Japan - February 2020

SPOTLIGHT
Savills Research

Japan Hospitality

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Hospitality sector facing a short-term adjustment

Summary

- The number of annual overseas visitors to Japan has risen for the eighth consecutive year, marking YoY growth of 2.2% for 2019. Unfortunately, the goal of 40 million visitors in 2020 appears out of reach.

- The outbreak of the Novel Coronavirus (COVID-19) is likely to significantly disrupt the hotel market for the time being.

- The number of rooms added in 2020 is anticipated to exceed the previous year, whilst a sharp drop in new supply thereafter should ease some concerns about the overall level of supply.

- The growth in the level of spending on accommodation per night continues to outpace the change in visitor numbers. An emphasis on expanding luxury facilities aims to capitalise on this trend, with 50 luxury hotels expected to be built across Japan.

- Inbound tourism from major countries outside of the top five visiting nations, such as Thailand, Singapore and the UK, showed double-digit growth for the eighth consecutive year.

- Occupancy remains above 85%, though a dip in hotel performance was observed this period as the sector adapts to market conditions. A cap rate adjustment is expected as a result.

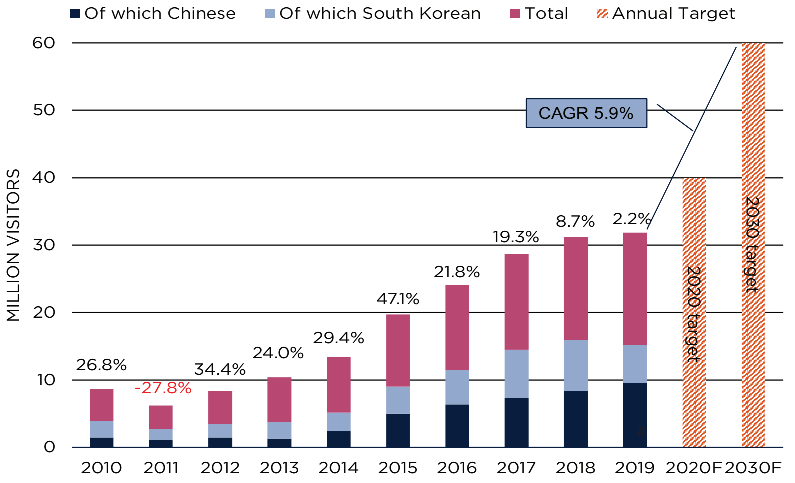
- Hotel investment volumes for 2019 skyrocketed by 74% YoY to around 571 billion yen – the highest level since 2007 – with both overseas and domestic investors purchasing portfolios and large-ticket assets.

INTRODUCTION

Based on preliminary data from the Japan National Tourism Organization (JNTO), Japan welcomed around 31.9 million visitors in 2019 (Graph 1). This amounted to only a 2.2% increase year-on-year (YoY), despite the boost to inbound tourism in the run-up to the Rugby World Cup in September. In fact, visitor numbers surprisingly fell 0.6% YoY during the tournament as the disruptive impact of Typhoon Hagibis took hold. Although the positive annual change is welcome – the eighth year in a row – it now means that a growth rate of 25% would be required to hit the 2020 target of 40 million. This is certainly a tough ask, with the estimate made in mid-January by JTB Corporation, Japan's largest travel agency, of 34 million visitors in 2020 being a case in point.

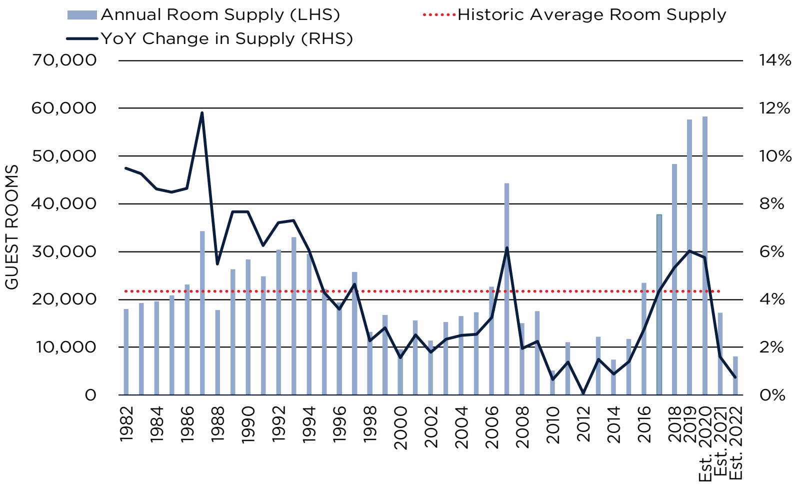
Major concerns include the large hotel supply, as well as the significant drop in Korean visitors to Japan following the breakdown in relations between the two nations since August 2019. Having experienced a slight decline of 4% YoY for the first seven months of 2019, this figure plummeted to a 60% YoY fall during the latter five months. Yet, there appear to be early signs of some recovery. Inbound tourism from South Korea rebounded in November and December, growing 3.9% and 21.0%

GRAPH 1: International Arrivals And Annual Growth Rates, 2010 to 2019



Source Japan Tourism Agency (JTA), Japan National Tourism Organisation (JNTO), Savills Research & Consultancy

GRAPH 2: Hotel Guest Room Supply, 1982 to 2022*



Source Hoteres, the Ministry of Health, Labour and Welfare (MHLW), Savills Research & Consultancy
*As completion data provided by Hoteres is as of 6 December, total supply in 2019 includes hotels expected to be completed thereafter.

month-on-month, respectively, surpassing growth rates seen during the same period a year prior. Suffice to say, however, it looks unlikely that numbers will revert to pre-dispute levels any time soon. Yet, the most imminent risk to growth is the COVID-19 epidemic, which has already started to significantly weigh on the sector. These setbacks, however, could be an opportunity to shift the focus towards the quality and the diversification of visitors, as experienced during the Rugby World Cup.

HOTEL SUPPLY

The hotel market added an unprecedented number of rooms in 2019, as new supply exceeded 50,000 for the first time since the data was first collected in 1965 (Graph 2). As a result, the number of rooms currently sits above the one million mark. This is expected to expand further by over 58,000 this year, according to Hoteres, as the final preparations for the Tokyo Olympics are completed. Thereafter, however, there is a sharp decline in new supply expected as the market adjusts, with barely 10,000 new rooms due to be added in 2022 based on current disclosures.

When looking at the regions in more detail, the currently elevated levels of supply in Tokyo and the Kinki region (Greater Osaka) become apparent (Graph 3). Of these two, Tokyo will unsurprisingly be home to the greatest change in supply this year, as well as the sharpest fall post-2020. Meanwhile, with the second highest growth rate expected this year in the Kinki region, it will do little to allay concerns regarding the elevated levels of supply already felt by hoteiers. To capitalise on its ever-growing popularity, especially from Asian tourists, Okinawa is expected to see the highest levels of change over the longer term.

Visitor numbers fell short of expectations in 2019 and, for now, the recent outbreak of COVID-19 has dampened the momentum of inbound tourism. That said, the underlying fundamentals of the tourism industry remain solid, and Japan continues to be attractive for both tourists and investors alike. The initial promotional efforts along with the Olympics itself should showcase the country to an international audience, allowing inbound tourism to get back on track.

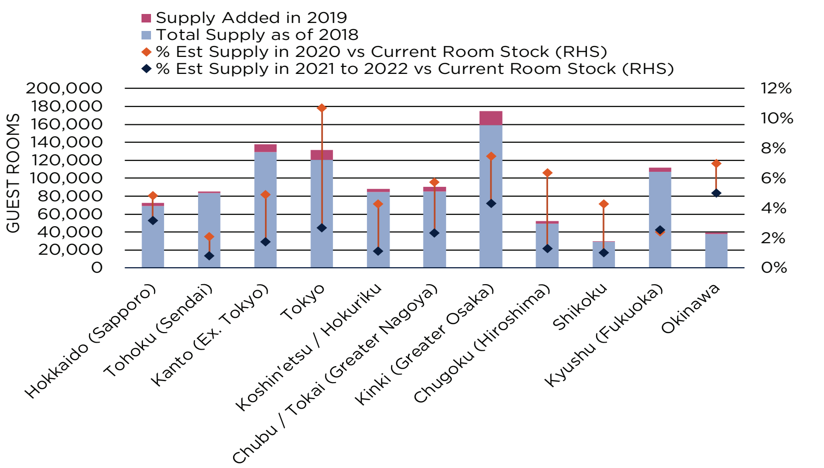
QUALITY OVER QUANTITY

Despite the underwhelming increase in inbound tourism in 2019, there is hope that the ongoing efforts by the government to attract a more diverse range of visitors is bearing fruit. Indeed, the Rugby World Cup last year successfully showcased Japan to a new set of visitors, and the Olympics will have a much more pronounced reach this year. These and other upcoming events will continue to act as a catalyst in attracting tourists from all corners of the world.

Historically, a significant share of inbound tourism originated from fellow Asian nations, most notably China and South Korea, and this remains the case today. In fact, despite the diplomatic tensions with the latter in 2019, the combined share of visitors from these two nations still stood at around 48%, just shy of the 51% observed in 2018. When looking at the top five visiting nations instead, namely: China, South Korea, Taiwan, Hong Kong and America, the need to diversify becomes even more clear. For instance, the average proportion of these five nations over the past decade has been above 75%, peaking at 79% in 2017. However, change is afoot. Annual growth from the top five nations turned negative in 2019, primarily dragged down by the sharp drop in South Korean tourists, whilst visitor numbers from nations outside the top five have continued to exhibit double-digit-growth every year since 2011. Subsequently, the overall proportion of the latter group has remained on an upward path (Graph 4).

It is not just diversification that adds to a sense of optimism going forward. Indeed, though visitor numbers have flattened somewhat, the spending habits of visitors tells a more encouraging story. According to data based on questionnaire responses provided by the JTA, spending on hotels[1] per night in 2019 grew by an estimated 2% YoY despite respondents staying around 3% longer in hotels. As such, the average nightly expenditure now exceeds JPY 24,500 per respondent[2] (Graph 5). Suffice to say, the aforementioned top five nations contribute a significant proportion of total spending on a weighted basis, though this share declined slightly in 2019. China, who accounted for around 30% of visitors in 2019, was

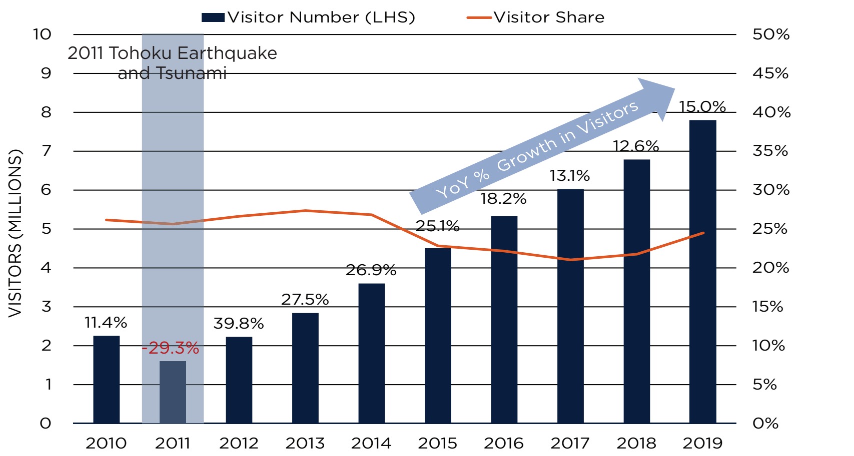
GRAPH 3: Total Hotel Guest Room Supply By Region, 2019* to 2022



Source Hoteres, MHLW, Savills Research & Consultancy
*As completion data provided by Hoteres is as of 6 December, total supply in 2019 includes hotels expected to be completed thereafter.

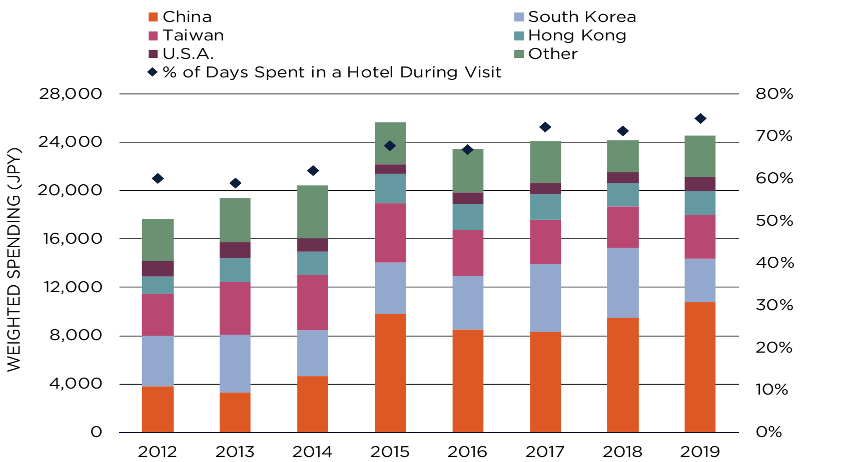
1 These hotels are defined as Western-style hotels, and therefore, facilities such as "Ryokans" (Japanese-style hotels), are excluded.
2 The data is based on each respondent to the questionnaire provided by the JTA, and could, therefore, include responses on behalf of groups of visitors.

GRAPH 4: Visitor Number, Share And Growth Rate For Non-Top Five Visitor Nations*, 2010 to 2019



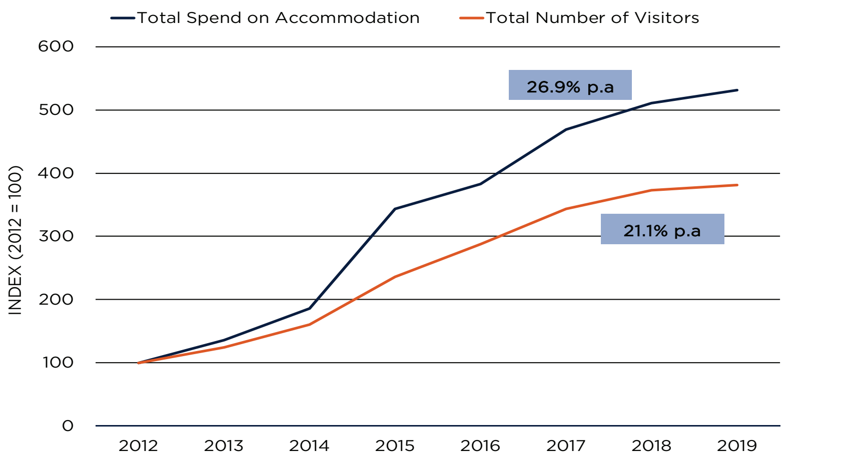
Source JNTO, Savills Research & Consultancy
*The top five visiting nations are: China, South Korea, Taiwan, Hong Kong and America

GRAPH 5: Average* Spending On Hotels Per Night And Per Respondent, 2012 to 2019



Source JTA, JNTO, Savills Research & Consultancy
* The data is weighted based on the proportion of inbound tourism, according to JNTO data, and considers the average number of nights stayed in a Western-style hotel.

GRAPH 6: Growth In Total Nightly Hotel Expenditure* vs Growth In Tourist Numbers, 2012 to 2019



Source JTA, JNTO, Savills Research & Consultancy
*The above is calculated by multiplying average spending on accommodation per respondent per night and overall annual visitors.

responsible for over 40% of total spending on accommodation, underscoring their ongoing importance to the hospitality sector and the tourism industry as a whole. As such, whilst the decline in Korean tourists has been somewhat manageable thus far, the impact of a reduction of Chinese tourists following the COVID-19 outbreak could be significant.

When observing the shifting spending habits of tourists in Japan, the impact of this to the sector over time becomes clear. Having broadly moved in lockstep with the increase in inbound tourism, the growth in total nightly expenditure on hotels exploded in 2015, and the spread between these two metrics has been expanding ever since (Graph 6). In fact, on an annualised basis, expenditure has outstripped visitation numbers by around 6% a year, stressing the importance of focusing on spending power rather than the number of visitors.

The hotel market in Japan continues to evolve in order to take advantage of the changing consumer landscape, and this has been seen in none more so than the luxury sector. For instance, acknowledging that Japan significantly lags its peers in this market, the government announced special financial measures late last year to encourage the opening of 50 luxury hotels across Japan. If these plans come to fruition, it would be a boon to the industry, alleviating the need to attract a larger number of visitors to maintain overall growth.

JAPAN HOTEL MARKET

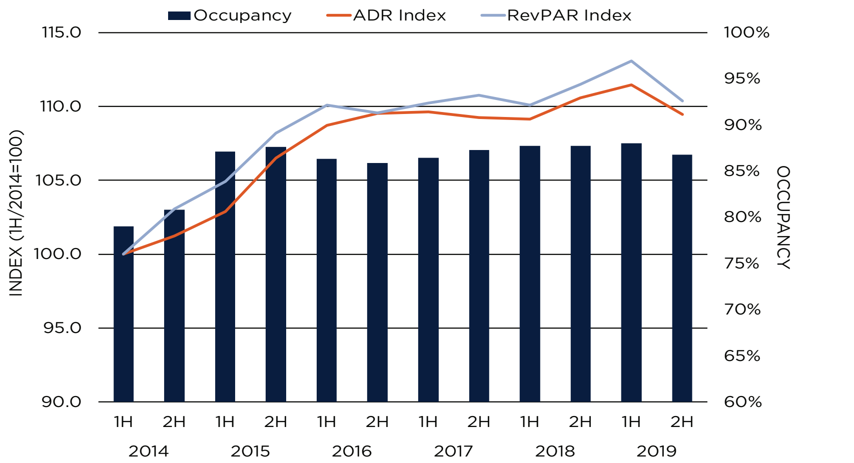
Savills tracks the performance of over 100 hotels owned by five J-REITs[3] to analyse market trends. Our analysis focuses on limited-service hotels; full-service and resort properties are excluded due to limited data. Given that most of the existing hotel stock is in the limited-service category, this should provide a good proxy for the overall market trend in Japan[4].

In a slight reversal from the previous period, 2H/2019 saw average daily rates (ADR) and revenue per available room (RevPAR) indices drop by 1.1 and 1.2 points YoY, respectively. Similarly, occupancy fell by around 1.0% to 87%. Given the rapid increase in supply experienced over the past few years, an adjustment is not surprising. However, if market conditions continue to weaken beyond 2020, it would certainly be a cause of concern, and therefore worth keeping a close eye on going forward.

Adding to these concerns and weighing on the bottom lines of hotel operators are the cost pressures arising from persistent nationwide labour shortages in the sector. Given the variety of roles needing to be filled

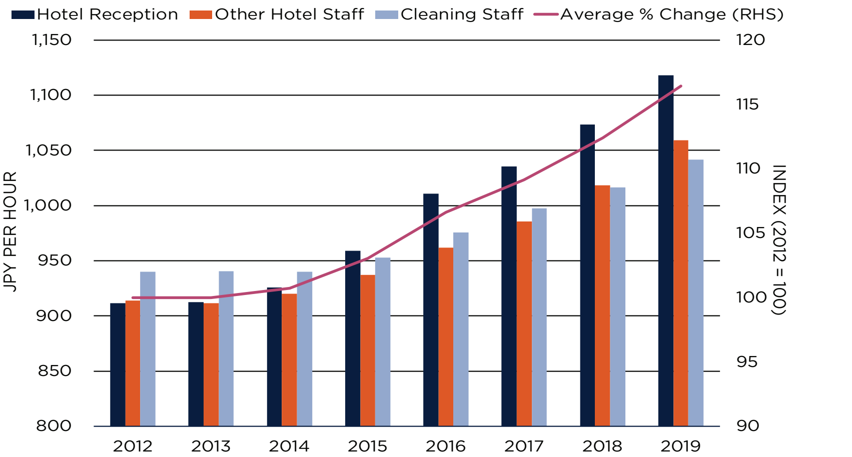
3 The five J-REITs consist of Japan Hotel REIT, Invincible Investment, Hoshino Resorts REIT, Ichigo Hotel REIT, and Mori Trust Hotel REIT. Since new samples are added when J-REITs acquire hotels, the sample size and composition may change marginally between survey periods.
4 As of this report, Tokyo accounts for over 30% of the sample hotels while other Kanto prefectures and Kansai account for about 15% each.

GRAPH 7: Trailing-twelve-month Limited-service Hotel Performance, 2014 to 2019



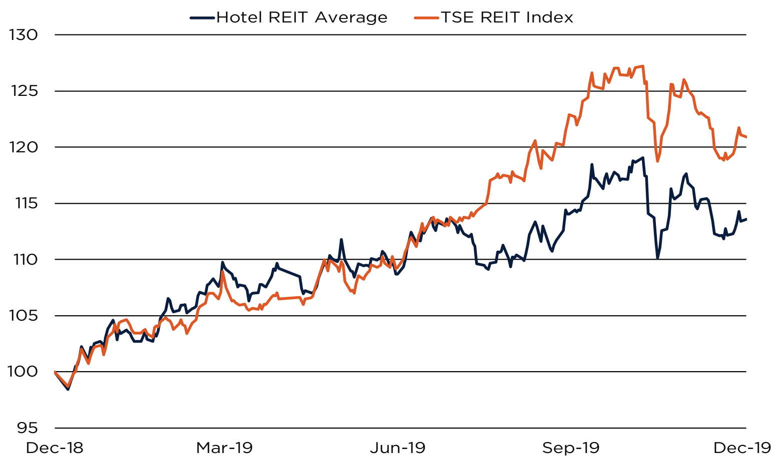
Source J-REIT disclosures, Savills Research & Consultancy

GRAPH 8: Average Hourly Wage, And Wage Growth For Part-time Jobs In The Hotel Sector For The Three Main Metropolitan Areas*, 2012 to 2019



Source Jobs Research Center (JBRC), Savills Research & Consultancy
*The three main metropolitan areas consist of: Greater Tokyo, Greater Osaka and Greater Nagoya.

GRAPH 9: TSE J-REIT Index vs Hotel J-REIT Average Performance*, 2019



Source J-REIT Disclosures, Japanese Exchange Group, Savills Research & Consultancy
*The average returns of the five main Hotel J-REITs described above are used.

at a hotel, the estimated 16% increase in average part-time wages since 2012 is a worry, especially given this trend is unlikely to abate anytime soon (Graph 8). This could, however, present an opportune entry point for a well-resourced and experienced operator, as smaller inexperienced players have no choice but to exit the industry.

INVESTMENT

The hotel investment market in 2020 has had a somewhat subdued start as potential investors battle a combination of limited opportunities and stretched valuations. These elevated valuations were also observed in 2019 as, according to data provided by Real Capital Analytics (RCA), investment volumes skyrocketed by 74% YoY to around 571 billion yen – the highest since 2007. The change was even more marked in 2H/2019. Investment increased by 106% YoY to over 300 billion yen, reaching highs not seen since 2015. The most notable transactions during the period include: the acquisition of Leopalace 21's hotel portfolio, consisting of three assets with a total of 429 rooms, by Goldman Sachs for a combined 16 billion yen in October 2019, as well as the acquisition of The Westin Tokyo for 95 billion yen in December, reportedly by a Chinese billionaire.

The ongoing saga concerning office owner and hotel operator Unizo Holdings appears to have some legs. Having seemed set for an employee buyout (EBO), backed by U.S fund Lone Star Global Acquisitions at JPY 5,100 per share, Blackstone made a counteroffer in late January of JPY5,600 – close to three times higher than the share price before initial takeover talks. Meanwhile, Fortress Investment Group has also upped its bid by 27% to JPY5,200, according to Reuters. Furthermore, it now appears the EBO option is back on the table following an increased bid of JPY5,700 in early February. Regardless of the outcome, interest from firms, such as Blackstone and Fortress, provides some confidence in the attractiveness of institutional-quality hotel assets going forward. In fact, a successful outcome from this takeover could tempt more investors to look at other listed opportunities, further buoying the sector. Indeed, despite lingering uncertainty about the global political and economic environment, Japan remains a popular market for investors and this trend looks set to continue for the time being.

Given the turbulent market conditions for the hotel sector in 2019, the market was unable to capture the boost in J-REIT unit prices observed in other sectors. Having moved in concert with the broader TSE REIT index up until July, the Japan-South Korea dispute appears to have been the initial catalyst for divergence in performance thereafter (Graph 9). That said, hotel-focused J-REITs returned a solid 14% over the year.

TABLE 1: Selected J-REIT Investment Transactions Announced In 2H/2019

PROPERTY NAME	APPROX. PRICE (JPY BIL)	PRICE PER ROOM (JPY MIL)	CAP RATE	LOCATION	BUYER
Hotel MyStays Sapporo Aspen	15.5	51	4.60%	Sapporo, Hokkaido	Invincible J-REIT
Hilton Odawara Resort & Spa	13.0	80	4.60%	Odawara City, Kanagawa	Mori Trust (50%) and Mori Trust Hotel REIT (50%)
Hotel MyStays Premier Narita	10.6	15	4.70%	Narita City, Chiba	Invincible J-REIT

Source J-REIT disclosures, Nikkei RE, Savills Research & Consultancy

OUTLOOK

On the back of solid growth in inbound tourism during 2018, optimism was high for 2019. With the anticipated influx of tourists for the Rugby World Cup, as well as the Olympics later this year, the 2020 target looked within reach. Indeed, the prospect of Integrated Resorts (IR) further down the line, combined with the 2025 Expo in Osaka even made the 2030 target a real possibility. Unfortunately, it has not been all smooth sailing. Following a series of setbacks, centred around natural disasters, diplomatic conflict, as well as the COVID-19 epidemic, the target this year now looks out of reach.

The continued impasse between Japan and South Korea in 2019 highlighted the risks resulting from the hospitality sector's over-dependence on visitors from a select few nations. Though the decline in Korean tourists had a somewhat limited impact on overall spending, the emergence of China as a significant contributor has emphasised the importance of Japan ensuring that Chinese tourists continue to flock to its shores. That said, the recent outbreak of COVID-19 in China has, unfortunately, derailed these plans. While the full impact of this outbreak is yet to be understood, we have already seen numerous hotel cancellations across the globe, including in Japan, and this is expected to continue, weighing greatly on the sector.

Furthermore, the development of much-anticipated IR facilities appears to have hit a snag following bribery scandals coming to light. Amid the controversy, however, for now, plans remain on course for openings in 2024/25, despite the government deferring the decision of its so-called "basic policy" until later this year. Given the potential boost to inbound tourism, the fact that the scandals have not completely curtailed the prospects of IR facilities is a boon for the hospitality sector.

Though risks to the sector aplenty, fundamentals are still sound and there remain ample opportunities, especially for shrewd operators able to adapt to changing demand. Furthermore, the current difficulties in the sector should lead to a cap rate adjustment, making hotels an established asset class for yield. The transition towards a more diverse visitor base, as well as attracting those with greater spending power should be a fillip to the hotel industry, with the luxury hotel sector best placed to benefit. Although the inbound visitation target looks likely to be missed this year, there is hope that the lead up to the Olympics, as well as the games itself, can be a platform for greater growth over the longer term.

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