



Is 2003 a Class B “Problem”?

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How will the “2003 problem”, which is the name given to the 2.94 million SF of office space that is to be completed in Tokyo during the next 3-4 years; effect the Class B market in Tokyo? The US has historical data from several different office markets from which to draw conclusions.

An interesting study was completed by Moody’s Investors Service last year that compared the dynamics of the Class A and B Office Markets. The study was based on Office markets in US and focused on the reaction, in terms of vacancy, of the these types of markets in relation to changes in the supply and demand of office space. In most major markets, Class A space has shown a more volatile reaction to changes in the market and is therefore considered to be the “hare” compared to Class B which plays the “tortoise”.

The following possible reasons for this phenomenon were identified in the report:

1. Typically, most new office construction in major markets is Class A space which results in no change in the supply side for Class B space. This is also true in the Tokyo market where over 90% of the space under construction is considered to be Class A. In terms of total inventory, in the largest markets in the US, such as New York, Boston and Chicago, the portion comprised by Class A is 60% or greater. Using a definition based on a building size of 100,000 SF or more, the Class A portion in Tokyo is approximately 35%. The larger inventory of class B and C space in Tokyo should further insolate those markets from an influx of new Class A space.
2. Owners of Class A space are reluctant to lower rents resulting in delay before rents are reduced to a level that would attract tenants currently leasing Class B space. The reason cited for this is that landlords do not want to risk committing to lower rents for a long-term lease only to discover that the market was stronger than first believed. However, in Tokyo most tenants still execute 2-year leases. Therefore, owners of vacant space in Tokyo should be more willing to lease space immediately knowing that if the market turns out to be stronger than anticipated the lease rents can be adjusted upwards.
3. Contrary to what might be expected, historical data in the US indicates that the Class B office market is no more vulnerable than Class A to periods of soft demand. It is likely that during

a recessionary period that Class B tenants are more likely to close operations than the larger companies that lease Class A space. However, according to the Moody's report, there is a steady supply of new business in the US that cannot afford Class A space resulting in more stability for the B market. In Japan, where employees traditionally have worked for the same company during their entire career, the demand from new companies is not as strong. In addition, although the A market is generally comprised of large tenants that are unlikely to fail, a weak economy can cause lay-offs and space reductions. This factor could be intensified in Tokyo as the lack of long-term leases makes it easier for tenants to reduce their space in such a situation.

In summary, the fact that virtually all of the new office space related to the "2003 Problem" is Class A and that the current inventory of Class B space is large in proportion to the new space makes one believe that the impact on Class B rents will be minimal. However, the counterbalancing forces in the US that help prevent a shift in demand to Class A space, such as long-term leases and a steady supply of new business, are not as strong in Japan.