



# Tokyo Office Market Outlook 2004

## INVESTMENT RESEARCH REPORT

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### Conclusions

Japan is slowly emerging from the shadow of more than a decade of economic stagnation, and it appears that the current recovery is becoming self-sustaining. The office market in Tokyo presents promising investment opportunities for international investors. The following points characterize the current conditions in the Tokyo office market:

- **The Japanese economy has emerged from recession.**

After three economic downturns since 1992, Japan has once again emerged from recession. This time, there are important differences that may herald the emergence of a sustainable, if moderate, expansion. Business spending is growing and exports are rising. While structural constraints on economic growth remain, Japan is better positioned to enter a period of prolonged economic growth than it has been since the bubble economy burst.

- **The Tokyo regional economy is far stronger than the national economy.**

Tokyo is already the most prosperous and productive region in Japan, and the metro area is poised to become even more prosperous and productive than the rest of the country. Public policy choices have tilted to Tokyo's advantage, and continuing policy decisions will cement its position as the nation's most economically robust city for the foreseeable future.

- **The Tokyo office market has weathered a huge surge of Class A construction.**

Net demand for space in 2003 was the strongest it has been since the end of the bubble economy in the early 1990s. However, as of third quarter 2003, the vacancy rate in Tokyo stood at 7.1%, well above its recent nadir of 3.4% in mid-2001. This upward trend in vacancy is entirely due to a huge influx of supply, not because of a drop-off in demand. Rather than creating a glut of Class A space – well over 1 million square meters of it has been built since mid-2001 – the construction surge was a rational response to an undersupply of high quality space. However, existing, lower-quality buildings face unprecedented challenges from the new state-of-the-art buildings.

- **Tokyo's economy is far more internationalized than other Japanese cities.**

The vast majority of multinational corporate activity in Japan is in the Tokyo metropolitan region. For most foreign companies, the size of their Tokyo operations dwarfs their presence in other cities around the country. Foreign investment banks and telecommunication companies have become significant players in the local Tokyo market and are now major tenants in many Class A buildings around the city. These same companies generally have only a token presence in other major cities. Foreign firms are demanding an international standard of real estate practices, and therefore revolutionary ideas about pricing and valuation are taking hold in Tokyo far more rapidly than in other Japanese cities.

- **Tokyo's economy is increasingly disengaged from the nation's.**

To the extent that Tokyo's economy becomes more internationalized, the region becomes more tethered to global conditions rather than the domestic economy. Further, policies that were designed to discourage growth in Tokyo are now reversing to encourage it. The outperformance of the Tokyo economy since the late-1990s suggests that this is happening to some extent. The situation is becoming somewhat analogous to London, where the capital region thrives while much of the rest of the nation stagnates.

- **Office properties remain an attractive investment in Tokyo.**

Investment returns for non-real estate assets remain extremely low in Japan. Stocks have made a comeback since May 2003, but investors are still smarting from a decade-long slump that saw equity values tumble by more than 80% since their 1990 peaks. Returns on newly issued ten-year government bonds currently stand at about 1.4%, and have been as low as 0.6% in recent months. In contrast, yields on real estate assets, even for Class A buildings in central Tokyo, remain comfortably above borrowing costs. For example, recent transactions in central Tokyo indicate that yields are about 4.5% for Class A office space. Since non-recourse lending rates are about 2.8%, spreads are roughly 170 basis points in the city center. Reasonable rates of return are attainable for real estate by employing leverage. While the deflationary environment gives pause for concern about future values and cash flow levels, risk can be minimized to some extent through fixed term leases.



# I. Japan's Real Estate Financial Revolution

Japan has experienced a real estate finance revolution in recent years. The seeds of this revolution were sown in the post-war land price bubble that burst in the early 1990s. The bursting of the bubble had painful repercussions for the Japanese economy in general, and real estate investment in particular. But it also set the stage for the development of a far more orderly and transparent real estate investment market.

The architects of Japan's post-war economic miracle created an economic system where land acted as the key depository for the nation's real wealth. In effect, the land market acted as the nation's real financial market and as such the major source of capital for investment. The banking system acted as a passive channel to funnel capital to land owners using the value of their land holding as collateral to secure their loans. In a further prop to the land market, the tax system gave significant disincentives to sell property. Given strong incentives to buy and negative incentives to sell, it is not surprising that over the 45 years between 1945 and 1990 the price of land increased faster than did gross domestic product (GDP).

The system was beautiful in its simplicity and operated as a flawless machine for decades. Unfortunately, the system created the seeds for its own eventual destruction. The upward bias (land prices fell in only one year between 1950 and 1990) created a belief that land prices could only rise even as property slowly but steadily disconnected from economic reality over time. The destruction of the system began with the great asset bubble of the 1980s. A flood of excess liquidity poured into the commercial real estate markets of most major Japanese cities and was most strongly felt in the major urban centers of Tokyo, Osaka and Nagoya. As land prices soared, an illusion of massive wealth was created. Since every major corporation was heavily invested in the commercial real estate market, the equity markets spiraled upwards in response to the increase in land prices. Households got into the game through the equity markets. One of history's greatest bubbles (far greater than even the recent Internet bubble in the United States) took in nearly everyone in Japan.

Beginning in 1990, the bubble burst, causing a collapse in land prices and a ripple effect throughout the Japanese economy that still has a long way to play out. The collapse has destroyed the ability of banks to act as financial intermediaries and has weighed firms down with massive quantities of debt. The disintermediation of the banks has disconnected the real estate market from the old financial system. It has laid the groundwork for a new, modern real estate market linked to the financial markets. The elements of this new market include:

- 1) **The Special Purpose Corporation law was passed in 1997, followed by the Asset Liquidation Law in 2000.** These laws have enabled real estate to be securitized in Japan for the first time and have facilitated the creation of tax efficient vehicles that are being increasingly utilized by foreign investors.
- 2) **A real estate investment trust (REIT) law was passed in 2000, spurring the formation of a number of REIT companies.** The first REITs began trading on the Tokyo Stock Exchange in September 2001. The emergence of REITs is creating demand for income-producing Class A and B office buildings in central Tokyo.

- 3) **A revised tenancy law went into effect in March 2000.** This law allowed fixed term leases to be signed for the first time and has been an important factor in creating a sale/lease-back market.
- 4) **A commercial mortgage backed securities (CMBS) market is developing.** Bonds securitized by a portfolio of property loans can now be sold in Japan. The CMBS market will provide added liquidity, enabling large amounts of troubled real estate to be taken off the books of banks, insurance, finance and construction companies.
- 5) **Non-recourse lending is now available.** Traditional lending for real estate development has been made to corporations based on existing collateral rather than based on the returns that a proposed project can potentially generate. Because of the grave position of many Japanese lenders and the huge amount of bad real estate related loans that they still carry on their books, little real estate related lending has been done by Japanese banks in the past decade. Most projects that have been developed since the end of the bubble economy are self financed, either through cash held by the developer or by raising cash through securitizing the cash flow of existing real estate or that of a proposed project.
- 6) **Accounting rules now require consolidated financial statements.** The implementation of these new rules was expected to take place in April 1, 2002; however, this date has been set back as old-guard elements attempt to delay the inevitable for as long as possible. The new accounting rules mean that firms will no longer be able to bury underperforming real estate in subsidiary companies but instead will be forced to deal with it directly. At the same time, the mark-to-market requirement on real estate that has lost more than 50% of its book value has already forced firms to revalue real estate in their portfolios beginning in fiscal 2000. The accounting rule is increasing – albeit gradually – the pace of restructuring of real estate by corporations that are postponing large latent losses.
- 7) **There is a gradual acceptance that the value of land is not intrinsic but rather related to the revenue that a property can generate.** The value of land in Japan has traditionally been related to the prestige attached to the property rather than the income that the property can generate. However it is becoming clear, in the Tokyo market at least, that a fundamental change in the way land is valued is taking place. In time, this will result in a restructuring of the land market in the Tokyo office market.

The bursting of the Japanese land market bubble was painful. But it has led to crucial regulatory and attitudinal changes. Real estate can now be securitized and there are emerging REIT and CMBS industries. The relationship between tenants and landlords has been rationalized, and there's an emerging sale/leaseback market. Most fundamentally, land increasingly is being valued based on its economic utility, rather than its historic prestige.

## II. Japanese Economic Update

The Japanese economy has emerged yet again from recession. Unlike the three previous recoveries from recession since the early 1990s, this rebound appears to be on solid ground, and is more likely than not to evolve into a sustainable expansion. Gross domestic product is expanding at an impressive rate, propelled by growing business investment, and labor markets have stabilized. While structural constraints on economic growth remain, Japan is better positioned to enter a period of sustained, albeit moderate, economic growth than it has been since the bubble economy burst. This growth will not be distributed equally across the country, as Tokyo will continue to solidify its position as the economic engine of Japan, while the rest of the country will at best sustain production at today's levels.

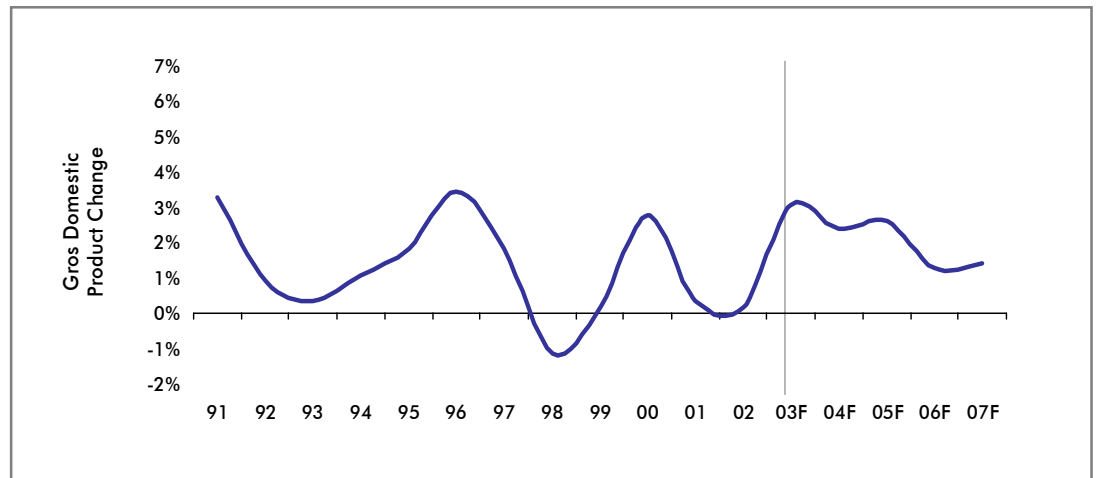
The doom and gloom that has surrounded local and world media reports about Japan's ailing economy over the past decade has overshadowed the country's considerable structural strengths. Education levels are among the world's highest, especially in science- and engineering-related occupations. Income levels, a good proxy for the economic productivity of a country, are very high even by the standards of developed nations. The manufacturing sector is still the most efficient in the world, and Japanese companies continue to develop and produce many of the world's most innovative products. As the labor force ages and there are fewer young workers, Japanese companies have become increasingly adept at moving manufacturing facilities to less expensive areas (especially China) or closer to their customers (such as auto factories in the U.S.). Although these facilities produce goods in other countries, the higher value-added functions generally remain in Japan, and generate larger profits than if the products were to be produced domestically. This bodes well for Japan's long-term competitiveness as one of the world's premier industrial exporters.



## Investment Driven Expansion

Gross domestic product (GDP) is on-track to expand by 3.1% in 2003, as shown in **Exhibit 1**, the fastest growth rate since 1996 and second fastest since 1991. This expansion is forecast to remain intact at least through 2007, with growth averaging 2% from the end of 2003 through 2007. This is at or near the bottom of the major industrialized countries in terms of expected economic growth, but Japan is not likely to suffer through another decade of stagnation either. Labor force growth will remain positive for the rest of the decade, but thereafter, barring an unlikely influx of foreign immigration, Japan will have to cope with a shrinking working-age population base and a growing number of retirees. This means that in the very near future, *all* of Japan's economic growth will be due to increases in productivity, since labor force growth will fall to zero and eventually turn negative.<sup>1</sup> Given Japan's severe labor force constraints, even 2% growth represents solid gains in living standards, not to mention a welcome psychological change.

### Exhibit 1 Japan's Economy Is Finally Firming

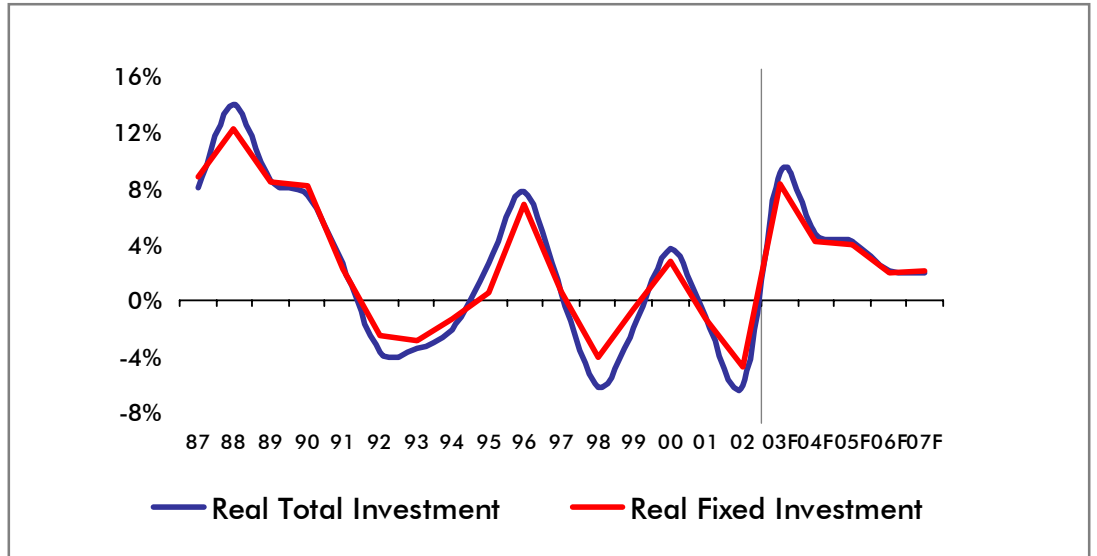


Source: Economy.com

The major reason GDP is growing now is that Japanese business investment is rising at its fastest rate since the 1980s, as shown in **Exhibit 2**. Real fixed investment is on track to grow by 8.3% in 2003, the highest increase since 1989, and real total investment is on its way to an estimated 9.2% hike over 2002, the best performance since 1988. There are two reasons for this increase in business spending. First, rising exports, shown in **Exhibit 3**, are stoking demand for investment. Japanese manufacturers are ramping up their activity in response to growing demand and the anticipation of an improving global economy going forward. Second, spending is increasing because fixed capital investment has been declining or anemic since 1995, and it is finally becoming less expensive to replace tired equipment rather than to repair it well beyond its economic life. This replacement cycle will continue since Japanese manufacturers must replace and upgrade their equipment to remain competitive in the global economy.

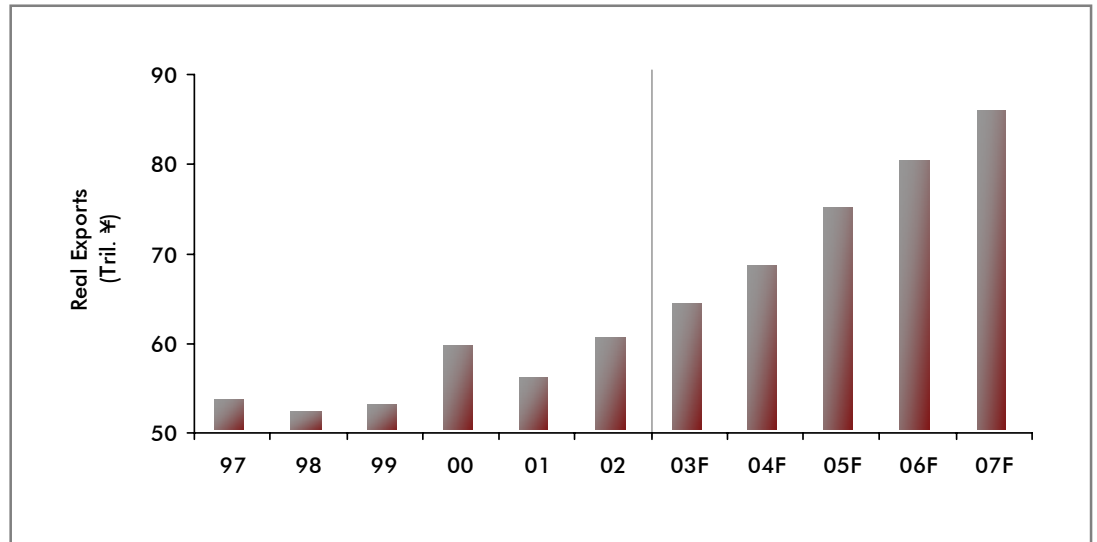
<sup>1</sup> GDP over the long term is equal to the sum of labor force growth and productivity gains. In the case of Japan, labor force growth is projected to turn negative over the next decade and fall for the foreseeable future, meaning GDP can only expand if productivity remains positive.

## Exhibit 2 Business Investment Is on the Upswing



Source: Economy.com

## Exhibit 3 Exports Are Ramping Up



Source: Economy.com

## Pressures Remain

This is not to say that all is well with the Japanese economy. There are significant structural challenges that must be addressed or Japan will remain at risk of an endless cycle of anemic recoveries from severe recessions. First and foremost, the domestic financial system is essentially insolvent. Despite some progress in requiring banks to acknowledge and eventually write off nonperforming property loans, there are still trillions of yen tied up in property loans that are highly unlikely to ever be paid in full. This capital, if made available, could be used for productive investment; as a consequence of this, banks are not a facilitator of economic activity but rather a drag on it. The process of restoring solvency to the financial sector is moving in fits and starts, characterized so far more by proclamations than by painful actions. Until this process is completed, the domestic finance sector will remain a significant constraint to economic growth in Japan.

The insolvency of the financial sector, to a significant degree, also contributes to one of Japan's other major economic constraints: asset price depreciation. Real estate prices in general, and land prices in particular, have collapsed since the early 1990s; although the rate of decline has slowed in recent years, asset price deflation continues even as the economy picks up steam. The role of banks have in contributing to deflation is self-sustaining, a cycle that must be broken before asset price depreciation abates. Banks have lent on many properties that suffered from declining rental rates, and eventually these properties have failed to meet their debt service. Banks are reluctant to foreclose on the loan because doing so would cause them to sell the collateral at a price lower than their loan. Instead, banks take a write-down on their capital account, and their ability to lend is restricted. This restricted lending ability continues the cycle of asset price depreciation.

There are other constraints to economic growth as well, including a rapidly aging workforce and a swelling of the base of retirees, a transportation network that is so expensive it impedes the movement of goods and people across the country, and an over-reliance on inefficient public infrastructure spending to spark economic growth. Japan also faces the same challenge as every other economy with a high standard of living, namely, how to compete with low-cost manufacturers in China and elsewhere. That competition, combined with gradually loosening trade barriers, has and will continue to have the dual impact of goods price deflation (which, on net, is a good thing for Japanese consumers and the economy, although it displaces local producers and some retailers) and an erosion in the manufacturing job base (which, on net over the short-term, is an economic drag).

These constraints, on balance, are enough to crimp growth but, given Japan's considerable strengths, not enough in themselves to doom the country into a constant cycle of recession punctuated by occasional expansions. Regulators are making slow progress with financial reform. Real estate prices have fallen to the point that they more closely reflect the present value of their future income streams. Demographic challenges loom, but continued productivity gains will likely be sufficient to keep GDP in positive territory even as the labor force ages. All is not well in Japan, but it's better than it has been in over a decade.

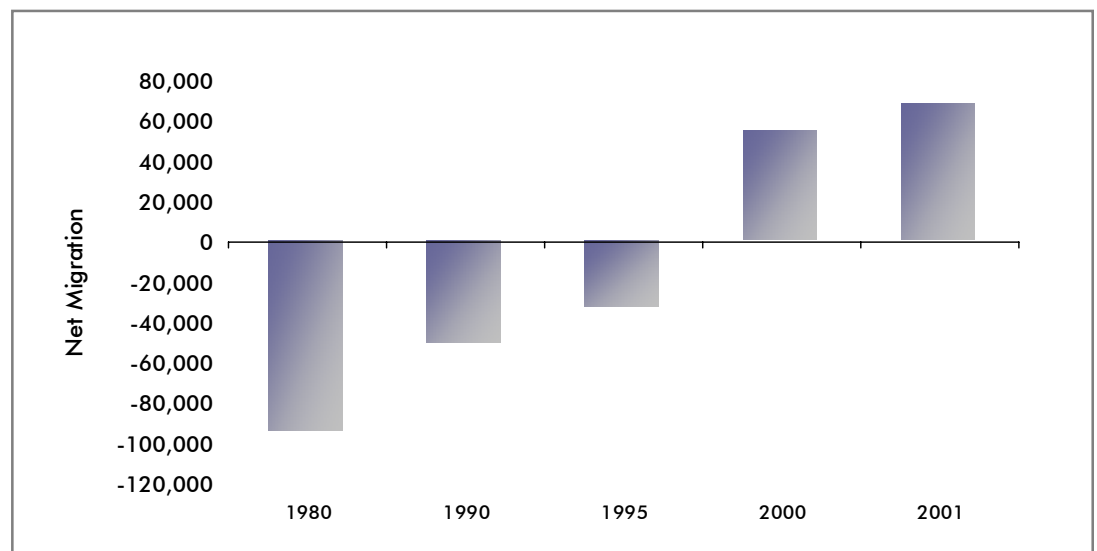
## Tokyo Is Breaking Away

It's misleading to generalize about economic growth in Japan because there are really two economies: Tokyo and everywhere else. This distinction is important because Tokyo, already the most prosperous and productive region in Japan, is poised to become even more prosperous and productive than the rest of the country. One reason the gap will widen is that Tokyo has natural agglomeration advantages for service industries, most notably financial and business services. Greater Tokyo is the center of government, the center of commerce, and home to nearly 25% of Japan's residents.

Public policy choices are also tilting to Tokyo's advantage. There has been a marked shift in policymakers' attitudes towards economic growth in general since the early-1990s. When the economy was booming, as it was throughout the 1980s, Japanese planning officials adopted a policy of "deconcentration" that served to divert growth out of Tokyo's most congested areas. The goal was to channel economic activity to less congested areas, and the focus was solely on the costs of a rapidly expanding economy (which was taken for granted) in terms of infrastructure and congestion, rather than on the benefits of growth. The deconcentration policy worked in two ways:

- First, the policy of deconcentration provided incentives to companies that established or moved operations into outlying cities such as Osaka and Kyoto. This successfully diverted population out of Tokyo, as shown in **Exhibit 4**. The trend has reversed, as dwindling economic opportunities elsewhere encourage a re-migration into Tokyo. Historically, the "Londonization" of Tokyo was feared, whereby the main city in a country booms while the rest of the country stagnates. Now, Tokyo is increasingly seen as the only catalyst for growth that Japan has, and policymakers are coming to grips with the reality that Japan will need to encourage rather than discourage accelerated concentration of people and businesses in Tokyo.

**Exhibit 4 People Are Flowing Into Tokyo Again**



Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications

- Second, public policy attempted to apply the policy of deconcentration *within* Tokyo, in an effort to divert growth out of the most congested areas within the metro area into less dense areas. Even up to 1998, the official policy of the National Land Bureau was to “halt the excessive concentration of advanced urban functions in the center of Tokyo. These functions should be redistributed to the areas surrounding Tokyo...” This policy has changed, and now planning officials are beginning to stress the *benefits* of agglomeration rather than focusing on its costs. For example, the long-proposed Manhattan Plan for the Maronouchi area is now happening as a means to re-concentrate office activities in the central core, with the intention of attracting more multi-national firms to Tokyo.

As a result of the shift in policy to one that does not discourage concentration, Tokyo will cement its position as the most economically robust city in Japan. Most or potentially all of the net economic growth that occurs in Japan over the coming years will be in Tokyo.

Global financial services houses are particularly underrepresented in Tokyo, but conditions are changing to encourage more expansions. Despite its status as the most affluent economy in Asia, Tokyo is not a major international finance capital in the same way that London and New York are. There are many regional banks and other finance-related companies doing business in Tokyo, but most of them are Japanese-based institutions that service both domestic and, to a lesser extent, international markets. For companies looking to service Asia out of one central location, Tokyo faces considerable competition from Hong Kong, Shanghai and Singapore, and from other Asian capitals. As the Japanese economy becomes less opaque and more open to foreign competition, Tokyo has the potential to become a true global finance powerhouse. This is happening to a limited extent already, as companies such Goldman Sachs have set up large operations in the city over the past few years, but the untapped potential is far larger than the existing base of global finance activities.

The economic recovery underway in Japan, while not a boom by any measure, is a first step on the path towards sustainable growth. Clearly Japan faces significant structural hurdles that it must address and eventually overcome, and the restructuring process in the financial services sector will constrain growth for the foreseeable future. But the momentum for a sustained recovery is in place. This growth will almost entirely emanate from Tokyo going forward, driving new job gains and stoking continued demand for office space. The Tokyo office market is generally healthy even after the Year 2003 construction boom, but Class A properties are best positioned to benefit from the expanding economy going forward.

### III. Tokyo Office Market Overview

Tokyo's office market remains generally healthy relative to other global business centers and to other cities in Japan. The office market is reversing a decentralization trend that took place in the 1980s, as falling land values and hence rents have lured business back into the core city center. The construction boom labeled as the "Year 2003" problem is mostly resolved, and Tokyo's office market has weathered the influx of supply. The new, state-of-the-art projects have raised tenant expectations, and modern buildings are experiencing healthy occupancies and rental rates while poorly located or lower quality buildings are struggling to survive in this new environment. Class A buildings will maintain their position over non-Class A properties and capture the bulk of net demand over the next few years.

#### Re-Centralizing Market

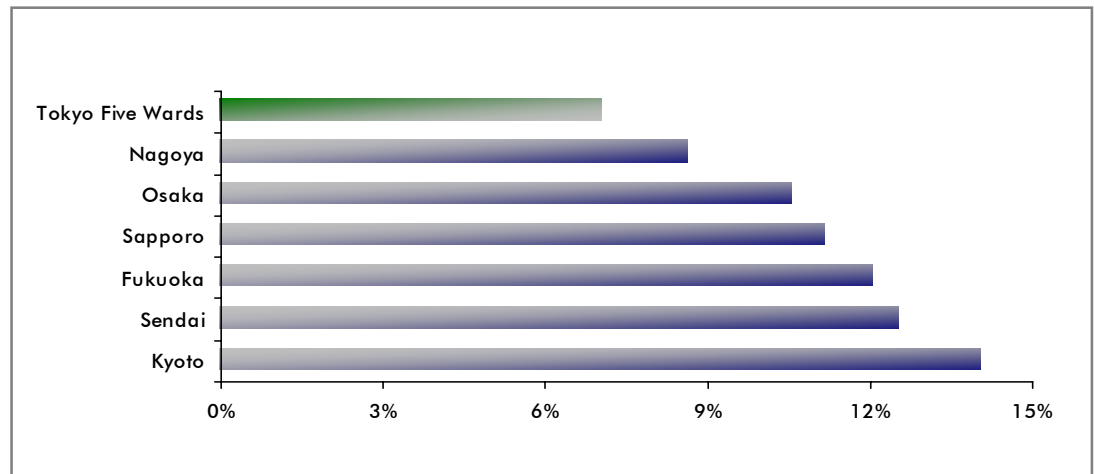
The spatial complexity of the present-day Tokyo office market is a relatively recent phenomenon. As late as 1975, nearly half of all office space in the Tokyo market was located in the central part of the city in Chiyoda and Chuo Wards, in the vicinity of Tokyo station. By 1997, Chiyoda-ku and Chuo-ku held only 33% of Tokyo's total office space while the total amount of office space in Minato-ku, Shibuya-ku and Shinjuku-ku –the other major wards of central Tokyo – accounted for nearly 32%. This decentralization was driven by surface and subway rail transportation improvements in suburban areas and by land price increases in the city center during the 1980s that increased the relative attractiveness of locations outside the center.

It is now clear, however, that the decentralization of the Tokyo office market during the 1980s and into much of the 1990s has begun to reverse. This reversal is to a significant extent due to the relative decline in land values in the center of the city as well as major transportation infrastructure improvements that took place in the center of Tokyo during the last decade. The combination has made the city center significantly more attractive relative to locations outside central city areas. As a result, the current wave of Class A office construction in central Tokyo is transforming the center into something very different than what has existed in the past. Over the next several decades, central areas of Tokyo will increase in density and the center will in time become more like the centers of other major world cities such as Hong Kong, London and New York.



As shown in **Exhibit 5**, Tokyo’s five central ward office vacancy rate is significantly lower than those found in other major Japanese cities. While Tokyo’s office vacancy rates remain comfortably in the single-digits, vacancy rates in a number of major cities, including Fukuoka, Sapporo and Kyoto, are at or near record high levels. Vacancy rates in Osaka, Nagoya and Sendai are all far higher than in Tokyo. The size of the gap between Tokyo and other Japanese cities illustrates a major difference in the economy of Tokyo relative to other cities.

### Exhibit 5 Tokyo’s Vacancy Rate Is Japan’s Healthiest



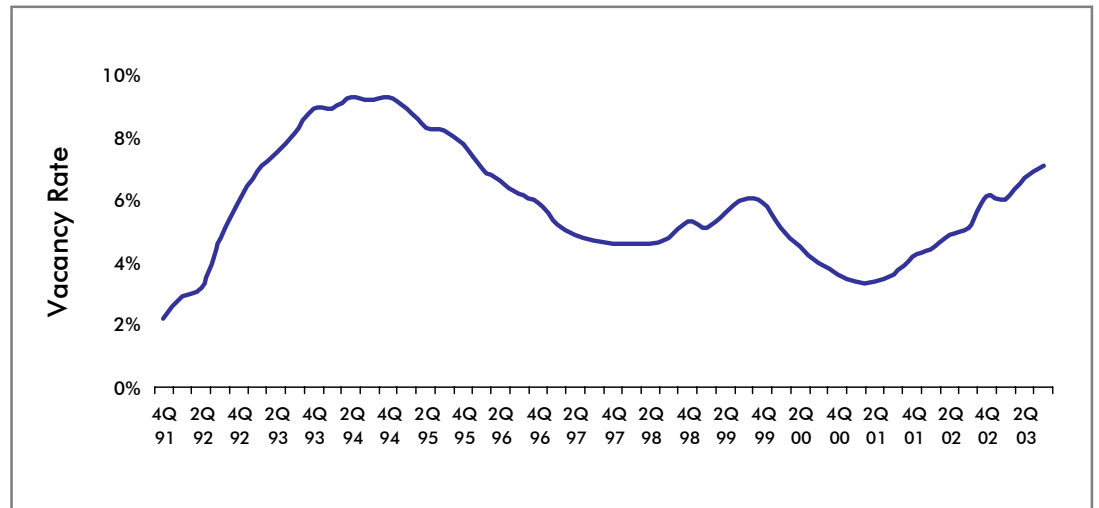
Source: IDSS Data Systems; CB Richard Ellis

### The Market Weathers 2003

The much anticipated “Year 2003 Problem” is mostly resolved, and Tokyo’s office market has fared much better than many expected, especially in the Class A segment. The Year 2003 Problem refers to the massive amount of Class A office space that has either been built or will come on-line by the end of 2003. In the five quarters since June of 2002, over 1,360,000 square meters of space was added to Tokyo’s Five Central Wards, a rate of increase unseen since the end of the bubble economy in the early 1990s.

The Year 2003 Problem turned out to be a much less tumultuous event than was expected only a few years ago. Overall vacancies in Tokyo now stand at 7.1%, as shown in **Exhibit 6**, higher than they have been since 1995 but far below consensus predictions of rates of 10% or worse. Indeed, since the end of the tech-induced economic boom of 2000, vacancy rates have risen from 3.4% to 7.1%, or a total of 460 basis points. Most major global business centers, including London and New York, have experienced worse performance in terms of vacancy rates, and construction levels were not nearly as high as they were in Tokyo.

## Exhibit 6 Vacancy Rates Are Up, But Below Historic Peaks



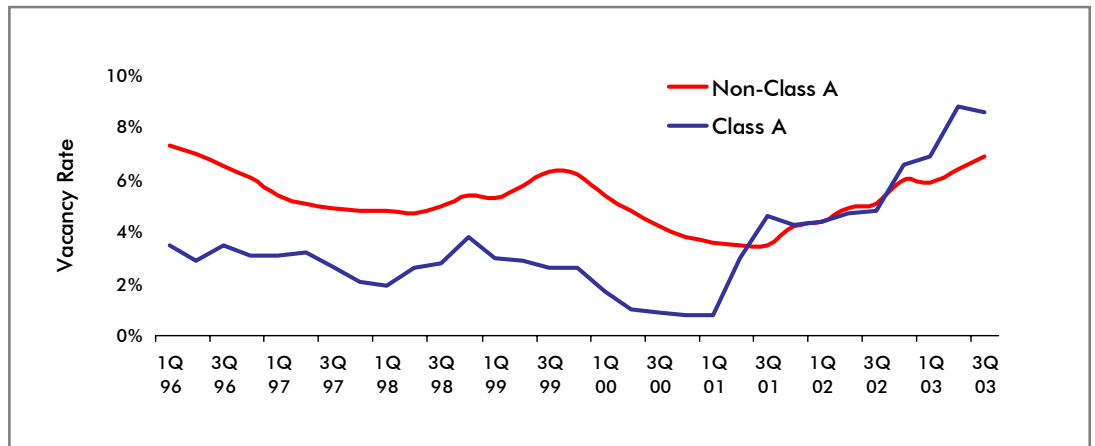
Source: IDSS Data Systems; CB Richard Ellis

The construction boom has been enabled by a variety of factors. First and foremost, land prices in prime locations continue to fall, and are now at levels that make an economic return on development feasible. Second, demand for state-of-the-art Class A space has outstripped supply for many years, and as such developers are assured of leasing activity even in periods of soft overall demand.

Much of this new supply has been delivered in the core business districts, including Maronouchi in Chiyoda-Ku, Roppongi in Minato-ku and Shinjuku, rather than in peripheral areas that experienced most of the construction activity in years past. Rather than saddling these prime areas with disastrous vacancy rates, so far they have been the strongest performing submarkets in Tokyo, with net absorption in new buildings coming at the expense of buildings (especially older ones) in less prestigious areas. Properties not well located near major transportation lines, or those without modern amenities, are performing particularly poorly, as tenants continue to trade up to higher quality buildings.

The shifting fortunes of the Class A and non-Class A markets are charted in **Exhibit 7**. Vacancies in both segments have risen markedly, and the shift from a Class A vacancy rate of under 1% in 2000 to today's rate of 8.6% certainly stands out. Non-Class A vacancies rose from 3.8% in 2001 to only 6.9% now, so at first blush it would appear that the non-Class A segment fared as well or better than the Class A segment over the past two years. Vacancies tell an incomplete story, however. The Class A vacancy rate has risen *entirely* due to additions in supply, whereas the non-Class A segment has been the victim of very anemic demand. A sizeable portion of the rise in the Class A vacancy rate is due to new buildings that are still in the lease-up phase, whereas the non-Class A vacancy rate rise is mostly due to tenant departures. Further, note that the Class A vacancy rate fell in the 3<sup>rd</sup> quarter of 2003, whereas the non-Class A rate continued to rise.

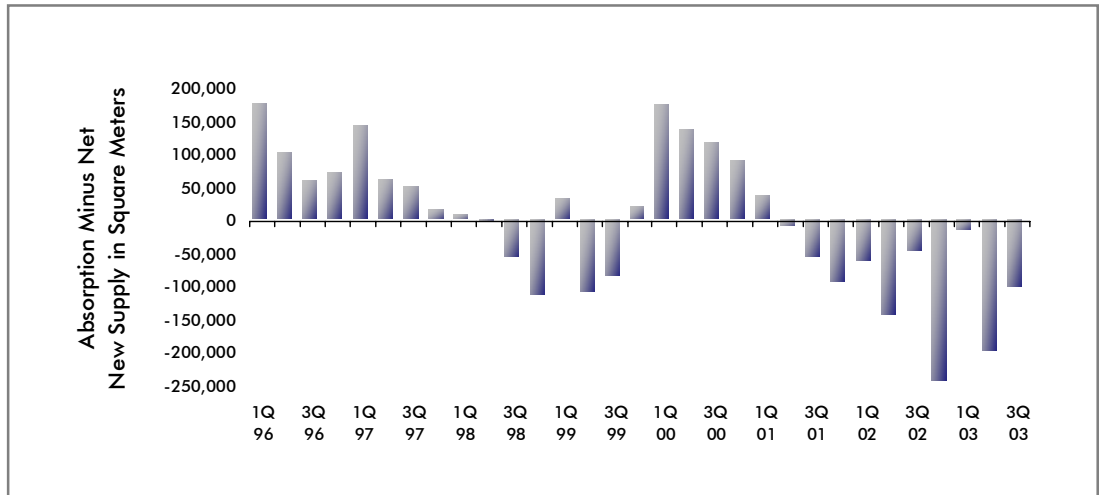
### Exhibit 7 Class A Vacancy Rates Have Begun To Improve



Source: IDSS Data Systems; CB Richard Ellis

Another way to look at the strength of the leasing market for new buildings in Tokyo is shown in **Exhibit 8**, which tracks net demand minus new completions. This indicator is a good proxy for demand for existing buildings, since newly constructed buildings are generally delivered with a high amount of pre-leasing. Demand minus new supply was quite weak in the late-1990s, due to recessionary conditions, but then accelerated into strongly positive territory in 2000 when the economy began expanding again. Since then, demand has been consistently negative for existing buildings. Even during 2003, when the Japanese economy has been expanding and office market leasing activity has been quite strong, existing buildings have fared quite poorly.

## Exhibit 8 Existing Buildings Are Struggling To Retain Tenants



Source: IDSS Data Systems; CB Richard Ellis

While space remains relatively tight in the Tokyo office market, demand for additional space is generally conditional on prices being lower than in existing buildings of similar quality and location. Deflation has exacted a toll even on Japan's strongest office market. Asking rental rates in newly built buildings are not much higher than they were in lesser quality buildings before the construction boom, and effective rents are in some cases lower even for prime floors. The leasing market remains very strong and new buildings are filling up, but existing buildings face competition that is forcing them to accept lower rates.

The flight-to-quality trend is being fueled in large part by non-Japanese companies, especially in the Roppongi and Maronouchi districts. Multi-national companies demand state-of-the-art space for at least two reasons. First, corporations are highly image conscious, and require a prestigious location to give an impression of credibility. Second, new office buildings include amenities that simply aren't available in older buildings, even in Class A properties that were built 20 years ago, including highly efficient floorplates and the ability to provide broadband cable and other infrastructure to floors for specialized uses (such as trading floors) that would require very expensive retrofitting in existing buildings. Demand for top-quality space has existed in Tokyo for years, but it is only recently that land prices and hence rents (still second highest in the world after London) have descended enough to entice tenants to lease it.

## Outlook

The near-term outlook for the Tokyo office market is generally positive, although there will be a continued divergence in performance between high-quality, well located properties and less functional buildings. No longer are poorly maintained, inconveniently located properties able to command top rents simply because office space is difficult to find in Tokyo. The flight-to-quality trend has raised the bar for landlords, who will need to be ever more flexible in providing competitive rents and amenity packages in order to retain and attract tenants.

There will still be demand for non-Class A space in Tokyo. In fact, the current business investment boom and accompanying economic expansion will likely cause some upward movement in rental rates, even in less-than-prime properties. The Year 2003 construction boom is winding down, so pressure on existing buildings will lessen as new towers approach full occupancy. And as companies further centralize their operations in Tokyo, demand for non-Class A space for back-office use will rise, especially in locations convenient to transportation nodes. While non-Class A building owners may no longer be able to count on full occupancies at stratospheric rents, they will continue to attract tenants, albeit at lower rents than they would have commanded before the Year 2003 building boom.

While functional, well located non-Class A buildings will hold their own over the long-term, going forward the growth in demand will be focused on the Class A segment. Multi-national firms will expand their operations in Tokyo, given the continuing opening of the Japanese economy to foreign companies, and these firms will continue to demand high-end office space. There is a risk that another construction boom in a few years could result in an oversupply of top quality buildings, but so far it appears that the surge in supply has been met by at least an equal amount of demand. This demand has largely come via relocations at the expense of other buildings. Going forward there will be more of a net positive effect as future expansions, rather than just relocations, increasingly take place in Class A buildings, especially by financial services companies and other highly visible tenants.



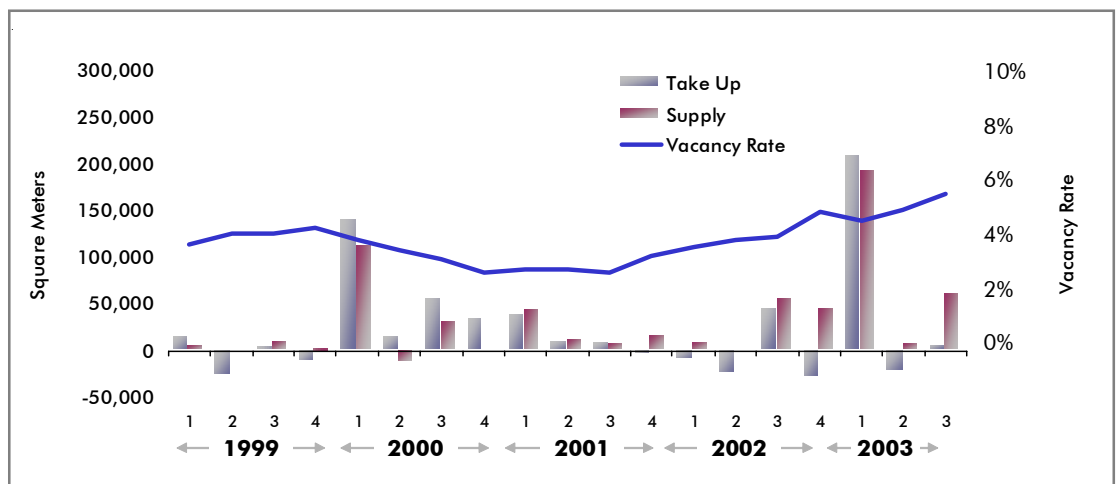
# APPENDIX: FIVE CENTRAL WARDS CONDITIONS

## CHIYODA WARD

Chiyoda ward is the most central of the five wards. Stretching west of Tokyo Station, and surrounding the Imperial Palace, it contains the traditional Marunouchi-Otemachi financial district. The stability of its vacancy rate over time is a testament to its relative attractiveness. As illustrated in Exhibit 9, the ward entered the beginning of the Year 2003 building cycle with a vacancy rate of just over 4%, the lowest vacancy rate in the five wards. Thus, the ward entered the current period of increased supply in good position with a relative lack of vacant space. The correlation between take up and supply has remained constant over the past year and a half, as the delivery of over 350,000 square meters of new space has caused the vacancy rate to rise only to 5.5%, the lowest of the Five Central Wards.



Exhibit 9 Chiyoda Ward - Take Up/Supply/Vacancy



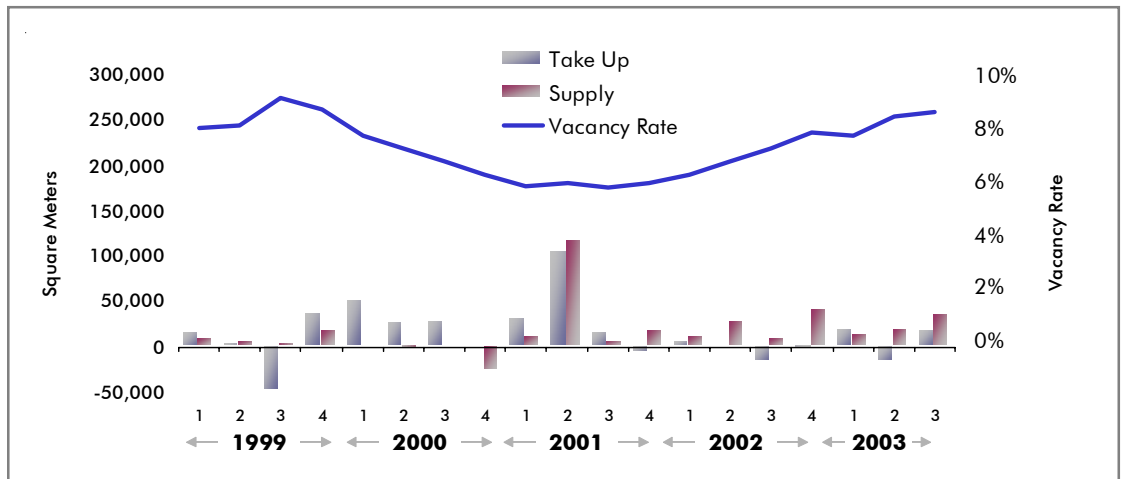
Source: IDSS Data Systems; CB Richard Ellis

## CHUO WARD

Chuo ward, located immediately east of Tokyo Station, contains the renowned Ginza shopping district and the historic Nihonbashi commercial area. Although it contains the new Harumi district built on land-fill islands, it is primarily an older business center which services traditional regional banking headquarters and back office operations. The overwhelming percentage of its office stock is functionally obsolete, and its vacancy rate has been the highest or close to the highest of the five wards for many years. Take up has been mostly positive since the third quarter of 2002, but positive demand has not been enough to keep the vacancy rate from rising to 8.6% as of third quarter 2003, as shown in **Exhibit 10**. Chou continues to suffer from an “old” image that is being increasingly reinforced by the delivery of trophy-quality space in the prestigious Chiyoda and Minato wards to the west and south.



**Exhibit 10 Chuo Ward - Take Up/Supply/Vacancy**



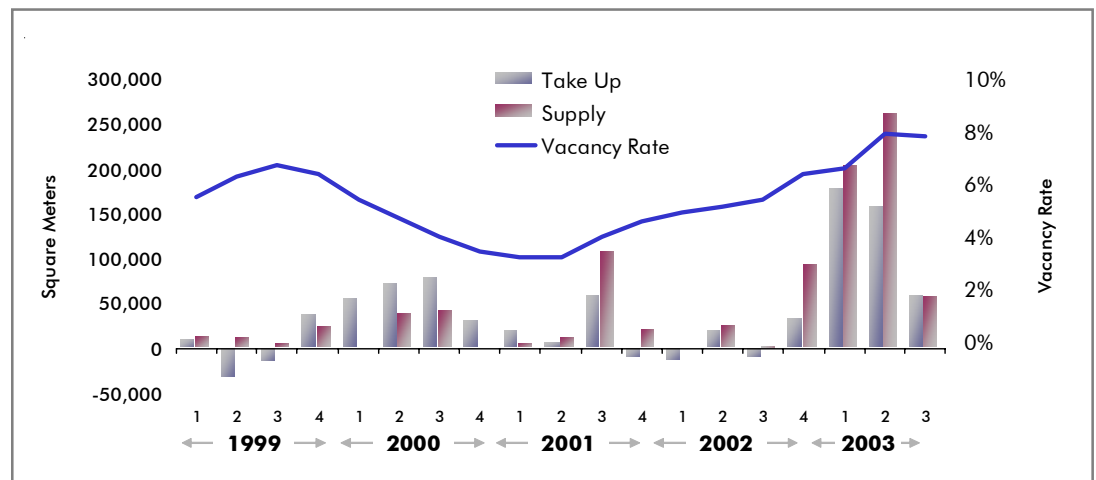
Source: IDSS Data Systems; CB Richard Ellis

## MINATO WARD

Minato ward is Tokyo's uptown, with its prestigious Ayoma and Omote-sando retail boulevards, Roppongi nightlife center, and large concentration of foreign firms and embassies. The emerging Shinagawa business cluster is located along the ward's eastside adjacent to the port. Tokyo's newest and arguably most impressive multi-use project, Roppongi Hills, was completed in spring 2003 and includes the ultra-modern 380,000 square meter Roppongi Hills Mori Tower. Take up in the ward has been far and away the strongest of the five wards since the third quarter of 2002, as seen in **Exhibit 11**. Take up was especially strong in the first half of 2003, as new projects were delivered with substantial pre-leasing. Vacancies rose from a recent low of 5.1% in 2002 to 7.9% in second quarter 2003, but strong leasing activity caused the vacancy rate to dip to 7.8% in the third quarter. Nearly all of the recent take up was in high quality space, and much of the take up came at the expense of lesser quality buildings in other areas.



**Exhibit 11 Minato Ward - Take Up/Supply/Vacancy**



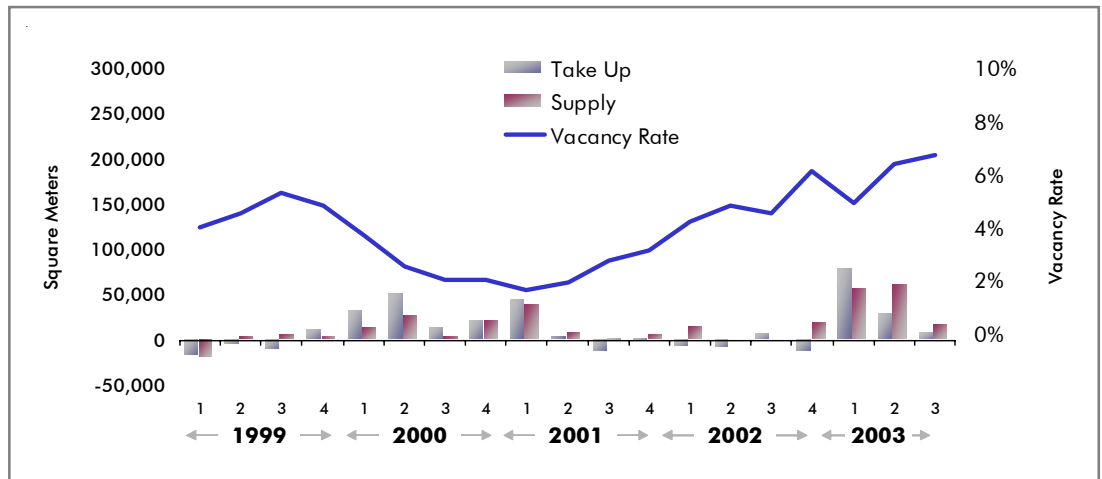
Source: IDSS Data Systems; CB Richard Ellis

## SHIBUYA WARD

Known for its trendy youth culture, Shibuya ward appropriately became the “Bit Valley” during Tokyo’s 2000 technology boom. The ward’s relatively small office market saw a frenzy of activity during the recovery, as shown in **Exhibit 12**, even as the ward’s vacancy rate plunged below 2% in early 2001. Dramatic cooling took place at the end of the technology boom, although the resulting increase in vacancies was not nearly as large as it was in other tech centers across the globe. Shibuya’s vacancy rate now stands at 6.7%, the second lowest of the five wards after Chiyoda.



**Exhibit 12 Shibuya Ward - Take Up/Supply/Vacancy**



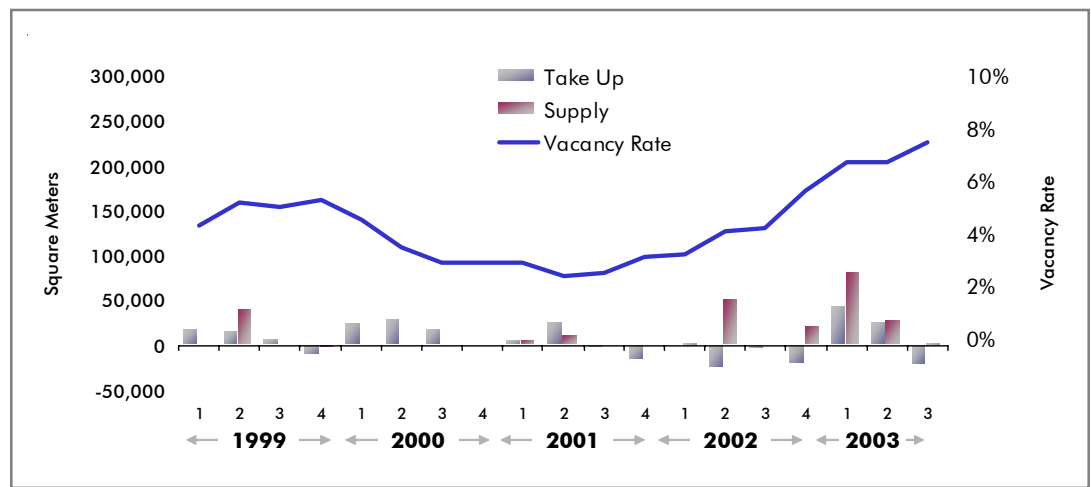
Source: IDSS Data Systems; CB Richard Ellis

## SHINJUKU WARD

Shinjuku ward contains the largest concentration of master-planned high-rise office buildings, located adjacent to Tokyo's Metropolitan Government offices. Shinjuku station is the busiest in Japan, serving an estimated two million commuters daily, making the district an ideal location for companies looking to minimize their employees' travel times. Shinjuku has slipped in stature recently, due in large part to the recent availability of modern, trophy quality office buildings in Minato and Chiyoda wards. Before the Year 2003 building boom, which has largely passed Shinjuku by apart from some new non-Class A construction, companies looking for large floorplates and modern amenities often found their only options in Shinjuku. While vacancies of 7.5% are healthy by world office market standards, as shown in **Exhibit 13**, the direction of the vacancy rate is of concern, and it may be that the ward has suffered a lasting blow now that high-rise tenants have more options elsewhere. Nevertheless, Shinjuku's excellent location and amenity base mean that it will retain its position as one of Tokyo's prime office districts.



**Exhibit 12 Shinjuku Ward - Take Up/Supply/Vacancy**



Source: IDSS Data Systems; CB Richard Ellis

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