Tokyo Office Rents on the Way Down

By Jun'ichi Hirano

Tokyo office rents are finally starting to come down after their long, unbroken ascent. Sanko Estate, which handles 14% of all office space in the metropolitan area (including Tokyo, Kanagawa, Chiba and Saitama prefectures), reports that figures to July of this year show a decline in actual rents (including deposits and other non-rent payments) in nine of Tokyo's 23 central wards. Of the three neighboring prefectures, Saitama has also seen office rents fall. Most of the turnaround took place in April and May 1991.

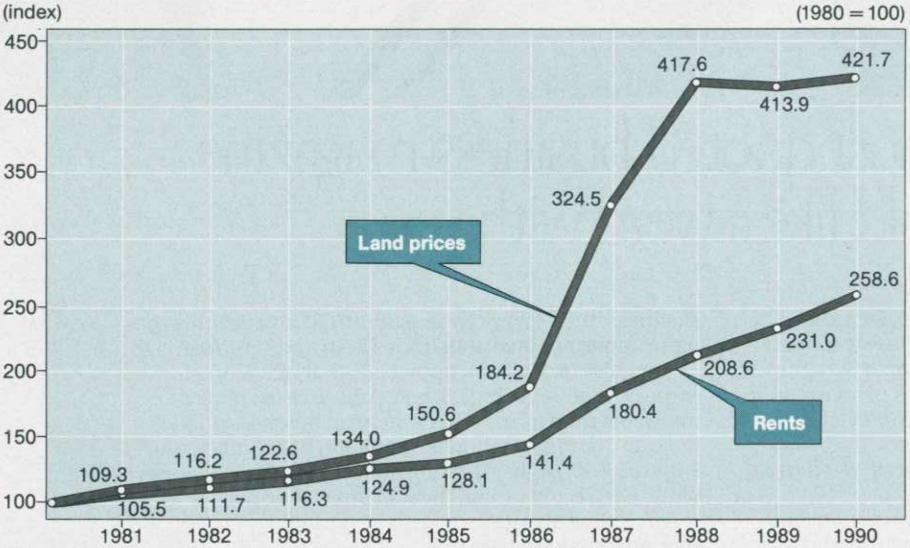
This comes as a change from the rapid, almost rampant, increases in stock and land prices in what was called the "bubble economy" starting in 1987 or so. Within this bubble economy, Tokyo land prices and office rents rose very fast and very far (Fig. 1).

Looking at the year-on-year increase in (officially posted) prices for commercially zoned land in Tokyo, the figures were 10.8% in 1984, 19.6% in 1985, 74.9% in 1986 and 36.7% in 1987. Again according to Sanko Estate, actual office rents in the downtown Marunouchi district soared from ¥36,600 per *tsubo* (a Japanese unit of measurement equivalent to about 3.3 square meters) in 1984 to ¥38,100 in 1985, ¥40,200 in 1986, ¥53,500 in 1987 and ¥69,500 (about $500 at the rate of ¥140/$) in 1988, and it looked as though prices were going to go into orbit.

However, stock prices have since collapsed, at one point this year to half of their peak value, and land prices have also started to edge down. The standard land prices announced by the National Land Agency in September show Tokyo area land prices down 1.0% and Osaka area land prices down 15.3% from the previous year. To many people, this represents the bursting of the economic bubble, and a recessionary mood is gaining ground in Japan.

The bursting of the bubble has also been a major factor in the collapse of office rents. Until recently, most Japanese have believed that land prices and rents were immune from the old rule that what goes up must come down. Now they know better.

Fig. 1 Tokyo Commercial Property Prices and New Office Rents



Note: Land prices are officially posted prices; rents taken from Tokyo Building Owners and Managers' Association data.

Among the primary factors determining office rents are (i) land prices and (ii) the balance between the supply of available office space and the demand for this space. Of the two, supply and demand is more readily reflected in rents.

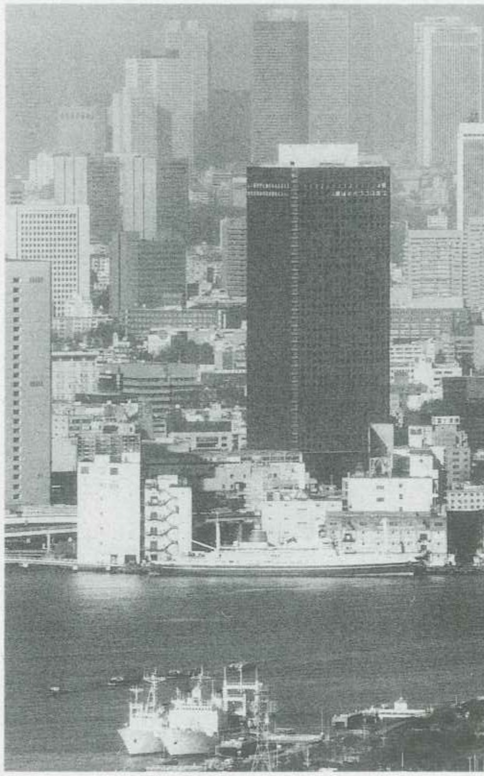
Yet when Sanko Estate surveyed the supply and demand for office space in the areas where the rent decline has been most conspicuous, it found that these areas do not have conspicuously more space available than other areas do. Instead, the decline seems to be a reaction or technical correction in the wake of the past several years' major increases. In a single year from 1989 to 1990, Tokyo area office rents rose 25%. Now they are adjusting downward.

Information hub

Going into the 1980s, Japanese companies moved quickly to become more international and more information-intensive. As a result, many companies sought to locate their head offices in Tokyo–Japan's information hub. At the same time, there was a rush of overseas companies setting up shop in Tokyo. The result was sharply stronger demand for Tokyo office space.

At the same time, new office construction was also up. The peak in new building came in 1985 and 1986, with the 265 hectares of office construction starts in 1985 soaring to 399 hectares in 1986. This 50% increase was the strongest of any year throughout the decade.

The year 1985 also saw the Plaza Accord, designed to adjust the yen/dollar exchange rate by letting the yen appreciate more. Seeking to avoid the economic slump that would normally accompany a decline in exports as the yen appreciated, the Bank of Japan lowered the official discount rate. From a high of 9.0% in March 1980, the official discount rate slipped over the next seven years until it was only 2.5% in February 1987–the lowest it has been since the end of World War II. Other



High demand for office space in metropolitan Tokyo prompted the building of a large number of new offices facing Tokyo Bay.

interest rates followed suit, and there was soon an ocean of excess liquidity with nowhere to go, and conditions were ripe for land prices to take off.

Another factor contributing to the boom in new office construction was the fact that the Ministry of Construction relaxed the land-use regulations in 1984. In October 1987, just as the bubble was inflating, there was an amendment to the Building Standards Law including an easing of the restrictions on building size. As a result, there was a plethora of urban redevelopment plans, including the Marunouchi redevelopment plan unveiled in January 1988 by Mitsubishi Estate, which owns and manages much of the Marunouchi area. As the economy expanded, so did the supply of and demand for office space.

On the demand side, not only were companies anxious to move their headquarters to the Tokyo area, they also needed more and better space to accommodate the increasing use of office equipment. At the same time, there was a drive for more comfortable offices and more space per worker.

In addition to these purely economic factors, construction was also boosted by the tax advantages offered builders. Before land prices took off, the assessed prices that were used as the basis for calculating property taxes were much lower than actual land prices. According to the Misawa Homes Institute of Research and Development, there was a considerable tax benefit from the fact that the assessed prices were only about 40% of actual prices. (They are now about 70% of actual prices.) At the same time, builders were able to gain other tax advantages by depreciating their new buildings. Likewise, it was reasonable to expect strong capital gains on the land itself.

Although building entails high initial outlays, the combination of depreciation and higher rents meant that rental office buildings became strong money earners in their third decade. And when this happened, companies were propelled to build new buildings to get the tax advantages of profit-offsetting investment. This is what happened these four or five years, as substantiated by the fact that by far the largest number of buildings in Tokyo are 24 to 25 years old.

Even without these considerations, office building construction offers a safe, easy investment for people who already own land. It is safer than building a hotel, it is less expensive than building residential units, and the rental income is higher than on residential units.

Damaging forecast

Looking for reasons to explain the tight market in Tokyo office space, some people have cited the office space forecast announced by the National Land Agency as part of its May 1985 Draft Plan for the Remodeling of the Greater Tokyo Region. This forecast predicted that companies in the Tokyo area would employ 5,065,000 people and would need 5,140 hectares of office space by the year 2000. While these figures were sharply higher than those put out by one of the big commercial banks some time later, they were believed at least to the extent that panicked companies rushed to lock in office space while they still could. Even though the National Land Agency revised its numbers downward in November 1987, the damage had already been done.

Tokyo office rents are much higher than those in other commercial centers. If Tokyo is set as the standard of 100, says the Japan Association of Real Estate Appraisal, office rents in London are only 82, those in Paris 51, and those in New York 43.

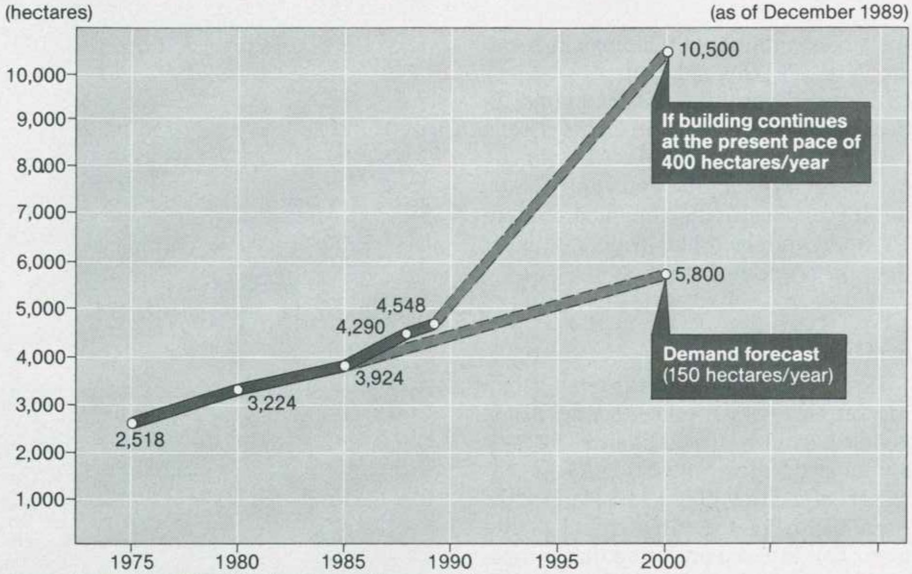
Again, we return to supply and demand in seeking to understand why Tokyo office space is so expensive. The vacancy rate for Tokyo offices is currently 0.2% (according to the Tokyo Building Owners and Managers Association). By contrast, vacancy rates in cities in the United States typically run 10% to 15%. In addition, in the Japanese case, the blue-chip companies all want to locate their headquarters in Marunouchi, Otemachi and a few other prestige addresses. There seems to be a feeling that the company's prestige can be enhanced by where its head office is.

In the United States, there are plenty of prestigious companies that are not headquartered in Manhattan. Yet the big Japanese companies all want to have their offices at Tokyo's best addresses. This is demonstrated by the differences in land prices and office rents in Tokyo and Osaka. Although Osaka is Japan's second-largest city, Tokyo land prices average about 50% more—and Tokyo office rents about 150% more—than Osaka's.

According to the Research Institute of Construction and Economy, the United States embarked on a massive wave of tax cuts and deregulation in the Reagan years. A whole forest of new buildings went up in New York. Yet the U.S. real estate market started to slump in 1985 and 1986. Indeed, many of the big Japanese acquisitions, including Mitsui's purchase of the Exxon Building in 1986 and Mitsubishi's of the Rockefeller Center in 1989, were the result of Japanese buyers buying into a stagnant market.

Because the Japanese economy tends to resemble the United States', albeit with several years' lag, it should have been possible for people to see the writing on the wall and to realize that Japan's own real estate market would be in trouble before long. Even so, people were caught unawares because everyone assumed land prices would just keep going up and because Japan had never had an

Fig. 2 **Office Space Supply and Demand in Tokyo's 23 Wards**



Source: Research Institute of Construction and Economy, Tokyo

office space glut before. Instead of looking at the future in the light of cold reality, people blithely assumed that office rents would keep going up and up.

If Japan has come this far in the United States' footsteps, what about the future? Is Japan doomed to a prolonged U.S.-like real estate recession? What is the supply-and-demand outlook?

There is a very real possibility that the Tokyo area may find itself with more office space than the market will bear. There are a number of major new development projects due to come on line by 2000 that could exacerbate this situation, including Tokyo's Waterfront Subcenter, Yokohama's Minato Mirai 21 Project, and Chiba's Makuhari New City Development.

Looking just at Makuhari, this project started in 1983 and is targeted for completion in 2000, at which time the Makuhari New City will employ 150,000 people. About 15 hectares of the Industrial and R&D Area designated to house the big rental office buildings has yet to be sold. Since applications were first accepted in 1983, about 200 companies have bid for land in the project. The peak was in 1989 and 1990, when there were up to 20 new companies a month. Yet there have been only about a dozen applicants this year. Asked to explain the drop-off, the Makuhari New City Development Division within the Chiba Prefecture Public Enterprise Agency puts it down to the collapse of the stock market and an otherwise unfavorable financial climate.

Signs of glut

One of the Makuhari project's attractions is its proximity to the Narita international airport, but this is offset by the fact that it is 25 kilometers from downtown Tokyo. In Tokyo, every kilometer away from the center hurts.

The Research Institute of Construction and Economy ran a forecast in December 1989 on the outlook for Tokyo office space (Fig. 2). This study was done at the bubble's peak, and the results showed that supply would far outstrip demand, and that rents would plummet as a result, if the current pace of construction were continued until the year 2000. Even though the pace of construction has slackened somewhat since then, a glut is still forecast.

Typically, a decline in land prices and rents is preceded by very thin trading volumes. This weak demand then makes itself felt in prices and rents. According to Sanko Estate, total trading in office space in the Tokyo area was only 382,000 *tsubo* (slightly over 1,260,000 square meters) in the first six months of 1991–a decline of 23% from first-half 1990–and the outlook is for more of the same for the latter half of this year.

Trading volume is clearly down. Land prices have also started to slip. And if cracks develop in Japanese companies' desire to have Marunouchi addresses, there is no reason why Tokyo should not see excess supply and sharply lower office rents.

A number of the foreign-based banks and securities companies that had rushed to set up shop in Tokyo in the 1980s have since pulled up stakes. Given Tokyo's high rents and personnel costs, they complained, it was an uphill struggle for them to compete with the established Japanese banks and securities companies. And when the stock market collapsed, Tokyo lost its attraction. Among the foreign banks and securities companies that have left Tokyo in the last year are Belgium's Generale Bank, America's Chemical Securities and Britain's Morgan Grenfell. All of these firms cited the need for restructuring and the high cost of office space and personnel in Tokyo.

In the Kabuto-cho area where Japan's big securities houses gather, companies anticipating lush profits in the ongoing bubble economy were contracting for new office space even before it was built. But when the bubble burst, they found themselves unable to pick up their options, leaving both owner and renter out on a limb.

During the bubble's peak, it was the big players such as the banks, securities companies, real estate agents and investment consultants–the very people who were profiting from the bubble–who were contracting for Marunouchi offices at an unheard-of ¥100,000 per *tsubo* per month. Now these firms are pulling back. And at those prices, the empty offices are going begging. They are obviously going to have to lower their prices if they want to find takers.

People are finally waking up to the fact that office rents are governed by the same economic law as everything else.

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