Executive Summary

- The Tokyo Grade B office segment is considerably larger than that of Grade A in terms of the leasable area and the number of properties.
- Grade B rents are at an early stage in the upturn and growth is expected to continue in the medium term.
- Grade B assets are an attractive investment target as they can potentially deliver yield spread of over 100 bps above Grade A assets.
- The number of transactions in Grade B assets was triple that for Grade A assets in the 2010-13 period, and more Grade B properties should become available for sale.

1. Overview of the Japanese Economy and Tokyo Office Market

Japan’s economy is picking up after two decades of stagnation on the back of “Abenomics”. Corporate spending and exports strengthened gradually over the course of 2013, partly helped by the weakening Japanese yen, which has depreciated by more than 15% against the US dollar since end-2012, and the core CPI figure reached a five-year high in February 2014. Although real GDP growth slowed unexpectedly in 4Q13, and consumer confidence in February 2014 fell to its lowest level in over two years ahead of a planned consumption tax hike in April 2014, the consensus view remains that moderate recovery should continue on the back of the government’s fiscal stimulus package and ongoing monetary easing.

The real estate market in Japan is just starting to recover due to improving business conditions and investment opportunities are arising in various market segments. The office sector is drawing keen attention from both domestic and foreign investors, as rents are finally trending upward but remain significantly below their pre-global financial crisis (GFC) peaks, and Tokyo office rents still lag the recovery in other major global financial centres (Figure 1).

Although a large office market with all-grade stock totalling about 30 million sqm (on a net leasable area basis) in the five central wards of Tokyo, the Grade B market segment comprises most of the core investment targets and accounts for the biggest share of real estate investment transactions. Moreover, the Grade B market in itself refers to a very wide range of assets in terms of building quality, specification and location, and selecting an appropriate investment target requires detailed information and expertise.

2. Grade B Office Leasing Market

In this report, we start by looking at the key characteristics of Grade B assets in comparison with Grade A assets, and focus on office space in the five central wards, or kus, of the Tokyo CBD (i.e. Chuo, Minato, Chiyoda, Shinjuku and Shibuya). Comparing the total stock size for each grade, the Grade B segment is a considerably larger market, at about 1.2 times that of Grade A in terms of the leasable area (Figure 2) and about five times that of Grade A in terms of the number of properties.
In terms of building characteristics in the leasing market, Grade B buildings are usually smaller (both total floor area and floor plate) and older than Grade A buildings (Figure 3).

Tenant characteristics also differ between building grades. For example, occupiers of Grade A office buildings tend to include more MNCs and Japanese companies that require larger floor areas. On the other hand, occupants of Grade B offices mainly comprise medium-sized domestic and foreign corporations as well as specialist offices (e.g. law firms and accounting firms), newly set-up enterprises and branch offices of large corporations.

Despite the differences in the building and tenant characteristics, the market fundamentals for both office grades do not differ fundamentally. Historical demand and supply of Grade B office shows a similar trend to the Grade A segment. Net absorption of Grade B space exceeded new supply from 2004 to 2007, but net take-up was significantly less than new supply in 2008 and turned negative in 2009, due to the increasing number of bankruptcies of small- to mid-sized corporates and the surrendering of floors during the GFC. Occupier demand strengthened gradually from 2010 onwards and the vacancy rate began to trend lower in 2012 on the back of the improving economy and reconstruction demand after the 2011 earthquake (Figure 4). The average vacancy rate of the Grade B sector stood at 4.0% by end-4Q13 and was approximately 60 bps higher than the Grade A sector.

As of 4Q13, average Grade B office rents were about 60% of Grade A levels (Figure 5). The market cycle is similar for both grades, but past data suggests movements in Grade B rents slightly lag behind Grade A rents, e.g. the most recent rent peaks were 1Q08 for Grade A and 2Q08 for Grade B, while the rent trough was 1Q12 for Grade A and 4Q12 for Grade B (a lag of three quarters). Recently, Grade A rents have risen for six consecutive quarters, since bottoming out in 2Q12, whereas Grade B rents started rising in 1Q13 for the first time in 19 quarters on the back of improving sentiment from large- to medium-sized corporates.

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### Table: Office Grade Comparisons

<table>
<thead>
<tr>
<th>Office Grade</th>
<th>Average Gross Rents (Including Service Charge)</th>
<th>Vacancy Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Per Tsubo per Month</td>
<td>Change Q-on-Q</td>
</tr>
<tr>
<td>CBD Grade B</td>
<td>JPY 19,517</td>
<td>0.8%</td>
</tr>
<tr>
<td>CBD Grade A</td>
<td>JPY 31,812</td>
<td>1.0%</td>
</tr>
</tbody>
</table>

Source: JLL (Real Estate Intelligence Service), 4Q13
In Figure 6, we show both Tokyo Grade A and Grade B office in the “Rents Rising” (6 to 9 o’clock) quadrant of the JLL office clock, depicting a scenario where rents are rising. Grade A office is closer to 9 o’clock, signifying that rents have been rising for some time, albeit mildly. Grade B office is closer to 6 o’clock, signifying the earliest stage in the upturn and implying an expectation that rents will continue to rise in the near term.

One interesting point for potential investors is that fluctuations in rents and vacancy rates differ by grade. Past trends show that the difference between the peak and the trough values for vacancy rates is smaller for the Grade B segment (Figure 7 and Figure 8) than for the Grade A segment. Fluctuations in rents are similar for both grades in percentage terms during a cyclical downturn, but Grade A rents offer more of an upside based on evidence from the latest cycle. In this regard, Grade B assets seem more suited to those investors who prioritise stability in occupancy.

3. **Grade B Office Investment Market**

In this section, we analyse the characteristics of the Grade B office investment market in comparison with the Grade A office sector.

The main difference between the two grades is ownership. Most Grade A buildings are owned by long-term investors, such as major Japanese developers or life insurance companies, and are rarely sold. Therefore, investment opportunities are quite limited for both Japanese and foreign investors. On the other hand, there are a larger number of Grade B buildings, with a more diverse group of owners ranging from corporations and real estate funds to wealthy individuals, and each may have a different investment strategy, such as holding period and the selling price. This should provide higher liquidity and in turn more trading opportunities for Grade B assets.

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**Figure 6: Global Office Property Clock (4Q13)**

Source: JLL Research, 4Q13

**Figure 7: Historical Fluctuation in Tokyo Grade A & Grade B Office Rents and Vacancy Rates**

<table>
<thead>
<tr>
<th>Gross Rent</th>
<th>Grade A</th>
<th>vs</th>
<th>Grade B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rising</td>
<td>+81.9%</td>
<td></td>
<td>+38.7%</td>
</tr>
<tr>
<td>Falling</td>
<td>-41.9%</td>
<td></td>
<td>-40.4%</td>
</tr>
<tr>
<td>Vacancy Rate</td>
<td>Grade A</td>
<td></td>
<td>Grade B</td>
</tr>
<tr>
<td>Rising</td>
<td>12.8% to 0.6%</td>
<td></td>
<td>8.1% to 1.8%</td>
</tr>
<tr>
<td>Falling</td>
<td>0.6% to 7.8%</td>
<td></td>
<td>1.8% to 7.7%</td>
</tr>
</tbody>
</table>

Source: JLL (Real Estate Intelligence Service), 4Q13

**Figure 8: Tokyo Grade A & Grade B Office Rents and Vacancy Rate Trend, (4Q02 - 4Q13)**

Source: JLL (Real Estate Intelligence Service), 4Q13
The breakdown of office building transactions that took place in the Tokyo CBD from 2010 to 2013 (Figure 9) shows that the number of transactions in the Grade B office sector was about triple the figure for the Grade A office sector. Considering that Grade A office transactions were mainly between J-REITs and their sponsors, an even more significant number of investment opportunities exist in the Grade B office sector for non-REIT investors.

In addition, Grade B buildings generally have the same level of earthquake tolerance as Grade A buildings, but buildings graded lower than Grade B are mainly older or smaller buildings with less earthquake tolerance, and are likely to be outside the scope of institutional investment. As such, it is not surprising that the Grade B office sector is drawing attention as the main investment target and sees the largest transaction volume.

Figure 10: Tokyo Grade B Office Transactions (2013)

<table>
<thead>
<tr>
<th>Transaction Date</th>
<th>Building Name</th>
<th>Completion</th>
<th>Address</th>
<th>Price (JPY million)</th>
<th>Gross Floor Area (sqm)</th>
<th>Net Leasable Area (sqm)</th>
<th>Price per NLA (JPY million)</th>
<th>Investment Yield (NOI)</th>
<th>Purchaser</th>
<th>Vendor</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 2013</td>
<td>Aplus Tokyo Building</td>
<td>1994</td>
<td>Shin-ogawamachi, Shinjuku-ku</td>
<td>4,350</td>
<td>6,764</td>
<td>4,487</td>
<td>969</td>
<td>4.7%</td>
<td>Kenedix Realty Investment (REIT)</td>
<td>Aplus, Two domestic companies</td>
<td>Strata-title</td>
</tr>
<tr>
<td>November 2013</td>
<td>SIA Takanawadai Building</td>
<td>1985</td>
<td>Takanawa, Minato-Ku</td>
<td>5,250</td>
<td>9,265</td>
<td>6,952</td>
<td>755</td>
<td>5.0%</td>
<td>Kenedix Realty Investment (REIT)</td>
<td>SPC of Morgan Stanley</td>
<td>63% Strata-title</td>
</tr>
<tr>
<td>August 2013</td>
<td>Shibuya R Sankei Building</td>
<td>1990</td>
<td>Shibuya, Shibuya-ku</td>
<td>5,270</td>
<td>7,289</td>
<td>4,403*</td>
<td>1,197</td>
<td>5.1%</td>
<td>Tokyu REIT (REIT)</td>
<td>The Sankei Building</td>
<td></td>
</tr>
<tr>
<td>August 2013</td>
<td>Itopia Nihonbashi SA Building</td>
<td>1995</td>
<td>Nihonbashi Horidomecho, Chuo-ku</td>
<td>2,200</td>
<td>7,362</td>
<td>3,267*</td>
<td>673</td>
<td>6.1%</td>
<td>Kenedix Realty Investment (REIT)</td>
<td>SPC of MGPA</td>
<td></td>
</tr>
<tr>
<td>April 2013</td>
<td>TK Shinbashi Building</td>
<td>1999</td>
<td>Shinbashi, Minato-ku</td>
<td>5,650</td>
<td>7,144</td>
<td>5,052</td>
<td>1,118</td>
<td>5.2%</td>
<td>Activia Properties (REIT)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*1 Figure refers to purchased area for strata-title transaction.
Source: JLL (Real Estate Intelligence Service), 4Q13
Grade B office properties are a more popular investment class than any other asset class in the current Japan market. However, quality and investable Grade B office properties have been limited and investors have been competing for limited opportunities.

J-REITs are considered the dominant investor group in the Grade B investment market, but a growing number of offshore investors are actively participating in the market to acquire quality Grade B office assets. In addition to experienced legacy investors, who are returning to the market after the GFC, a sizable amount of new equity has been raised in the past year by offshore investors who are eager to seek quality Grade B assets.

Apart from the large offshore funds, other newcomers are predominantly Asian (especially Hong Kong and Singapore). Although the fund sizes are relatively small, these Asian funds have been aggressively looking for investment opportunities in quality Grade B office buildings, which can offer higher yield spreads compared with their home markets, such as Hong Kong, Singapore and Shanghai.

Market acquisitions in the Grade B office sector by J-REITs in 2013 (Figure 10) indicated investment yields in the range of 4-6%, which is significantly higher than the 3.5-4% on average for the Grade A office sector.

Investment yields on both Grade A and Grade B office assets have been falling since 2009, but Grade B yields have fallen by much more than Grade A yields -80 bps versus -20 bps between end-2009 and end-2013 (Figure 11 and Figure 12). Past data shows that the spread between Grade A and Grade B office yields tends to contract during market upturns and expand during market downturns. The main reason for this is that Grade A assets are rarely sold, which has helped to cap expansion in investment yields during market downturns, but also limits the magnitude of yield compression during a market upturn.

In the present low interest rate environment, the Grade A office sector provides small positive spreads above the yields on ten-year Japanese government bonds (JGB) (currently below 1%), but the Grade B office sector can deliver additional yield spread of about 100 bps, and is thus a very attractive investment target even from a global perspective.

**Figure 11: Tokyo Grade A & Grade B Office Investment Yield Trend**

**Figure 12: Fluctuations in Tokyo Grade A & Grade B Office Investment Yield**

<table>
<thead>
<tr>
<th>Investment Yield</th>
<th>Grade A</th>
<th>vs</th>
<th>Grade B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compressing</td>
<td>-190 bps</td>
<td></td>
<td>-200 bps</td>
</tr>
<tr>
<td></td>
<td>3Q03 → 4Q07</td>
<td></td>
<td>1Q03 → 4Q07</td>
</tr>
<tr>
<td>Rising</td>
<td>+70 bps</td>
<td></td>
<td>+170 bps</td>
</tr>
<tr>
<td></td>
<td>4Q07 → 2Q10</td>
<td></td>
<td>4Q07 → 3Q09</td>
</tr>
</tbody>
</table>

Source: JLL (Real Estate Intelligence Service), 4Q13

Note: Investment yield refers to Net Operating Income (NOI) Yields.
4. Grade B Office Characteristics: SWOT Analysis

As the Grade B office market consists of a very wide range of assets, making informed investment decisions based on a clear understanding of their various features can help lower risks and enhance returns. The following SWOT analysis summarises the key characteristics of the Grade B office sector (Figure 13). In sum, the Grade B office sector is a very attractive investment target despite some shortcomings, and provides more stable occupancy rates combined with higher yield spreads.

Figure 13: SWOT Analysis: Tokyo Grade B Office Sector

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Numerous occupiers</td>
<td>Lower status than Grade A</td>
</tr>
<tr>
<td>Numerous landlords</td>
<td>More volatile investment yield</td>
</tr>
<tr>
<td>Large number of investable properties</td>
<td>Slower rental recovery than Grade A</td>
</tr>
<tr>
<td>Wide yield spread</td>
<td>Wide range in terms of quality</td>
</tr>
<tr>
<td>Relatively stable occupancy rate</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Threats</th>
</tr>
</thead>
<tbody>
<tr>
<td>Upside to return is expected with improved management effort</td>
<td>Many alternative buildings exist in the neighbourhood</td>
</tr>
<tr>
<td>Capital inflows from domestic and cross-border investors</td>
<td>Short construction period</td>
</tr>
<tr>
<td>High liquidity and more trading opportunities</td>
<td>Competition can increase relatively easily</td>
</tr>
</tbody>
</table>

Source: JLL (Real Estate Intelligence Service), 4Q13

5. 12-month Outlook for the Tokyo Grade B Office Market

The office investment market in Japan has become very active due to expectations for continuing economic recovery coupled with a weaker Japanese yen. The recovery in Tokyo office rents is likely to continue over the next few years, and both Grade A and Grade B rents are projected to rise by 5-10% in 2014. As the leasing market stabilises, more properties should become available for sale, offering a wider range of choices for potential purchasers.

Source: JLL (Real Estate Intelligence Service), 4Q13

Figure 14: Rental & Yield Outlook for the Tokyo Grade B Office Market

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