Nihonbashi Muromachi Nomura Building in Chuo (4,500 *tsubo*)

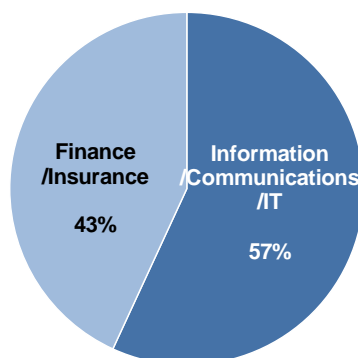
* Figures in parentheses () represent estimates of contracted floor space based on site surveys and published data.

3-2 Tenant Relocation in 2011 and Beyond

Relocation demand will continue to be driven by the Information/ Communications/ IT and Finance/ Insurance sectors

Of major relocations (floor space $\geq 1,000$ *tsubo*) scheduled for 2011 or beyond, as of the end of 2010 nine companies, representing a total floor space of 43,000 *tsubo*, had already made the decision to relocate to new buildings scheduled for construction. These were all firms in the Information/Communications/IT or Finance/Insurance sectors, which indicates that these two sectors will probably continue to drive the office relocation market (Fig. 16). Of these nine companies, two will move to buildings slated for completion in 2012.

Figure 16 Office relocations by industry category (floor space basis)
(Relocations to buildings scheduled for completion after 2011)



Source: NRE

Examples of companies scheduled to relocate after 2011

- Financial company Q will integrate its Systems Division to a new location in the Harumi 2-Chome Development, District 2-4 (10,000 *tsubo*)
- IT company R purchased the Ojima 2-Chome Project building in Koto (8,000 *tsubo*)
- Financial company S will integrate its offices and relocate to the Kodansha Mejirodai Building A in Bunkyo (5,400 *tsubo*)
- Information company T will relocate to the Fujimi 1-Chome Project in Chiyoda to consolidate its offices (3,500 *tsubo*)
- IT company U will expand its offices by relocating to Shibuya Hikarie, which is scheduled for completion in 2012 (3,000 *tsubo*)

Improved corporate earnings and higher stock prices could stimulate latent office demand

At present most office demand is being driven by companies in the Information/Communications/ IT and Finance/Insurance sectors. The major reasons given by relocating companies are “restructuring and integration”, or “mergers and consolidation”, indicating that most demand is due to the effects of organizational restructuring or changes in corporate metabolism. Future demand will depend largely on whether or not this type of relocation spreads to other industry sectors.

Our interviews of a variety of different companies revealed that under current conditions, with the exception of a few rapidly growing companies, most firms remain wary of investing in domestic office facilities. On the other hand, these companies are actively working to restructure and reorganize their businesses, and are at the same time looking for new growth opportunities. As this process of restructuring winds down and companies decide on what new growth strategies to pursue, office optimization will emerge as a major issue.

Companies that sharply reduced their conference rooms and other communication spaces in order to reduce fixed costs after the Lehman shock are starting to feel pinched for space. If business sentiment improves as a result of stronger corporate earnings and higher stock prices, this type of latent demand will come to the surface and could spark a general recovery in office demand.

4. Demand and Supply Balance in Tokyo's 5 Central Wards

4-1 Net New Supply from 2011~2014

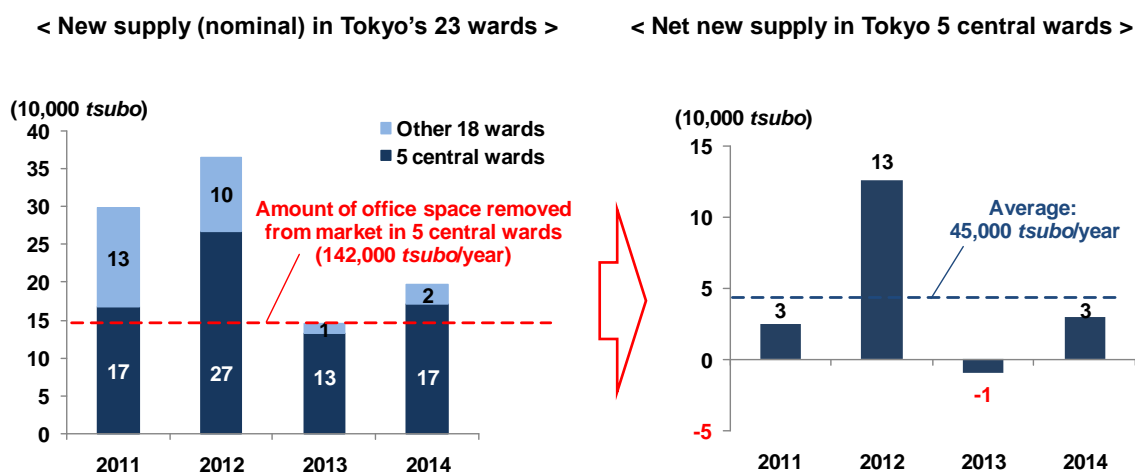
Net new supply in the 5 central wards will be low, except in 2012. Even in 2012, net new supply will be only 43% of the 2003 level

Net new office supply (new supply - lost supply = net new supply) in the 5-ward area from 2011~2014 will remain at relatively low levels, except in 2012. We estimate that the annual net increase over the 4-year period will be 45,000 *tsubo* (Fig. 17). One reason for this is that an increasing amount of office space is being removed from the market each year in the 5 central wards. During the last four years we calculate that the average amount of leased office space (including owned offices) lost each year to demolition, obsolescence or other factors was 142,000 *tsubo*/year.* The net increase in supply in 2012 will be 130,000 *tsubo*. Although this is much higher than the current 4-year average, it represents only 43% of the net new supply that entered the market in 2003.

There have been concerns that the office market would be adversely affected by the large surge in new supply in 2012, but after taking into account the amount of office space that will be removed from the market, it turns out that net new supply will be surprisingly low in the 5-ward area, where reconstruction is the main source of new office space.

* The amount of office space removed from the market in the 5-ward area was calculated by subtracting the amount of floor space in new office starts from 2003~2006 from the net increase in office stocks from 2005~2008, published in Tokyo Land Report, 2009. (The amount of leased office space was calculated from this by applying a factor of 65% to the amount of total office space).

Figure 17 Nominal new supply and net new supply of office space in Tokyo's 5 central wards (2011~2014)
(Leased office space equivalent; includes owned buildings)



Source: NRE, based on data from the Tokyo Land Report, 2009, and proprietary NRE data.

4-2 Demand Growth Trends

Net increase in demand over the last ten years has averaged 70,000 *tsubo*/year, equivalent to 1% of the total leased office stock

Figure 18 shows the amount of increase in demand* for leased office building space in the 5 central wards from 2001–2010. Demand grew from 2003 through 2007, but fell for three years in a row from 2008–2011. The ten-year average is 70,000 *tsubo*/year, which represents about 1% of the overall stock of leased office space in the market.

* (If vacancies are increasing)

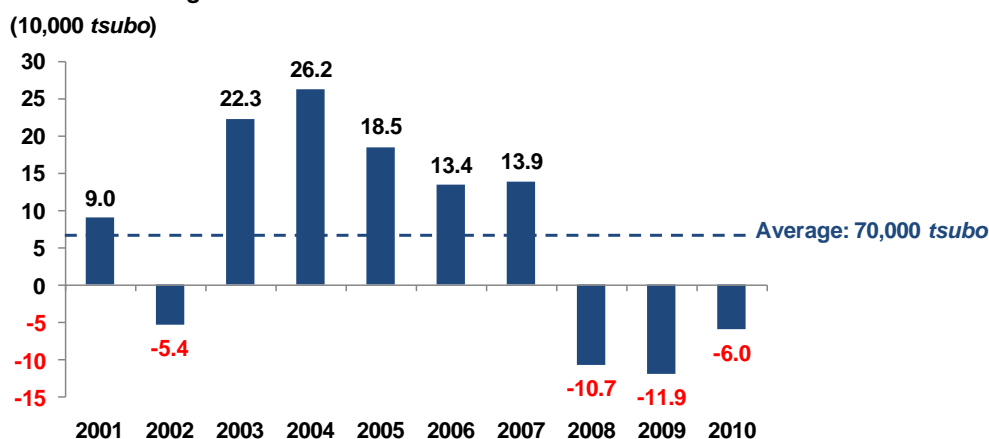
Net new demand = Net new supply – amount of increase in vacant office space

(If vacancies are decreasing)

Net new demand = Net new supply + amount of reduction in vacant office space

The office vacancy rate reached the 8% level in 2003, when a very large amount of new supply hit the market. At that time the total volume of leased office space increased (see page 7), but demand also grew by 223,000 *tsubo*. The sudden jump in new supply stimulated competition in the market and drove down rents, and this is thought to have boosted demand for large-scale relocations by firms looking to integrate their office functions. In addition, many firms put off relocation plans in 2002 in anticipation of better opportunities the following year, so there was a certain amount of pent up demand in the market.

Figure 18 Net increase in office demand in the 5 central wards



Source: NRE, based on data published by Miki Shoji

Most experts believe that under current conditions a sharp increase in office demand is unlikely. However, rent levels at newly constructed office buildings are coming down, and many companies reduced the size of their offices more than they should have after the global financial crisis. Many other firms want to expand their offices but are biding their time. Therefore, as was the case in 2003, the stage is set for the emergence of a considerable amount of latent demand. Corporate earnings are up, and should business sentiment continue to improve, a recovery in demand is quite possible.

4-3 Future Demand-Supply Balance

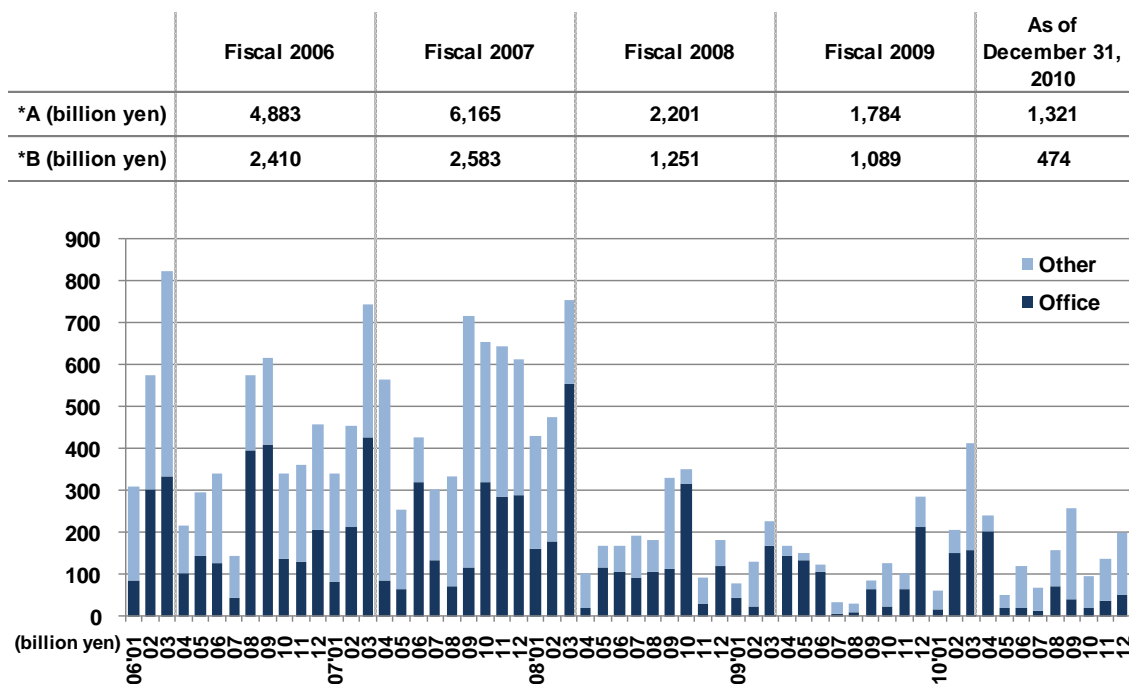
Net new supply will be less than half of the historical annual increase in leasing demand, so the future demand-supply balance could fluctuate widely depending on demand trends.

Net new supply in Tokyo's 5 central wards over the next 4 years is expected to average 45,000 tsubo/year. This is less than two-thirds of the average annual growth in office leasing demand over the last ten years (70,000 tsubo/year). Going forward, should business sentiment improve in 2011 and beyond, and office demand recover to the level of the ten-year average, the office leasing market should improve. The first half of 2012 will see a high concentration of new supply, and even if demand increases similarly, a temporary rise in vacancies is likely. However, we expect to see a significant recovery in the market during the second half of the year. It is important to keep in mind that the contraction in office demand that has continued for the last three years has generated significant latent demand. Moreover, our analysis of recent office relocations showed that despite the fact that the current outlook for the economy remains uncertain, leading companies are actively pursuing mergers and consolidation, or restructuring and integration strategies. Should this trend extend to other companies and industry sectors, market conditions could improve rapidly.

On the other hand, if business sentiment remains weak and the recovery in office demand is delayed until 2013 or later, vacancy rates in 2012 could rise to new record highs. The strength of the leasing office market in the next few years will fluctuate widely depending on demand trends, but as tenants become more selective, less attractive properties that are unable to compete will be left behind, and this could lead to vacancy rates that are relatively high compared with the historical average.

Conclusion

Figure 19 Total value of commercial real estate transactions (2006-2010)



* A : Total value of all commercial real estate transactions

* B : Total value of office real estate transactions

Source: NRE

If financial deregulation improves business sentiment, the office leasing market will recover

Turning our attention to the real estate sales market, transaction volumes have shrunk considerably since April 2008 (Fig. 19), and the total value of real estate sales transactions in 2009 fell below 2 trillion yen. There were some signs of improvement at the beginning of 2010, but recovery was delayed by the emergence of the debt crisis in Greece and other political and economic risk factors. The office sector has been particularly weak, and the sluggish office leasing market and uncertainty about the future of the economy have made investors wary.

However, the monetary easing policy implemented by the Bank of Japan led to a significant improvement in the stock market and the J-REIT market since the end of 2010. We hope that the combination of improved earnings and higher stock prices will provide a boost to business sentiment. Further, the rise in J-REIT investment unit prices has led to an increase in public offerings (PO), and this is also expected to help stimulate a recovery in the real estate market.

On the other hand, as we have described above, office leasing market conditions in Tokyo's benchmark 5 central wards are such that the market will be subject to wide fluctuations depending on how demand trends play out. If the recovery in corporate earnings and the renewed strength of the stock market cause business sentiment to improve, the demand-supply balance could improve very rapidly. In 2010, demand for large-scale relocations was driven primarily by firms in the IT or financial sectors, but if this trend spreads to other industry categories market conditions should recover strongly. A recovery in the

leasing market would also generate synergy and positively impact the real estate sales market.

However, the global economy exerts a stronger influence on domestic Japanese markets now than ever before, and global trends are very hard to predict. At present, monetary easing policies are driving up the prices of raw materials and foodstuffs, and this is having a destabilizing effect on political and economic conditions in newly emerging economies. For the foreseeable future it will be necessary to continue to carefully monitor developments in the global economy.

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Reference: “List of Very Large-Scale Buildings Scheduled for Completion from 2011~2014”**(XL Class: Floor space ≥ 18,000 tsubo)****2011**

Name of Project	Location	No. of Floors	Total floor space (tsubo)
Iino Building	Uchisaiwaicho, Chiyoda	27/B5	31,000
Shinjuku Front Tower (Kita-Shinjuku District Redevelopment)	Kita-Shinjuku, Shinjuku	35/B2	27,000
Nishi-Shinjuku 8-Chome Naruko District Redevelopment	Nishi-Shinjuku, Shinjuku	40/B3	51,000
Osaki Station West, District C Development Project (Sony Site Development)	Osaki, Shinagawa	25/B2	37,000
Gotenyama Project, Block A (Former Sony Headquarters Site Redevelopment)	Kita-Shinagawa, Shinagawa	9/B1	19,000
Higashi Gotanda District (B Block) Development Project	Higashi-gotanda, Shinagawa	21/B2	22,000
TD Project Toyosu 3-3 District	Toyosu, Koto	14/B1	29,000

2012

Name of Project	Location	No. of Floors	Total floor space (tsubo)
PF Project (Palace Hotel Redevelopment Project)	Marunouchi, Chiyoda	23/B4	42,000
JP Tower (Marunouchi 2-Chome 7 Project)	Marunouchi, Chiyoda	38/B4	64,000
Mitsui Sumitomo Insurance, Kanda-Surugadai 3-Chome Project,	Kanda-Surugadai, Chiyoda	22/B3	19,000
Otemachi 1-Chome Second District Redevelopment, Building A	Otemachi, Chiyoda	31/B4	33,000
Otemachi 1-Chome Second District Redevelopment, Building B	Otemachi, Chiyoda	35/B4	40,000
Marunouchi 1-4 Project (Togin Bldg & Sumitomo Trust and Banking Bldg & Mitsubishi UFJ Trust and Banking Bldg Redevelopment)	Marunouchi, Chiyoda	27/B4	42,000
Toranomon & Roppongi District Redevelopment	Toranomon, Minato	48/B4	43,000
Shinjuku Eastside Square Building	Shinjuku, Shinjuku	20/B2	51,000
Shibuya Hikarie (Former Tokyu Bunka Kaikan Site Redevelopment)	Shibuya, Shibuya	34/B4	44,000
Nanpeidai Project	Nanpeidaicho, Shibuya	22/B2	18,000
Toyosu 3-2 District Building	Toyosu, Koto	16/B2	29,000
Meiji-Yasuda Life Insurance New Toyochō Building	Toyo, Koto	12/B1	29,000
Aomi Q Block	Aomi, Koto	21/B1	19,000
Nakano 4-Chome Development Project, Zone 5	Nakano, Nakano	22/B1	45,000

2013

Name of Project	Location	No. of Floors	Total floor space (tsubo)
Kanda-Surugadai 4-Chome Block 6 Project	Kanda-Surugadai, Chiyoda	23/B2	30,000
KS Project (Kabukiza Redevelopment)	Ginza, Chuo	29/B4	28,000
Kyobashi 3-1 Project (Reconstruction of Katakura Kogyo Head Office Bldg and others)	Kyobashi, Chuo	24/B4	35,000
Okubo 3-Chome West District A-1	Okubo, Shinjuku	34/B2	41,000

2014

Name of Project	Location	No. of Floors	Total floor space (<i>tsubo</i>)
Otemachi 1-6 Project	Otemachi, Chiyoda	38/B6	60,000
Yomiuri Shimbun Headquarters Redevelopment	Otemachi, Chiyoda	30/B3	24,000
Sumitomo Mitsui Banking Corporation Otemachi Headquarters Building Redevelopment	Marunouchi, Chiyoda	29/B4	27,000
Iidabashi Nishiguchi Redevelopment Project	Fujimi, Chiyoda	30/B2	37,000
Loop Line #2 Shinbashi-Toranomon Area Redevelopment Project	Toranomon, Minato	53/B5	76,000
Shibaura Water Reclamation Center	Konan, Minato	32/B1	60,000
Kita-Shinagawa 5-Chome District 1 Urban Redevelopment Project	Kita-Shinagawa, Shinagawa	30/B2	27,000

* Data was collected from posted building permit signboards and other publicly available materials, and is considered valid as of the end of December 2010. Floor space figures shown here are for the entire building (rounded off to the nearest 1,000 *tsubo*).