

Japan - February 2019

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**SPOTLIGHT**  
Savills Research

# Japan Hospitality

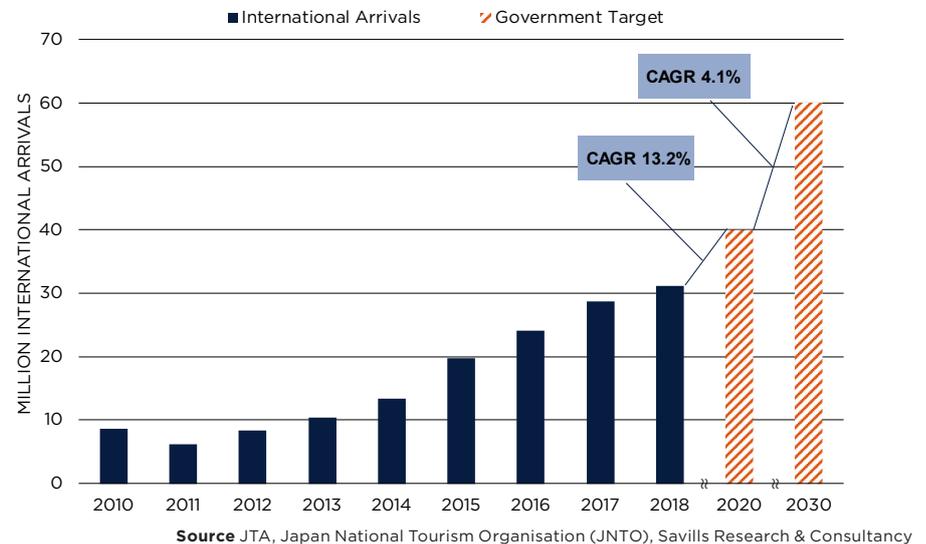


# Hotel fundamentals remain sound

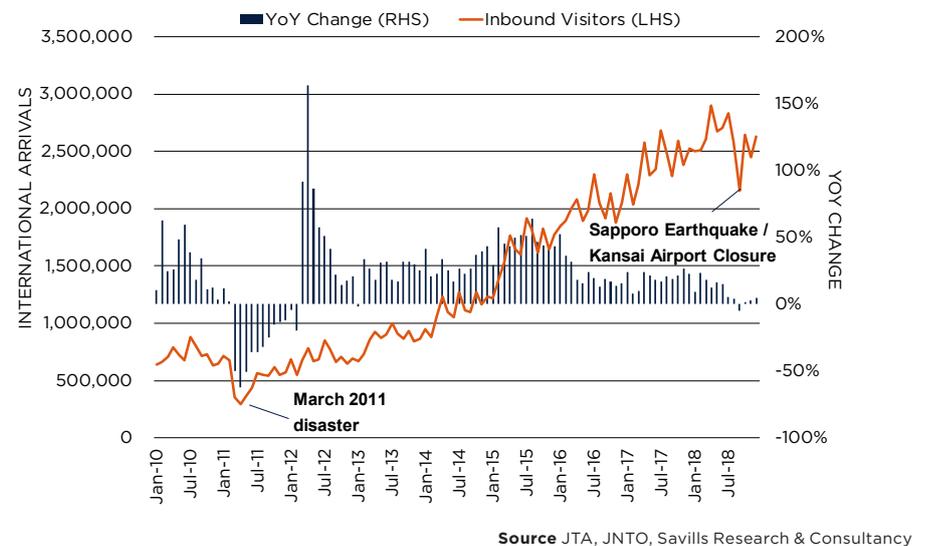
## Summary

- The number of annual overseas visitors to Japan has risen 8.7% YoY, to 31.2 million.
- Inbound tourist spending in 2018 was 4.5 trillion yen, up 2% YoY.
- The introduction of direct international LCC flights to local airports is supporting foreign travel to regional Japan.
- As inbound visitors move beyond Japan's metropolitan areas, major players are expanding their presence in regional markets.
- 2019 is expected to see record supply of hotel rooms, leading to some caution among hoteliers and investors. The impact of 2018 supply requires further monitoring.
- Occupancy remains strong and overall hotel performance improved marginally, despite 2018's negative pressures.
- Hotel investment volumes fell in 2018 along with total real estate investment volumes; however, the drop was much less pronounced than in other sectors. The current development boom should open up more investment opportunities.

**GRAPH 1: International Arrivals And Annual Growth, 2010 to 2018**



**GRAPH 2: International Arrivals By Month, 2010 to 2018**



## Introduction

In 2018, the number of overseas tourists to Japan reached 31.2 million, an increase of 8.7% year-on-year (YoY), surpassing the 30 million visitor milestone for the first time ever (Graph 1). Inbound tourist spending also grew for the seventh consecutive year, rising 2% to 4.5 trillion yen. These record figures were achieved despite a year of earthquakes, floods, typhoons, and exceptional heat. Inbound tourism to Japan appears to have entered a phase of stable growth that could prove resilient in the face of an economic slowdown. Even so, in September, the closure of Kansai International Airport and the Eastern Iburi Earthquake in Hokkaido (Sapporo) led to the first YoY drop in monthly

inbound visitors since 2013 (Graph 2).

Despite the year's challenges, the 2020 goal of 40 million annual visitors appears within reach – certainly much more so than in early 2016, when the then apparently quixotic goal was first announced – as momentum is set to pick up over the next two years. To start, the 2019 Rugby World Cup, which will be held in 12 cities across the country from September 20th to November 2nd, is set to boost visitors during an off-peak season and serve as a platform to showcase regional Japan.

Encouragingly, over 2 million ticket applications for the Rugby World Cup were processed during the first application period, with over 40% of demand reportedly coming

from outside of Japan, putting the event on track to host the largest number of overseas visitors in the history of the tournament. Applications for tickets to the 2020 Olympics are scheduled to open in April; if interest in the Rugby World Cup is any indicator, record-breaking overseas demand seems likely. These and other catalysts should also serve to support regional tourism.

According to the Japan Tourism Agency (JTA), stays by overseas visitors outside of Japan's top three metro areas accounted for over 40% of all inbound stays for the first time in 2017. YTD data to November 2018 suggests that this trend is extending, with some outlying prefectures seeing substantial growth over 2017 (Map 1). Aomori (Tohoku Region) and Fukui (Hokuriku Region), for example, posted 49.5% and 31.5% YoY growth, respectively, in inbound nights stayed. To be sure, non-core regional markets such as these still host a relatively small number of visitors, but further growth may offer untapped opportunities to astute investors and hoteliers.

Regional tourism is being partly driven by terminal expansions and new LCC routes

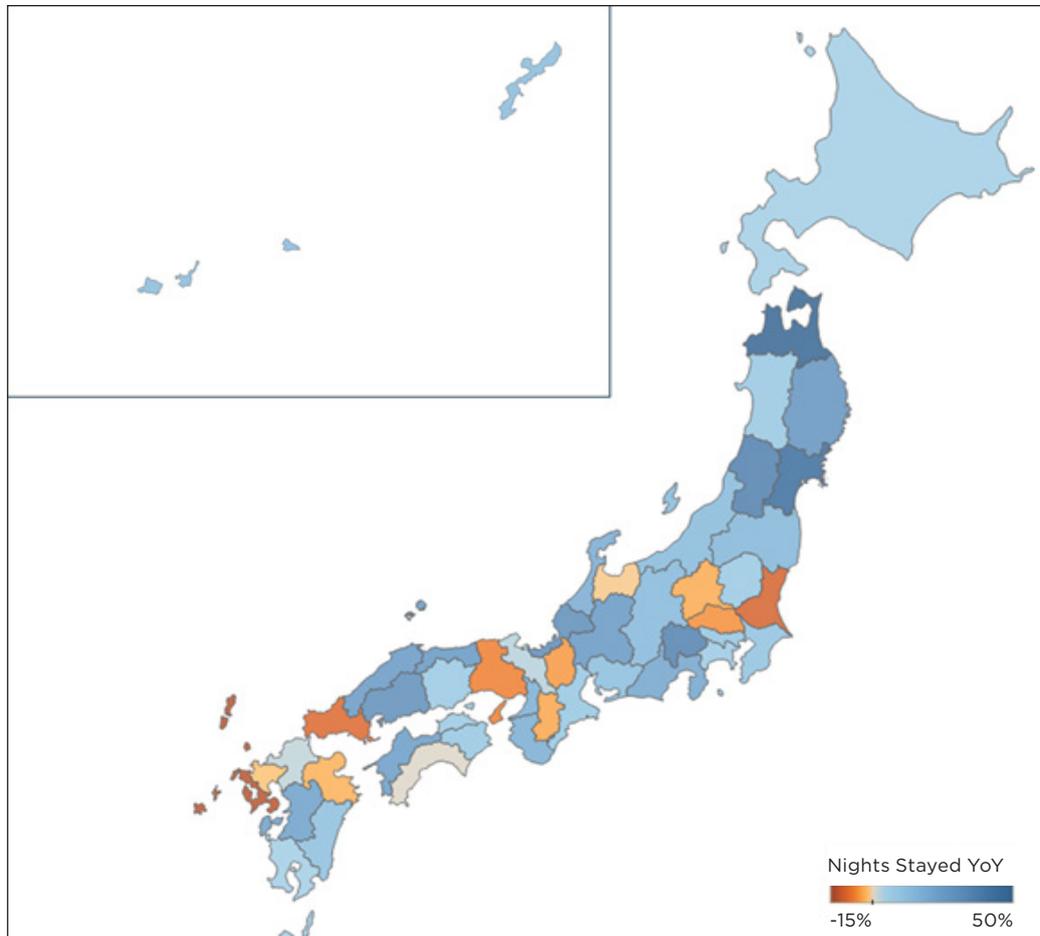
at local airports. Sendai Airport added its first international LCC route after being privatised in 2016 and recently completed a terminal expansion to increase capacity. In August 2018, Hanamaki Airport in Iwate saw the introduction of a route to Taoyuan

International Airport via Tigerair Taiwan. These new flights may be a key factor in the Tohoku Region's rapid growth in inbound nights stayed.

Indeed, limited airport capacity has been a drag on inbound tourism. Reports

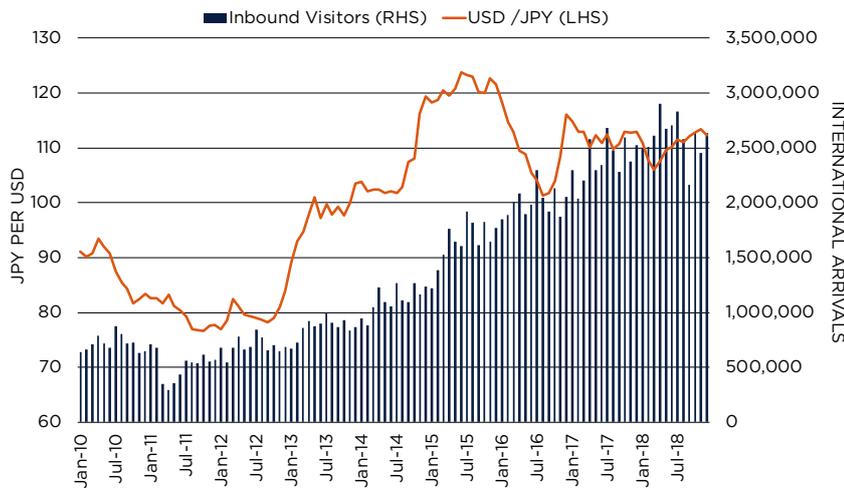
## The fundamentals of Japan's hospitality industry are strong, despite a year marked by natural disasters, and limited-service hotel performance has remained relatively sound. Though stricter minpaku regulation has reduced some competitive pressure on the industry, high supply levels and looming macro headwinds could weigh on the market.

MAP 1: Annual Growth Of Inbound Nights Stayed By Prefecture, 2018 vs 2017\*



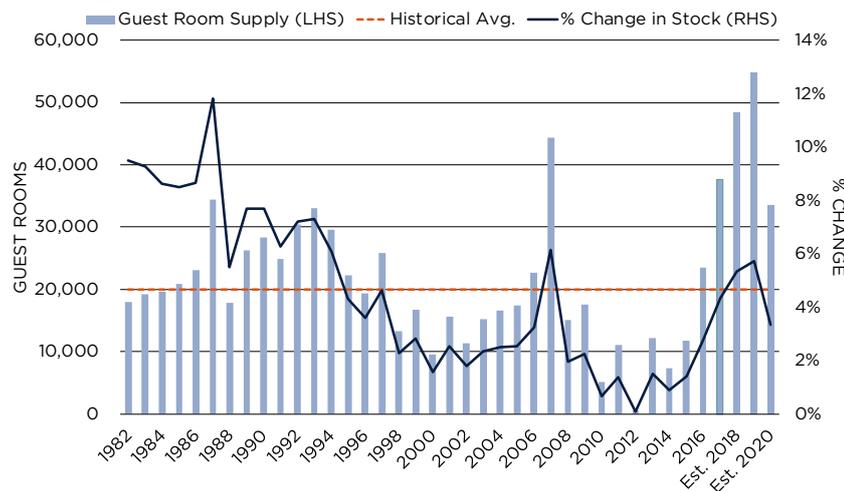
Source JTA, © OpenStreetMap (www.openstreetmap.org/copyright), Savills Research & Consultancy  
\*For the period from January to November of each year

**GRAPH 3: Monthly International Arrivals And Yen Movement, 2010 to 2018**



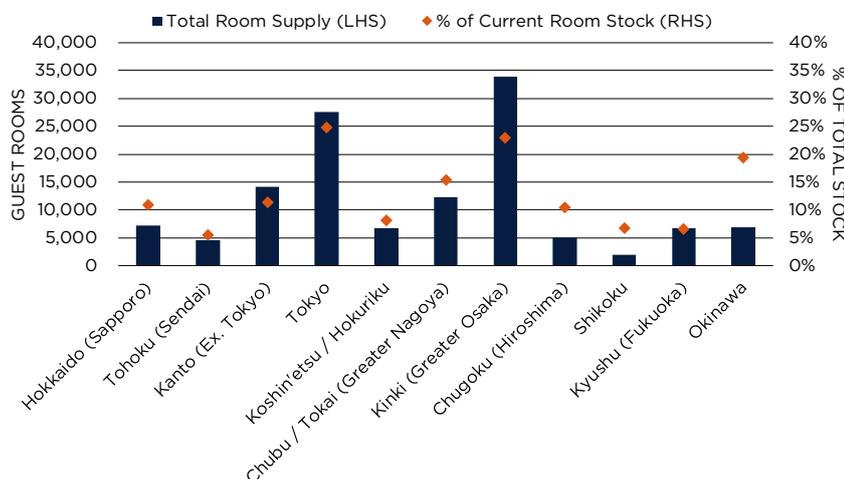
Source U.S. Federal Reserve Board, JNTO, Savills Research & Consultancy

**GRAPH 4: Hotel Guest Room Supply, 1982 to 2020**



Source Hotesres, Ministry of Health, Labour and Welfare (MHLW), Savills Research & Consultancy

**GRAPH 5: Hotel Guest Room Supply By Region, 2018 to 2020**



Source Hotesres, MHLW, Savills Research & Consultancy

Note: Current room stock refers to total stock as of March 30, 2018, based on MHLW's latest survey. As such, 2018 room supply is counted from the period beginning April 1.

indicate that Haneda Airport, Greater Tokyo's primary transit hub and Japan's largest airport by passenger traffic, is at full capacity, while nearby Narita Airport is fast approaching that level. A further diffusion of tourism to regional cities should help reduce the burden on Tokyo airports and potentially boost overall visits to Japan.

That said, looming headwinds could weigh on this strong demand. The depreciation of the Japanese yen that began in 2013 has been viewed as a driver of inbound tourism. As a safe haven currency, the yen tends to appreciate during global economic downturns. So far, some strengthening of the yen does not appear to have had much of a negative impact on inbound tourism (Graph 3). However, further deterioration in macroeconomic conditions could lead the yen to appreciate further, while the currencies of key sources of inbound tourism could depreciate significantly in such an environment. If these conditions were to persist, it might have a visible impact on inbound tourism.

Looking further ahead, new developments and tourist friendly government policies should help secure a stable demand base beyond 2020. It has been announced that Osaka will host the World Expo 2025 and it is increasingly likely that the area will see the development of an integrated resort, which will further add to the region's attractiveness as a tourist destination. Other developments in infrastructure and entertainment options throughout Japan, including new theme parks and existing resort expansions, will serve as additional catalysts moving forward.

**Incoming Supply**

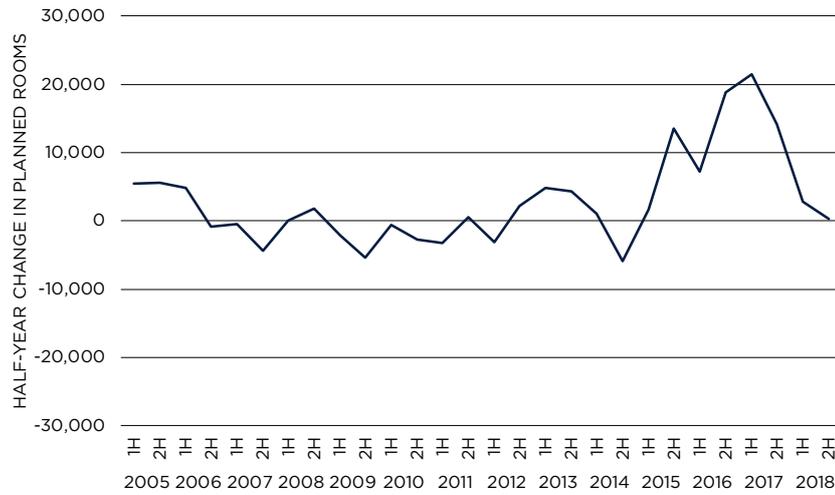
As discussed in previous reports, the main concern of hoteliers continues to be a high level of upcoming supply (Graph 4). Over the 2018<sup>1</sup>-2020 period, Tokyo is estimated to increase its room stock by 24.9%, while Greater Osaka and Okinawa are estimated to see increases of 23.0% and 19.4%, respectively.

Most of the supply to Tokyo and Osaka will consist of limited-service hotels, while Okinawa will see a boom in the full-service and resort markets. This rapid development is not surprising for some of Japan's top tourist destinations, though other areas in the country are set to see a significant expansion of their hospitality markets as well (Graph 5).

Indeed, developers have taken note of increasing tourism to outlying regions and are extending their reach into such markets. Marriott and Sekisui House announced a collaboration in late 2018 to develop a portfolio of up to 50 hotels in rural areas near roadside rest stops ("michi-no-eki").

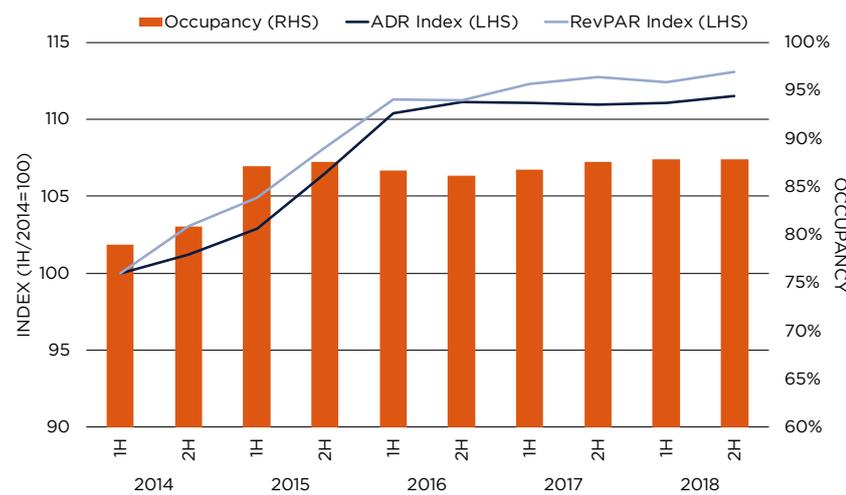
<sup>1</sup> 2018 supply is counted for the period from April 1 to December 31 in order to maintain consistency with MHLW's reported stock as of March 30, 2018. Supply forecasts are based on disclosures aggregated by Hotesres.

**GRAPH 6: Change In Number Of Planned Guest Rooms, 2005 to 2018**



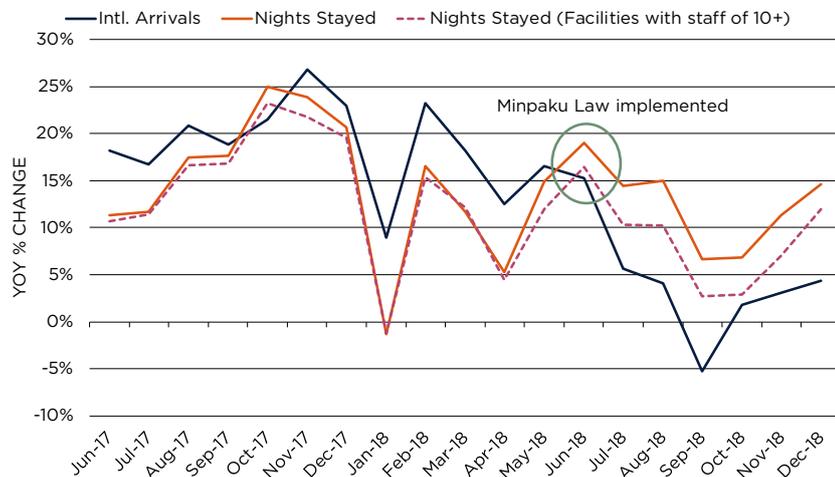
Source Hoteres, Savills Research & Consultancy

**GRAPH 7: Trailing-twelve-month Limited-service Hotel Performance, 2014 to 2018**



Source J-REIT disclosures, Savills Research & Consultancy

**GRAPH 8: Annual Growth In International Arrivals VS Growth In Nights Stayed, June 2017 to December 2018**



Source JTA, JNTO, Savills Research & Consultancy

Note: International arrivals numbers for November and December are preliminary estimates by JNTO.

Other players, such as Hong Kong-based Odyssey Capital Group, are renovating ryokan and repurposing traditional houses as luxury boutique hotels in some regional markets. As regional areas are expected to host significantly more foreign visitors in the future, development activity in these areas should continue.

Large upcoming supply of limited-service hotels could very well crowd the market. On the other hand, Tokyo is still expected to have a shortage of rooms during the 2020 Olympics. As with the logistics sector in the past, supply may in fact serve to induce more demand. With available accommodation in Japan still comparatively sparse, additional flexibility in booking rooms could draw in more tourists.

More positively for hoteliers, forecasts produced by industry publication Hoteres show that total planned hotels have dropped for the first time since 2014, with planned rooms remaining largely flat (Graph 6). This suggests that new supply should cool after 2020, similar to the Tokyo office sector. Developers may have become more cautious in the face of rising land prices and labour costs, combined with an already-robust supply pipeline and the sound, but lacklustre operating indicators of existing hotels. Securing a workforce could also prove challenging for new developments, particularly in regional markets.

**Japan Hotel Market**

Savills tracks the performance of over 100 hotels owned by five J-REITs<sup>2</sup> to analyse market trends. Our analysis focuses on limited-service hotels; full-service and resort properties are excluded due to limited data. Given that a majority of the existing hotel stock and supply pipeline is in the limited-service category, this should provide a good proxy for the overall market trend in Japan<sup>3</sup>.

Considering the hurdles faced by the industry in 2018, limited-service hotels held by J-REITs appear to have performed relatively well. In 2H/2018, average daily rates (ADR) and revenue per available room (RevPAR) posted YoY growth of 0.5% and 0.3%, respectively, while occupancy held at around 88% (Graph 7). Though marginal, this growth is notable in the face of large supply and negative pressures on demand during the year.

Reduced minpaku supply may have had a role in carrying hotel performance through the second half of the year, as revealed by statistics published by the JTA. YoY growth in monthly inbound arrivals had typically outpaced growth in nights stayed; however,

<sup>2</sup> The five J-REITs consist of Japan Hotel REIT, Invincible Investment, Hoshino Resorts REIT, Ichigo Hotel REIT, and Mori Trust Hotel REIT. Since new samples are added when J-REITs acquire hotels, the sample size and composition may change marginally between survey periods.

<sup>3</sup> As of this report, Tokyo accounts for over 30% of the sample hotels while other Kanto prefectures and Kansai account for about 15% each.

this trend reversed suddenly in June 2018, the month in which the minpaku law was implemented (Graph 8). Notably, while the number of inbound tourists fell by 5.3% YoY in September, the JTA's survey reveals that the number of nights stayed by international tourists actually increased by 6.6% during the same month. This may indicate a positive shift in demand for limited-service hotels, which could offset the negative impact of large supply.

Lacklustre ADR growth may be partially explained by domestic demand. While nights stayed among inbound visitors increased by 11.1% YoY, overall nights stayed, 83% of which is accounted for by domestic travellers, remained flat. Domestic travellers are generally less willing to pay a premium for accommodation, which is also likely weighing on ADR growth for limited-service hotels. Further, some domestic business travellers can no longer afford room rates in budget hotels following the initial price inflation caused by inbound demand.

Demand factors aside, rising labour costs continue to be the primary drag on hotel profits. Though concrete policies have been slow to manifest due to the political sensitivity of the issue, the Japanese government has been showing greater interest in attracting overseas workers to fill labour gaps and has been drafting new legislation to that end. In December 2018, the National Diet passed a new immigration law with the aim of attracting up to 345,000

workers over the next five years, targeting industries with a strong need for labour, including hospitality. Current measures may not fully assuage labour demand in the industry, but they may be a large step forward.

### Investment

Hotels have matured as an asset type in Japan with a diverse array of investors, including family offices, entering the market. Operators have grown more experienced in the country and some are taking active measures to boost performance. Orix Real Estate, for example, will consolidate 13 of its hotels under a new brand, "Orix Hotels & Resorts", subdividing these facilities into four categories and optimising them to meet the needs of their respective customers. Such performance factors are now reflected in pricing through yield differentials, making hotels more commodified and tradable as investment assets.

According to Real Capital Analytics data, hotel transactions of 287 billion yen took place across Japan in 2018. While this marks a 3% decrease YoY for the sector, total real estate investment was down 30% compared to 2017, as limited opportunities moderated transaction volumes across most asset types.

Tokyo still accounted for around 50% of hotel investment, though Sapporo, Fukuoka, and Sendai saw investment volumes increase over 2017. Significant regional transactions

included Hotel MyStays Premier Sapporo Park (Table 1) and S-Peria Hotel Hakata, which was rumoured to have been sold for six billion yen. According to the Japan Real Estate Institute, as of October, expected cap rates for limited-service hotels in Tokyo have held steady at 4.5%, while those of all regional markets have compressed, with a notable drop of 30bps in Sapporo since April.

Though investor demand appears solid overall, some potential buyers may be turning away from the market in the face of high prices - particularly in Tokyo - and caution regarding operating indicators. UBS, for example, announced in late 2017 its intention to invest US\$400 million in hotels in Tokyo and key regional cities, seeking value-add opportunities with the aim of capitalising on strong inbound tourist demand. In late 2018, however, UBS shifted gear and announced that it would instead invest US\$330 million in multi-family residential assets, citing the sector's stable performance and defensive qualities.

Hotel investment in 2019 has had a strong start, however. In January, Japan Hotel REIT announced that it would acquire Hilton Tokyo Odaiba from Hulic for 64.2 billion yen in April with an appraisal direct cap rate of 3.9%. Hulic had acquired the property from Elliott Management Corporation in November 2017 for 60 billion yen. With record supply forecast for 2019, the investment market may gain much-awaited flexibility, for new investors especially.

TABLE 1: Selected Investment Transactions Announced In 2H/2018

PROPERTY NAME	APPROX. PRICE (JPY BIL)	PRICE PER ROOM (JPY MIL)	CAP RATE	LOCATION	BUYER
Hotel MyStays Premier Akasaka	20.7	63	3.9%	Minato-ku, Tokyo	Invincible J-REIT
Hotel MyStays Premier Sapporo Park	16.7	40	4.7%	Sapporo, Hokkaido	Invincible J-REIT
the b akasaka-mitsuke	6.3	49	4.1%	Minato-ku, Tokyo	Tiger 2 GK

Source J-REIT disclosures, Savills Research & Consultancy

### Outlook

2018 was certainly a challenging year for the Japanese hotel industry. In the first half of the year, flooding in western Japan and a measles outbreak in Okinawa reportedly reduced visits and spending. In September, Kansai International Airport, Japan's primary LCC hub, was closed down for ten days following typhoon Jebi, while an estimated 500,000 people cancelled their Hokkaido lodging reservations in the week following the earthquake. Indeed, investors and hoteliers were given a rude reminder of the hospitality industry's inherent risks. Even so, bolstered by strong demand fundamentals and well-maintained transport infrastructure, it appears that the industry has well-withstood these unpredictable shocks.

Tourism is on the rise across the globe and especially in the Asia-Pacific region, as

economies develop and people have more resources to travel abroad. Japan stands among the top tourist destinations in the region and is quickly climbing the global rankings. This reliance on regional tourism brings on additional risk, however. While Japanese industries are less affected by the ongoing U.S.-China trade war, a resulting slowdown in the Chinese economy might weaken outbound tourism to Japan. Though inbound tourism from Europe and North America continues to see double-digit growth, Japan still remains highly dependent upon visitors from East Asia. Persistent global uncertainty could exacerbate these concerns.

Most pressing, large new supply throughout the country could weigh on individual performance for limited-service hotels; however, demand fundamentals are solid and look geared to strengthen

over the coming years. Further geographic diversification of supply and demand will also help mitigate the risks posed by natural disasters. Certain investors may take the opportunity to offload some of their portfolios, as evidenced by the asset reshuffling seen among large players in 2018. This could serve as an opportune entry point for new investors looking to break into the market. Overall, ADRs of limited-service hotels are likely to stay flattish, even with large supply. Upscale hotels, with very limited supply pipeline, are expected to perform better, supported by strong demand from inbound customers who are willing to pay a premium for higher-quality accommodation.



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