



Japan Real Estate Investment

# REVIEW

Part II Summer 2008

**NOMURA REAL ESTATE Development Co., Ltd**

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## Investment Review 2008 Summer Edition: Part II

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## 1. Introduction

Office stocks in Tokyo's 23 wards showed robust growth through most of the 1990s, but the rate of growth slowed toward the end of the decade, and total office stocks registered their first ever decline in 2006. New supply in Tokyo is now being generated primarily by reconstruction and urban redevelopment projects, so the likelihood of large-scale net increases in supply in the next 5 or 6 years is very low. Given these circumstances, we asked ourselves how the office market in Tokyo was likely to perform between now and 2011.

In our 'Investment Review 2008 Summer Edition: Part I' we surveyed the current status of office stocks in Tokyo, and took a fresh look at Tokyo's 'Prime Business Areas' by analyzing the relative concentrations of large-scale office buildings and major corporate head offices in various sub-districts within the Tokyo area.

In the present report ('Investment Review 2008 Summer Edition: Part II') we examine new supply trends in terms of building scale and location, along with the latest demand and tenant relocation trends in the Tokyo area. We then look at the balance between supply and demand in Tokyo's office market from 2008~2011, and attempt to clarify factors that could affect the market equilibrium during this period.

### **Point 1 Annual new supply from 2008~2011 will average 1,000,000 m<sup>2</sup>**

**-- Down 30% compared with 2003~2007 --**

Average new supply of office space in large-scale office buildings of B Class ( $\geq 3,300$  m<sup>2</sup>) or larger scheduled for completion in the period from 2008~2011 is expected to be around one million m<sup>2</sup> per year. This is approximately 30% lower than the average annual new supply of 1.47 million m<sup>2</sup>/year that was recorded from 2003~2007. In terms of scale, we found that new supply of extremely large-scale buildings of S class or greater (floor space of 30,000 m<sup>2</sup> or greater) will remain low through 2010. As a result, the supply side of the market for the time being will be dominated primarily by A class or smaller buildings (floor space less than 30,000 m<sup>2</sup>). The supply of S class or larger buildings will increase in 2011.

### **Point 2 Supply and demand trends weak in anticipation of market correction**

Vacancy rates in Tokyo's 5 central wards fell steadily until November 2007, but since that time they have trended upward. The number of relocations to the 5-ward area is also declining, especially among large-scale tenants. Although it is still a lender's market, we appear to have entered a period of correction, and many potential corporate tenants are taking a wait-and-see attitude in anticipation that rising vacancy rates may put downward pressure on rents.

**Point 3 New supply through 2011 will not affect the current balance between supply and demand**

Actual (net) new supply for the period 2008~2011 is estimated to be around 130,000 m<sup>2</sup>, if we take into account the loss of floor space through demolition of older buildings constructed prior to the introduction of current seismic resistance standards (assuming a 50-year lifecycle for older buildings of this type). This level of net new supply represents only 0.4% of total leased office stocks in the 5-ward area, so even in the absence of additional new demand the equilibrium between supply and demand is unlikely to be affected significantly.

**Point 4 Quality gap is widening**

The ongoing trend toward corporate consolidation and integration is creating needs for office space with improved specifications. Potential tenants are paying closer attention than ever before not only to location, but also to the quality of individual buildings. Older generation buildings are steadily being demolished and reconstructed. As a result, rising vacancy rates and falling rents are gradually driving inferior buildings out of the market.

(Note: In this report we use the following building-scale classifications.

- SS Class                    Total floor space  $\geq$  60,000 m<sup>2</sup>
- S Class                    60,000 m<sup>2</sup> > Total floor space  $\geq$  30,000 m<sup>2</sup>
- A Class                    30,000 m<sup>2</sup> > Total floor space  $\geq$  10,000 m<sup>2</sup>
- B Class                    10,000 m<sup>2</sup> > Total floor space  $\geq$  3,300 m<sup>2</sup>

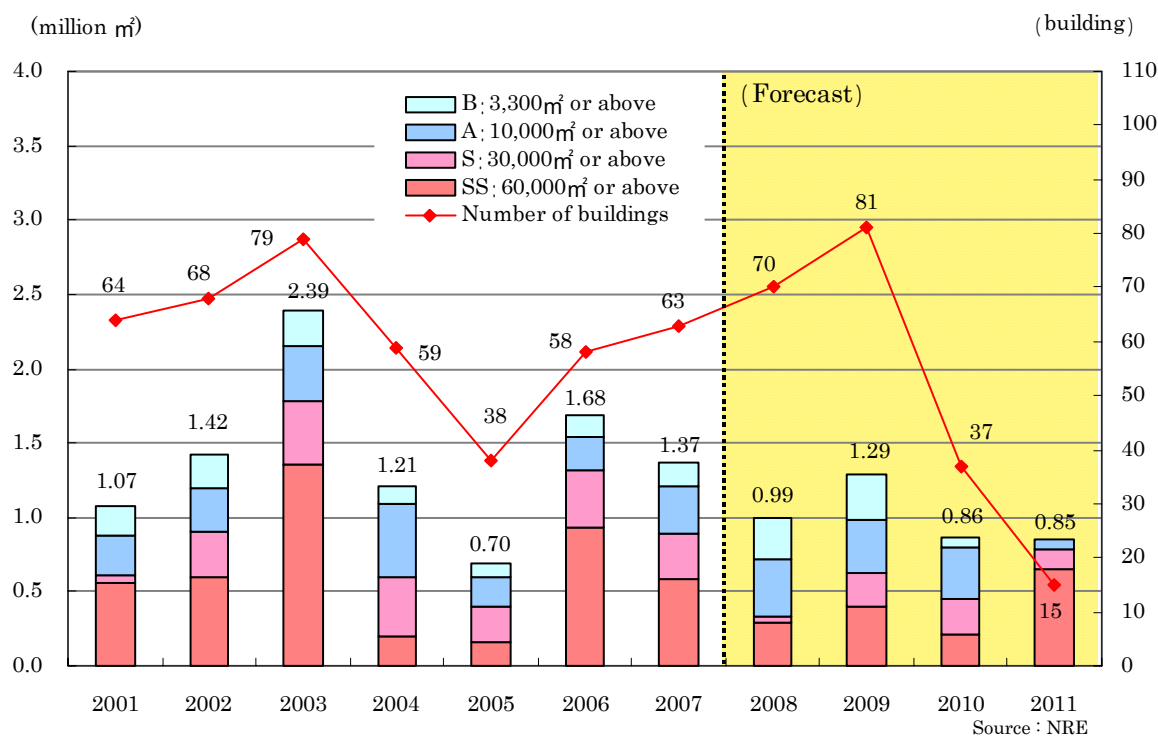
Buildings included in the present survey of new supply were limited to those intended primarily for use as office space, with a standard floor size of at least 330 m<sup>2</sup> (approximately 100tsubo), and a total floor space of at least 3,300 m<sup>2</sup> (approximately 1,000 tsubo). The amount of new supply shown represents total floor space used for office purposes. The figures are current as of the end of March 2008.

## 2. Tokyo Office Building Market

### 2-1 New Supply of Large-scale Office Buildings in Tokyo's 23 wards

#### 2-1-1 New Supply from 2008~2011

**Figure 1 New supply of office buildings in Tokyo's 23 wards (floor space  $\geq 3,300 \text{ m}^2$ )**



Note: New supply indicated in the bar graph represents total floor space in areas devoted to office use, excluding retail, residential, hotel and other areas. Red line shows the number of buildings completed each year.

Figure 1 shows the new supply of office buildings with a total floor space of 3,300 m<sup>2</sup> or greater in Tokyo's 23 wards between 2001 and 2011 (including those scheduled for completion during this period). Calculating the totals for 2008~2011 we find that new supply will average 1,000,000 m<sup>2</sup>/yr. This is about 30% lower than the annual average of 1.47 million m<sup>2</sup> constructed in the previous 5-year period (2003-2007).

**2008:** Seventy office buildings are scheduled for completion in 2008, with a total floor space of 990,000 m<sup>2</sup>. The number of buildings is higher, but total floor space is 28% less than in 2007. Only 4 buildings of S or SS class will come onto the market. Most new supply will come in the form of smaller A and B class buildings (<30,000 m<sup>2</sup>).

**2009:** More new office buildings will be completed in 2009 than in any year since 2001. The number of A and B class buildings will peak at 31, exceeding the number completed in 2008. The shortfall in office supply that continued through 2007 is thought to have stimulated this burst in development of smaller A and B class buildings, which can be completed in a

relatively short period.

**2010:** New supply of floor space will fall to only 67% of the level generated in 2009. Increased economic uncertainty is expected to cause developers to delay or reevaluate current construction plans. However, as we observed in 2008 and 2009, the number of A class and smaller buildings could rise if market demand strengthens in the near term.

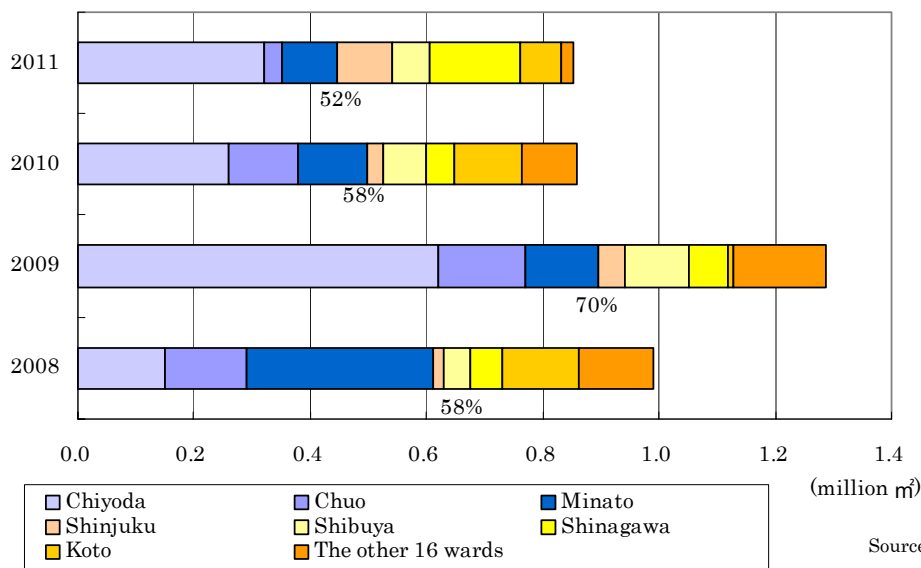
**2011:** Seven SS scale buildings will be completed in 2011. These will consist primarily of reconstruction projects. Most of the future building plans we are currently aware of are S class or larger. Depending on how the market develops, we could see a large increase in the number (and floor space) of A or B class buildings in 2011.

**2-1-2 New Supply by Ward and Sub-district**

Looking at the geographical distribution of new supply over the next four years (2008-2011) we find that the largest amount (34%) will be located in Chiyoda ward, followed by Minato (17%), Chuo (11%), Shinagawa (8%), Koto (8%), Shibuya (7%), and Shinjuku (5%). A relatively large quantity of new supply will be created in the waterfront districts of Shinagawa and Koto, exceeding the amount of new floor space in Shinjuku and Shibuya combined.

Figure 2 shows cumulative new supply of office buildings in Tokyo’s major wards from 2008-2011. The figures (%) shown represent the proportion of new supply located in the three central wards (Chiyoda, Chuo, Minato). In 2008 new supply will be quite low in Chiyoda and highest in Minato, but in 2009 and beyond Chiyoda will again return to the top spot. Moreover, in 2009 the three central wards will account for 70% of total new supply, but thereafter the ratio will fall to between 52-58%, indicating that peripheral wards will begin to account for an increasing proportion of new office supply.

**Figure 2 Supply of large-scale office buildings (≥3,300 m<sup>2</sup>) in Tokyo’s major wards**



Source : NRE

\* Figures (%) in the chart indicate the proportion of new supply located in the three central wards.

**Several SS class buildings will be completed in Chiyoda each year starting in 2009**

Chiyoda, which has long played a central role in the office market, will generate less than 200,000 m<sup>2</sup> of new supply in 2008. However, SS scale buildings are scheduled for completion in Chiyoda each year from 2009-2011, primarily as a result of reconstruction and so-called 'linked redevelopment projects'. This new supply will be concentrated in the area surrounding Tokyo Station. Major projects will include the Marunouchi Park Building (2009), Marunouchi 1-Chome Area Development Project (2010), and the Marunouchi 2-Chome Plan (2011).

**Large-scale redevelopment has ended in Minato; most new buildings from now on will now be S class or smaller**

The Akasaka Biz Tower will be completed in Minato in 2008, but no other SS class projects are scheduled for completion during the study period, except for the Chunichi Shimbun Shinagawa Project, which will be finished in 2010. From 2009 onwards annual new supply will be in the 100,000 m<sup>2</sup> range.

**Shinagawa will see large-scale increases in new supply in 2011 due to redevelopment projects**

Redevelopment projects involving former manufacturing sites of major corporations are slated for completion in Shinagawa in 2011, and these will generate a large-scale increase in new office supply, primarily in the Osaki area.

**Office buildings will increase in the waterfront districts of Koto ward**

In recent years Koto has joined Shinagawa as a major new business center. Office building developments are going forward in waterfront districts such as Shinonome (2008), Ariake (2010,2011), and Kiba (2010). Large-scale office buildings are also scheduled for completion in Toyosu in 2012 and thereafter.

**By area, the largest amount of new office supply will be located in Otemachi/ Marunouchi/ Yurakucho, followed by Akasaka and Osaki/Kita-Shinagawa**

We divided Tokyo's 6 central wards into 43 sub-districts. The sub-districts with the largest amount of new office supply in 2008~2011 are shown in Table 1. Otemachi/ Marunouchi/ Yurakucho will have the vast majority of new supply, followed by Akasaka, Osaki/ Kita-Shinagawa, Uchisaiwaicho/ Kasumigaseki/ Nagatacho, and then Nihombashi/ Yaesu/ Kyobashi, in that order. It is clear that new supply will be concentrated in currently recognized prime business areas.

\* These are the same 43 sub-districts within Tokyo's 6 central wards (Chiyoda, Chuo, Minato, Shibuya, Shinjuku, Shinagawa) that were used in Part I of this Review to rank Tokyo's Prime Business Areas.

**Table 1 Relative share of new office supply by sub-district (floor space basis) from 2008-2011**

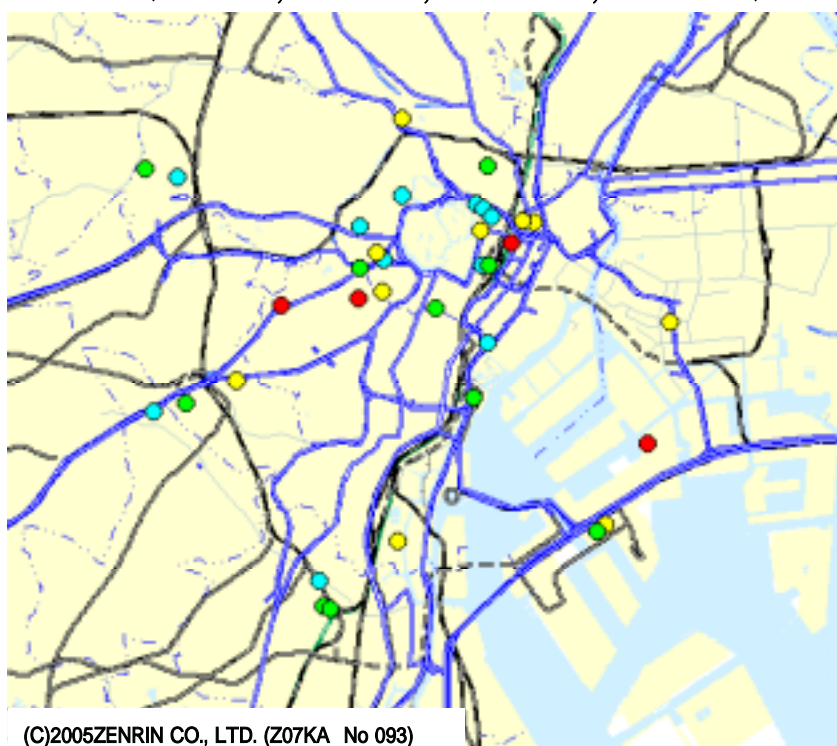
	Sub-district	Ratio
1	Otemachi/Marunouchi/Yurakucho	17%
2	Akasaka	5%
3	Osaki/Kita-shinagawa	5%
4	Uchisaiwaicho/Kasumigaseki/Nagatacho	4%
5	Jinnan/Udagawacho/Dogenzaka	3%
6	Nihombashi/Yaesu/Kyobashi	3%
7	Kanda-jinbocho/Kanda-ogawacho	3%
8	Ginza	3%
9	Kojimachi/Hirakawacho/Kioicho	2%
10	Nihombashi-muromachi/Nihombashi-honcho	2%

Source : NRE

**2-1-3 Distribution of New Supply of Extremely Large-scale (S Class or larger) Office Buildings**

The map in Figure 3 shows the locations of extremely large-scale S Class ( $\geq 30,000 \text{ m}^2$ ) or SS class ( $\geq 60,000 \text{ m}^2$ ) office buildings scheduled for completion in the Tokyo area between 2008 and 2011. Colors indicate the expected year of completion. The number of new projects in the vicinity of Tokyo Station remains large, but the overall distribution covers a relatively wide area (See Reference 1).

**Figure 3 Distribution of new supply of extremely large-scale (S class or larger) office buildings scheduled for completion in 2008~2011 (Red: 2008, Blue: 2009, Yellow: 2010, Green: 2011)**



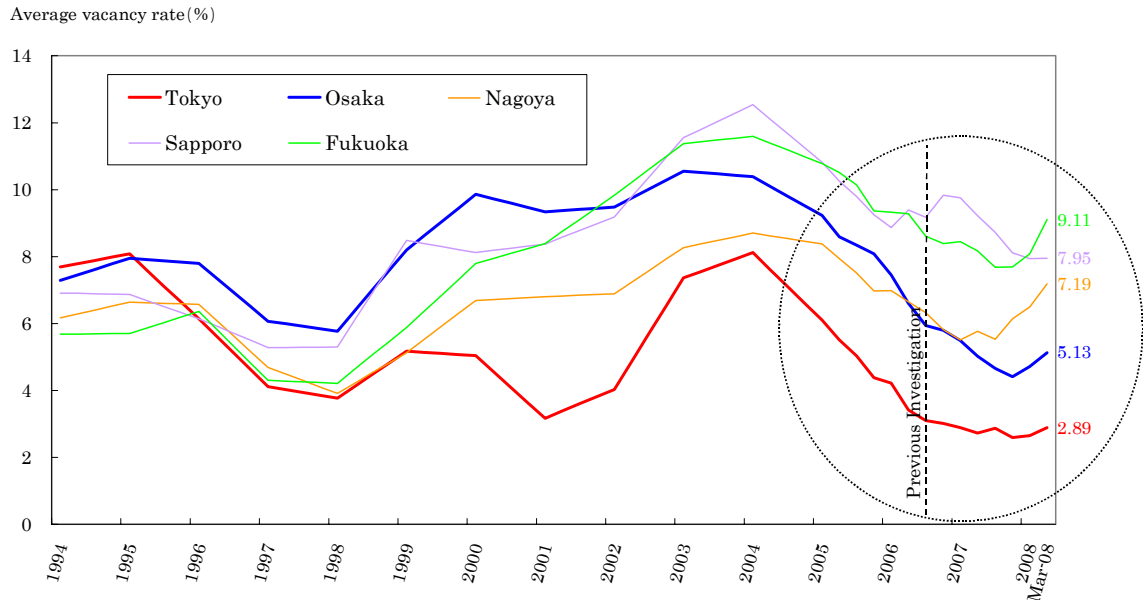
(C)2005ZENRIN CO., LTD. (Z07KA No 093)

Source : NRE

2-2 Supply and Demand Trends

2-2-1 Supply and Demand Trends in Tokyo and other Major Japanese Cities

Figure 4 Average office vacancy rates in business districts of major Japanese cities (December 1994~ March 2008)



Source : NRE, based on data Miki Shoji Co.,Ltd.

Figure 4 shows office vacancy rates in the major business districts of Tokyo, Osaka, Nagoya, Sapporo and Fukuoka. The most recent data indicate that the trend towards lower vacancy rates has ended, as vacancy rates are increasing in nearly all of these cities. Tokyo is no exception, however the vacancy rate in Tokyo as of the end of March 2008 was still low (in the 2% range), so the office market remains stronger there than in other major urban centers.

Figure 5 Vacancy rates in large-scale office buildings in metropolitan Tokyo (as of March 2008; Figures in parentheses indicate the change compared with March 2007)

Tokyo 23 wards	1.6%	(no change)	)		
3 central wards	1.9%	(up 0.5 points vs.2007)	)	Chiyoda	0.7% ( +0.1 )
6 downtown wards	1.2%	(no change)	)	Chuo	1.6% ( +0.4 )
14 neighboring wards	1.2%	(down 2.4 points vs.2007)	)	Minato	3.1% ( +0.9 )
3 neighboring prefectu	5.2%	(up 1.3 points vs.2007)	)	Shinjuku	2.1% ( +0.5 )
				Shibuya	1.2% ( +0.8 )
				Toshima	0.8% ( -0.8 )
				Bunkyo	1.3% ( +0.1 )
				Shinagawa	0.2% ( -0.8 )
				Taito	1.0% ( -0.9 )

Source : NRE, based on data from Sanko Estate

Note: Vacancy rates in Figures 4 and 5 differ because they are based on data obtained by different research institutes using slightly different study criteria.

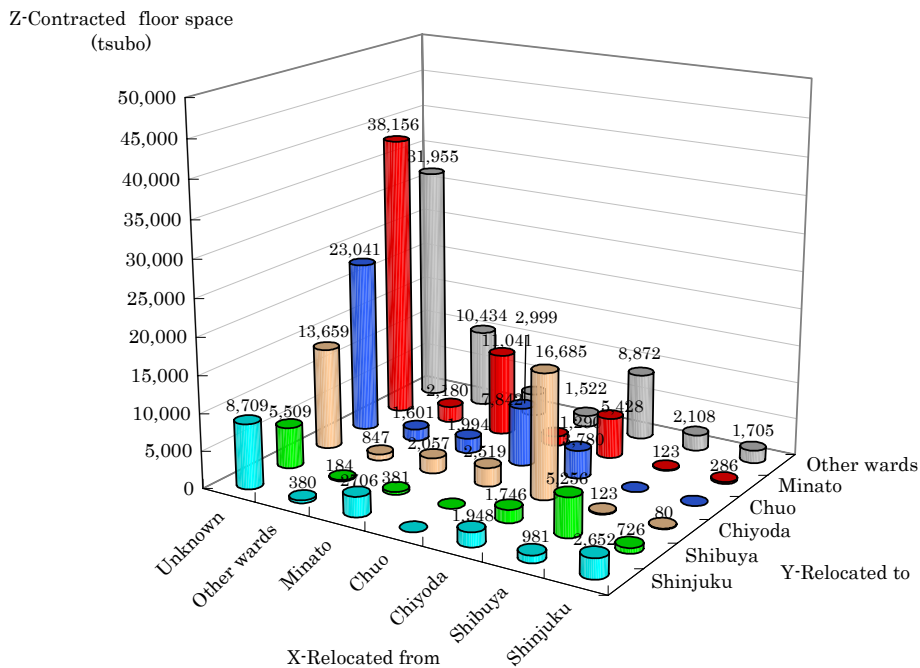
Figure 5 shows vacancy rates in large-scale office buildings in central Tokyo and surrounding wards as of March 2008. Figures in parentheses indicate the change compared with March 2007.

The data indicate that vacancy rates are worsening slightly in 6 of the 9 most central wards, and improving in peripheral wards such as Toyosu, Shinagawa, and Taito. It appears that high rent levels and a shortage of buildings that meet current tenant needs in central Tokyo are pushing up demand in these outlying wards. Vacancy rates are falling in the 14 remaining wards, but are rising in the three surrounding prefectures, so supply and demand trends in the greater metropolitan area present a rather uneven pattern.

**2-2-2 Tenant Relocation Trends in Tokyo’s 5 Central Wards (2007)**

Figure 6 illustrates tenant relocation volumes on a contracted floor space basis in central Tokyo for fiscal 2007 (April 2006-March 2007). Data shown are for relocations between Chiyoda, Chuo, Minato, Shinjuku, Shibuya, or Other areas. Former locations are shown on the X axis, new locations are shown on the Y axis, and relocation volumes (contracted floor space) are shown on the Z-axis. Former locations marked “Unknown” indicate tenants moving from self-owned office buildings, or tenants that consolidated multiple offices into a single location.

**Figure 6 Tenant relocation within Tokyo’s 5 central wards (Contracted floor space basis; April 2006-March 2007)**



Source : NRE

### **Tenant relocation in fiscal 2007**

The tenant relocation volume in fiscal 2007 totaled 210,000 tsubo. This represented a decline of 25% compared with the 280,000 tsubo recorded in fiscal 2006. The only large-scale (>10,000 tsubo) relocation involved the shift of Company A to the Granpark Tower.

### **Examples of relocation to new buildings completed in 2007**

- Company B completed construction of its own office building and consolidated its formerly dispersed office operations into the new building (approximately 4,800 tsubo)
- Company C shifted to the Shiodome Building (approx. 3,500 tsubo)
- Company D moved to the Think Park Tower (approx. 2,000 tsubo)
- Company E moved to the Think Park Tower (approx. 1,500 tsubo)
- Company F moved to the NBF Toyosu Garden Front (approx. 1,800 tsubo)
- Company G moved to the Sumitomo Fudosan Harajuku Building (approx. 1,500 tsubo)

### **Examples of relocations to or from existing buildings**

- Company A moved to the Granpark Tower (approx. 10,500 tsubo)
- Company H moved to the Monbukagakushou Building due to the closure of the Mizuho Bank Otemachi Head Office Building for reconstruction (approx. 8,000 tsubo)
- Four companies merged to form a single corporation and leased the Mitsubishi Tokyo UFJ Bank Nihonbashi No. 2 Annex Building in its entirety (approx. 5,800 tsubo)
- Company J moved to the Telecom Center Building (approx. 3,200 tsubo)
- Company L (approx. 2,500 tsubo) and Company M (approx. 1,500 tsubo) moved to the Shinagawa Seaside Panasonic Tower when Company K shifted a part of its offices out of that building.

### **Scheduled relocations to buildings currently under construction**

- Company N plans to relocate to the ‘Osaki 1-Chome Project’ (tentative name) (approx. 3,600 tsubo)
- Company O plans to move to the Nihombashi 3-Chome Project (tentative name) (approx. 2,400 tsubo)
- Company P will move to the Marunouchi Trust Tower Main Building (approx. 2,000 tsubo)

Relocation volumes fell in fiscal 2007. Noticeable trends during this year were shifts from older buildings to new buildings within Chiyoda, Minato and Shinagawa, and relocations

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due to the closure of older buildings for reconstruction. In contrast, most relocation in fiscal 2005 involved shifts away from central Tokyo to destinations in other wards (Koto, Shinagawa, etc.), while 2006 was characterized by large-scale corporate consolidations to locations in Chiyoda and Minato.

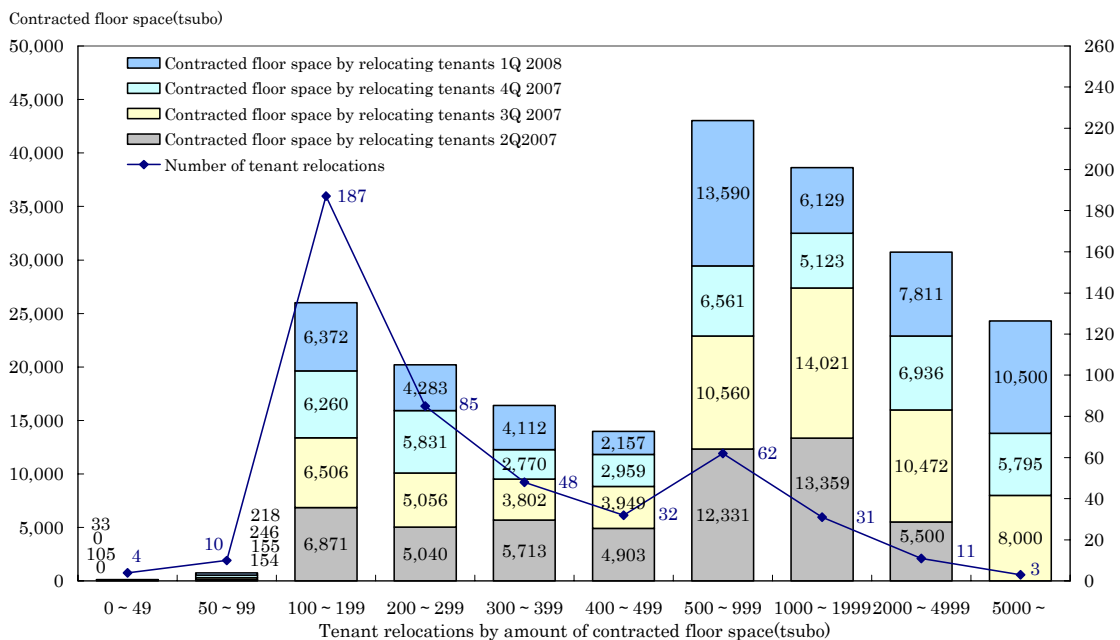
This data is based on contract information available at the time this report was compiled, so it includes buildings that have not yet completed construction.

### 2-2-3 Number of Tenant Relocations and Total Contracted Floor Space in Tokyo's 23 Wards

Figure 7 shows tenant relocation trends in Tokyo's 23 wards in fiscal 2007. The bar graph shows cumulative floor space by quarter and by size, while the dashed line indicates the total number of relocations. This amount of contracted floor space shown, including the expansion of offices in current buildings, represents new demand. However, information was unavailable for some self-owned or other types of office buildings, so it is expected that the actual figures for new demand were somewhat larger than the amounts shown here.

Overall contracted floor space was slightly less than 210,000 tsubo, and the total number of relocations was 473. Offices of 500 tsubo or less accounted for a total of 77,000 tsubo, while offices over 500 tsubo in size accounted for 137,000 tsubo, which indicates that about two-thirds of the total consisted of large-scale relocations. The figures for large-scale relocations include approximately 16,000 tsubo (11%) scheduled for new buildings still under construction.

**Figure 7 Number of tenant relocations and total contracted floor space in Tokyo's 23 wards (by size; April 2007~March 2008)**

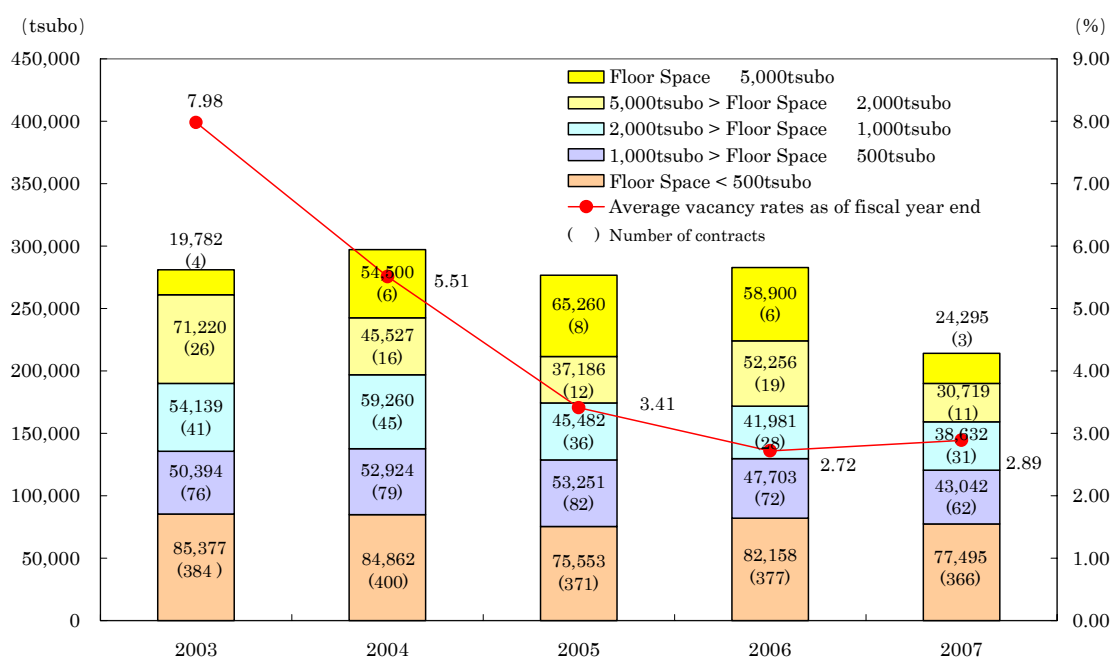


Source : NRE

By comparison, in 2006 total contracted floor space due to tenant relocation ( $\geq 500$  tsubo) was 201,000 tsubo, including 83,000 tsubo (41%) in new buildings that were still under construction. Future demand (floor space reserved in buildings still under construction) shrank significantly in 2007 compared with 2006.

Figure 8 shows tenant relocation levels since fiscal 2003, classified according to the scale of the relocation. It is clear from this graph that the total relocation demand fell in fiscal 2007, and that the decline in large-scale relocations was particularly remarkable.

**Figure 8 Contracted floor space due to tenant relocation volume, number of contracts, and average vacancy rates**



Source : NRE

What does this data on tenant relocation volumes tell us about demand in 2008?

First, new supply in 2008 is expected fall 28% compared with 2007, to 990,000 m<sup>2</sup> (See Figure 1). However, when we take into account the fact, as mentioned above, that future demand fell sharply in 2007 as compared with 2006, it is possible that vacancy rates may rise even further in 2008. Many tenant companies are currently taking a wait-and-see attitude in anticipation of a possible market correction, so it will be necessary to monitor future trends very closely. A rise in vacancy rates during the second half of 2008, for example, could put a sharp brake on new supply.

In such a scenario future supply might not increase, and our supply forecast (see Figure 1) could end up being too high.

### 3. Supply and Demand Forecasts for 2008~2011

#### 3-1 Actual Net New Supply

Because most new office supply in central Tokyo is being generated as a result of reconstruction of older buildings or urban redevelopment projects, it is important to recognize that floor space from new construction represents only nominal new supply. To calculate the actual net increase in office stocks it is necessary to subtract from nominal new supply the amount of office space lost due to reconstruction or diversion to other uses.

In our previous report ('Investment Review: Winter 2007') we divided office stocks into leased and self-owned office buildings, and estimated the amount of office space that would be removed from the market assuming building lifecycles of either 50 or 60 years. In the present report we limited our focus to older generation buildings constructed prior to the introduction of current seismic resistance standards, and assumed a building lifecycle of 50 years. Our estimates of actual (net) new supply also take into account the results of our study of large-scale office buildings ( $\geq 10,000$  m<sup>2</sup>) presented in 'Investment Review 2008 Summer Edition: Part I'.

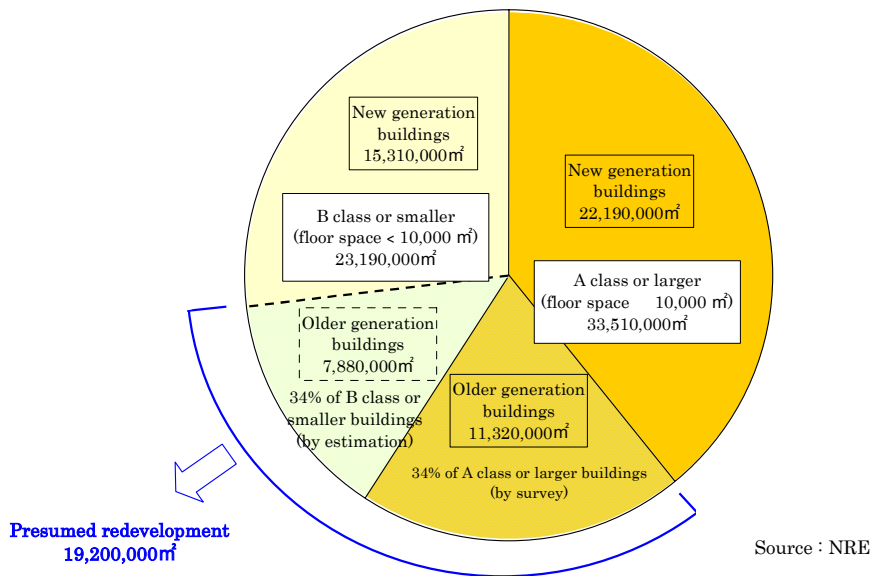
Further, in practice it is becoming increasingly difficult to differentiate between self-owned and leased buildings, and this status may change from time to time depending on circumstances, so for the purposes of the present forecasts we combined both types of office buildings together when calculating total supply. Based on the above conditions and assumptions we analyzed the balance between supply and demand in the office market for the period 2008~2011.

#### 3-2 Supply and Demand Forecasts for 2008~2011

##### **Nominal new supply will average 1,000,000 m<sup>2</sup> per year from 2008~2011**

As mentioned above, we calculated that the nominal new supply of office space will increase by 1,000,000 m<sup>2</sup> each year from 2008~2011. This represents 1.1% of the total office stock in Tokyo's 23 wards, and 2.8% of the total leased office stock in the 5 central wards.

**Figure 9 Proportion of older generation office buildings in Tokyo’s 5 central wards (total floor space: 56.7 million m<sup>2</sup>) built before the introduction of current standards for seismic resistance**



**Actual new supply will total 130,000 m<sup>2</sup>/year from 2008~2011**

We calculated actual (net) new supply by adjusting for the amount of office floor space likely to be removed from the market in Tokyo’s five central wards. We limited our adjustments to losses in the 5 central wards because they comprise a key business district containing 65% of the office buildings in Tokyo’s 23 wards. Office demand is stronger here than in other wards, and at the same time this area contains a high concentration of older buildings constructed according to outdated seismic resistance standards, so the probability of reconstruction is relatively high.

We reported in Part I of this Review that there are 33.51 million m<sup>2</sup> of office space in A class buildings (floor space ≥10,000 m<sup>2</sup>) in the 5-ward district, approximately 34% (11.32 million m<sup>2</sup>) of which is located in older buildings constructed prior to 1981, when current seismic resistant standards were first implemented. There are also 23.19 million m<sup>2</sup> of office space in B class buildings (<10,000 m<sup>2</sup>) in these 5 wards. If we assume that a similar percentage of these structures were also built before 1980, we can estimate that 7.88 million m<sup>2</sup> of this space is in older buildings with inferior seismic resistance. Therefore, the overall stock of office space in older buildings that don’t meet current seismic standards totals around 19.2 million m<sup>2</sup> (see Figure 9).

As mentioned earlier, there is a relatively high probability that these buildings will have to be demolished and rebuilt, or shifted to other, non-office related uses, in the near future, thus we believe our estimate of a 50-year building lifecycle is not unrealistically long. Even the newest of these seismically inferior buildings are now over 28 years old, so we estimate that about 870,000 m<sup>2</sup> will need to be reconstructed each year over the next 22 years (19.2 million m<sup>2</sup> X 1/22 yrs = 870,000 m<sup>2</sup>/yr).

Therefore, while nominal new supply will average around one million  $m^2$  per year, a similar amount (870,000  $m^2$ ) will be removed from the market due to the demolition of superannuated buildings, with the result that actual net new supply will be in the range of 130,000  $m^2$  ( $1,000,000 m^2 - 870,000 m^2 = 130,000 m^2$ ).

**New supply in 2008~2011 will not significantly affect the balance between supply and demand**

As explained above, actual net new supply of office space during the period under review will total about 130,000 $m^2$  per year. This represents only 0.3% of total leased office stocks in Tokyo's 23 wards, and only 0.4% of total leased office stocks in the 5 central wards, which comprise Tokyo's main business district. It is unlikely that such a modest level of new supply will have a significant impact on the overall Tokyo office market. To confirm this we estimated the effect this amount of new supply will have on vacancy rates in the 5-ward area. If we assume no increase in demand through 2011, the amount of actual net new supply (130,000 $m^2$  X 3 years) represents excess supply. This amount is equivalent to approximately 1.2% of overall office stocks in the 5 central wards, and would therefore tend to push up vacancy rates by 1.2 points. In fact, as of the end of May 2008 vacancy rates in the 5-ward area were about 3.3% (according to data published by Miki Shoji Co., Ltd.), so an increase of 1.2 points would bring the vacancy rate up to 4.5%. Such an increase is unlikely to significantly affect the supply and demand equilibrium. Moreover, even if we take into account the return to the market of office space lost temporarily due to renovation or other factors, we estimate that the vacancy rate will still remain in the 5% range. On the other hand, however, the specifications of newly reconstructed buildings are far superior to those of older structures, so it is likely that polarization of the market will accelerate, with rents and vacancy rates varying widely depending on building specifications.

## 4. Conclusion

### 4-1 Balance Between Demand and Supply

**Nominal new supply from 2008~2011 will depend primarily on buildings of A class or smaller**

As reported above, current data indicates that nominal new supply for the period 2008~2011 will be around 1,000,000 m<sup>2</sup>/yr. Because S and SS class buildings take a long time to design and build they are unlikely to have a major impact on new supply during the present study period. Any increases or decreases in response to near term changes in the market will likely be in the form of A class or smaller buildings.

This conclusion is supported by the results of the present study, which found that the number of A and B-class buildings scheduled for completion in 2008~2009 was nearly double that of our previously published estimate (on a floor space basis), reflecting the increase in office demand that occurred in 2007. Similarly, if leasing demand should continue to grow in 2008 at the same pace as in 2007, it is possible that new supply of A and B-class buildings in 2010~2011 could exceed our current forecasts.

In fact, however, the economic outlook during 2008 has become more uncertain due to the sub-prime mortgage crisis. This has caused some companies to delay plans to relocate to new office facilities, and there are signs that this may lead to readjustments on the supply side. Therefore, although there may be some upward adjustments in supply in the form of A class and smaller buildings if the economy should remain strong over the near term, at the present time we believe it is highly unlikely that nominal new supply between 2008~2011 will significantly exceed our current estimates.

#### **Impact of new supply on the supply/demand equilibrium is weakening**

We have calculated that the actual (net) new supply of office building space in the years from 2008 through 2011 will be around 130,000 m<sup>2</sup> per year. At this level upward pressure on vacancy rates will be minimal, even in the absence of new demand, and will not significantly disturb the balance between supply and demand in the market. It is true that if vacancy rates in leased office buildings in central Tokyo remain at the current 3% level we could see a certain amount of additional new supply in the form of A class or smaller buildings. However, even in such a scenario, new supply in the form of larger S or SS class buildings will be extremely limited, so we believe it is highly unlikely that new supply will significantly exceed our forecasts. Therefore, unless there are major changes in economic conditions, the supply and demand balance in Tokyo's office market is expected to remain stable at least through 2011.

So long as new supply is dominated by reconstruction and urban redevelopment projects, the impact of new supply on the market will continue to weaken. Under such conditions the location, specifications and other quality-related factors will acquire increasing importance,

and the gap between inferior and superior office buildings will continue to widen.

## 4-2 Shift from ‘Quantity’ to ‘Individual Building Quality’

### **Mismatches occurring between corporate needs, building specifications, and rent levels**

As stated above, new supply is having progressively less impact on the balance between supply and demand in the office market, so it is no longer possible to discuss market equilibrium simply in terms of the quantity of supply and demand. Over the next few years it will be necessary to monitor whether individual building specifications and rent levels match the needs of corporate tenants.

The latest data show that while vacancy rates are rising slightly in Tokyo’s 5 central wards, they still remain at the 3% level, clearly indicating that there is still a shortage of high-quality office space in this area. Japanese companies are continuing to work aggressively to secure adequate human resources by raising retirement ages and increasing recruiting targets, while at the same time M&A activities and other factors are forcing companies to improve management efficiency by consolidating and integrating office operations. However, high rent levels in buildings capable of meeting this demand have become a bottleneck, and a noticeable number of companies have adopted a wait and see attitude in hopes that a correction in the market will bring rents down. Under these conditions the need for office space in buildings in good locations that are large enough in terms of standard floor space, facilities specifications and building management systems to accommodate the needs of companies looking to consolidate their office operations, and which are available at reasonable rents, are expected to become stronger than ever before.

### **Energy conservation and environmental compliance**

The G8 Summit was held in Japan in 2008, and environmental issues were front-page news for days on end. The main theme of the summit was the reduction of CO<sub>2</sub> emissions, and the participating countries adopted a general framework to accomplish this goal. Against this background it is natural that office buildings should be expected to take steps to reduce their carbon footprints. It is likely that concrete numerical targets for CO<sub>2</sub> reductions will be established not only for individual office buildings but also for corporations as a whole, and responsibility for meeting these targets will not be limited to building owners but will include tenant companies as well. In June 2008 the city of Tokyo established its own municipal ordinance mandating CO<sub>2</sub> reductions, and has given this issue top priority, on a par with its efforts to acquire the rights to hold the 2016 Olympic Games.

As ‘Corporate Social Responsibility’ acquires increasing importance, corporate needs for environmentally friendly and energy efficient office space are growing, not only with regard to self-owned office buildings, but also for leased office buildings as well.

**In addition to transport infrastructure, current office stocks and concentration of corporate headquarters must be taken into account**

As described above, the quality of the individual office building is acquiring increasing importance in today's market. Nevertheless, before selecting a building, tenant companies must first decide which business district they wish to relocate to. The most important condition in this regard tends to be transport infrastructure. A typical example illustrating this point was the rise in demand for office space in the Shinagawa area after completion of the new Shinagawa Shinkansen (Bullet train) station. The switch to 24-hour operations at Haneda Airport and its expansion to accept international traffic, and the opening of the Fukutoshin Subway line are expected to have a major impact on business district rankings. However, in addition to transport infrastructure, the popularity of a business district is also affected by factors such as the layout of its streets, the degree of integration of various urban functions, as well as the size, type, and influence of the companies located in the area, so it is important to look at individual areas in more detail.

In Part I of this report we identified the Prime Business Areas within Tokyo by analyzing the concentrations of large-scale office buildings and major corporate headquarters in various sub-districts. We confirmed the existence of Prime Business Areas outside of the three central wards (for example Nishi-Shinjuku), and we also confirmed the emergence of the area between Tokyo Station and Shinagawa as an important business center. The popularity of business districts changes over time, so going forward it will be important to monitor these trends carefully from various perspectives.

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**Reference Materials: ‘List of Major Extremely Large-scale Buildings Scheduled for Completion between 2008~2011’ (Floor space ≥30,000 m<sup>2</sup>)**

2008

Name of Project	Location	No. of Floors	Total floor space (m <sup>2</sup> )
Akasaka Biz Tower	Akasaka, Minato	39/B3	187,000
Shinonome Project	Shinonome, Koto	10/B	63,000
Marunouchi Trust Tower Main Building	Marunouchi, Chiyoda	37/B4	115,000
Kita-Aoyama Project	Kita-Aoyama, Minato	25/B3	47,000

2009

Name of Project	Location	No. of Floors	Total floor space (m <sup>2</sup> )
Marunouchi Park Building	Marunouchi, Chiyoda	34/B4	206,000
Otemachi Area Redevelopment Project Phase 1 District A	Otemachi, Chiyoda	31/B3	74,000
Otemachi Area Redevelopment Project Phase 1 District B	Otemachi, Chiyoda	37/B3	88,000
Otemachi Area Redevelopment Project Phase 1 District C	Otemachi, Chiyoda	23/B4	71,000
Aobadai 3-Chome Project	Aobadai, Meguro	33/B3	57,000
Hirakawacho 2-Chome East District, Southern Section, Class 1 Urban	Hirakawacho, Chiyoda	24/B2	52,000
Shiodome Hama Rikyu Project	Ginza, Chuo	21/B2	49,000
Belgian Embassy Redevelopment Project (Private Building)	Nibancho, Chiyoda	13/B2	45,000
Nishi-Shinjuku 7-Chome Project	Nishi-Shinjuku, Shinjuku	33/B2	39,000
Osaki 1-chome project (The Third District Station East District Redevelopment District C)	Osaki, Shinagawa	17/B2	37,000
Sanbancho Project	Sanbancho, Chiyoda	15/B1	34,000

2010

Name of Project	Location	No. of Floors	Total floor space (m <sup>2</sup> )
Nagatacho 2-Chome Project (Capitol Tokyu Hotel Redevelopment)	Nagatacho, Chiyoda	29/B4	87,000
Marunouchi 1-Chome Redevelopment Project (Former JFE Building Redevelopment)	Marunouchi, Chiyoda	23/B4	80,000
Koraku 2-Chome West Redevelopment Project	Koraku, Bunkyo	34/B3	78,000
Chunichi Shimbun Sinagawa Development Project	Konan, Minato	19/B3	72,000
Shibuya Higashi 1-Chome Project	Higashi, Shibuya	26/B3	54,000
Ariake South G1 Division Project	Ariake, Koto	13/B1	50,000
Nihombashi-Muromachi East 2-2 District (Mitsui The Third Annex)	Nihombashi-Muromachi, Chuo	18/B5	41,000
Nihombashi-Muromachi East 2-4 District	Nihombashi-Muromachi, Chuo	21/B4	42,000
Fukagawa Gatharia West Side Redevelopment Project W2 Building	Kiba, Koto	10/B1	38,000
New Zenkyoren Building	Hirakawacho, Chiyoda	21/B2	87,000

2011

Name of Project	Location	No. of Floors	Total floor space (m <sup>2</sup> )
Ariake South A District Project	Ariake, Koto	20/B1	71,000
Marunouchi 2-Chome Project(The Tokyo Central Post Office Redevelopment)	Marunouchi, Chiyoda	37/B4	190,000
Osaki Station West Sony District Redevelopment	Osaki, Shinagawa	24/B2	100,000
Kita-Shinjuku District, Class 2 Urban, 1-2 Building	Kita-Shinjuku, Shinjuku	35/B2	94,000
Osaki Station West South District Redevelopment	Osaki, Shinagawa	25/B2	57,000
Hama Rikyu Inter City	Kaigan, Minato	26/B2	39,000
Iino Building Redevelopment Project	Uchisaiwaicho, Chiyoda	26/B5	106,000
Moto-Akasaka K Project	Moto-Akasaka, Minato	30/B3	54,000
Nanpeidaicho Project	Nanpeidai, Shibuya	22/B2	61,000
Mitsui Sumitomo Insurance Company New Building	Kanda-Surugadai, Chiyoda	23/B3	64,000

\* As of March 2008