Japan - August 2019

SPOTLIGHT
Savills Research

Japan Hospitality

savills

Hotel performance trends upward

Summary

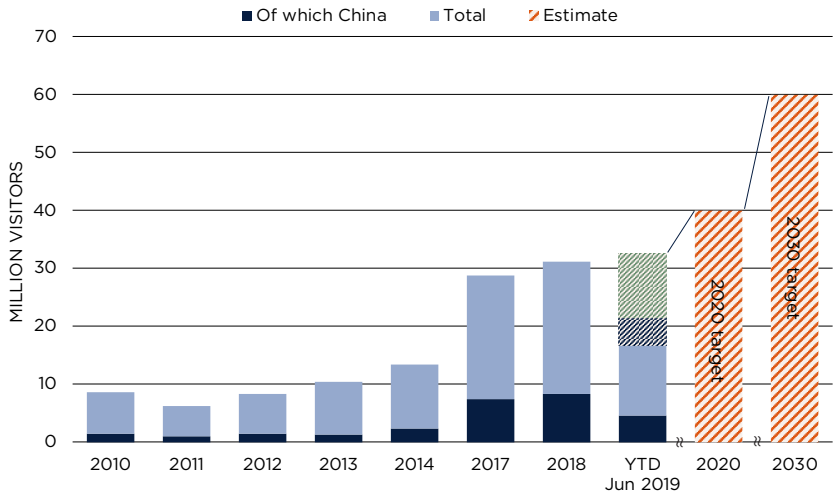
- Compared to the same period in 2018, the number of overseas visitors to Japan in 1H/2019 has risen 4.6% YoY. The country is still positioned to reach its goal of 40 million visitors in 2020.
- In 1H/2019, spending volume by inbound tourists increased by 8% YoY. As Japan's hotel sector matures, the government is trying to attract high-spending tourists.
- Visitation from countries such as South Korea, Taiwan, and Hong Kong slowed, while the U.S., Australia, and European countries showed double-digit growth.
- Expected decreases in supply in the coming years should offer some breathing room for hoteliers.
- The new minpaku (peer-to-peer accommodation) regulation along with the government's crackdown on illegal operators appears to have pared down the number of minpaku locations.
- Occupancy remains strong and hotel performance continues to improve steadily.
- Hotel investment volumes in 1H/2019 increased 10% YoY and new players continue to enter the sector.

INTRODUCTION

As of June 2019, the number of overseas tourists to Japan amounted to 16.6 million, an increase of 4.6% year-on-year (YoY). Although growth softened compared to the first half of 2018, 2H/2019 is expected to see a strong rebound over the prior-year period, as a series of natural disasters in the latter half of 2018 curbed inbound visitation. Additionally, the 2019 Rugby World Cup, which will be held in twelve cities across the country from September 20th to November 2nd, is set to boost visitors during a shoulder season and serve as a platform to showcase regional Japan. In 2020, the Tokyo Summer Olympics should be the tailwind that drives total inbound visitors to exceed 40 million.

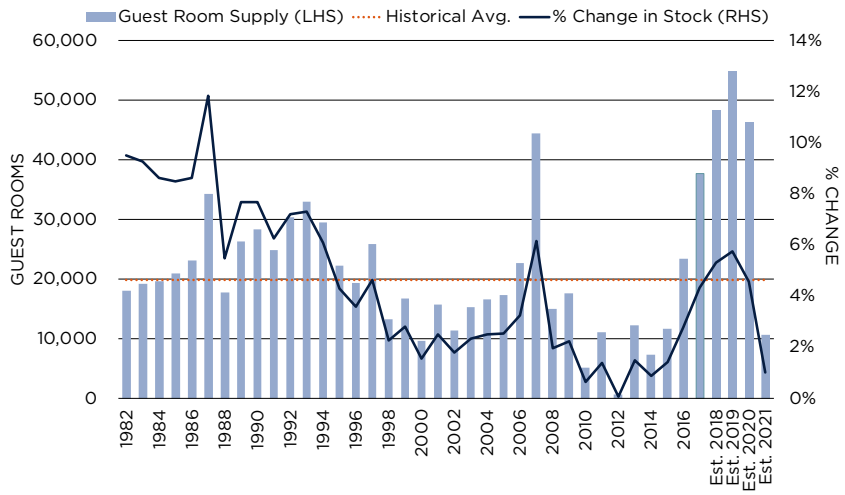
Notably, in 1H/2019, the number of visitors from South Korea, Taiwan, and Hong Kong, who have typically been driving total inbound visitation growth, dipped by 3.8%, 1.0%, and 1.1%, respectively. On the other hand, Western countries such as the U.S., Canada, Germany, Italy, and Spain registered double-digit growth over the same period. Growth in visitation from these countries might be a result of the Japanese government's recent marketing efforts, which aim to diversify the tourist base and attract high-spending travellers. Although the number of visitors from East

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



Source JTA, Japan National Tourism Organisation (JNTO), Savills Research & Consultancy
*The year-end 2019 figure is estimated using the year-to-date growth rate of 4.6% as of June 2019.

GRAPH 2: Hotel Guest Room Supply, 1982 to 2021



Source Hoteres, news articles, the Ministry of Health, Labour and Welfare, Savills Research & Consultancy

Asia dwarfs that from Western countries, Western visitors tend to stay significantly longer and generate more lodging demand per visitor, especially in the high-end segment.

On the supply side, hotel construction is expected to wind down from 2020, as discussed in the February 2019 Japan Hospitality report. This change should provide some breathing room for hoteliers, especially in the limited-service sector where the majority of supply has been accumulating. Furthermore, Japan's hotel stock is aging, especially in regional cities, which increases the need for new facilities to meet guests' shifting preferences.

Overall, Japan has been evolving as a tourist destination with an increasing array of lodging options. Luxury, international hotel brands are making an entrance in the Japanese market, eyeing growing opportunities in the high-end segment. Planned openings of branded residences also indicate that the country is evolving as a destination for the wealthy (please refer to the Tokyo Residential: Ultra Luxury report published in March 2019). Although the economic slowdown – especially in the Asia Pacific region – is a concern, Japan's hotel market is increasingly diversifying and maturing, strengthening its appeal to a wide range of investors.

Despite a series of natural disasters affecting demand in 2018, inbound visitation quickly recovered and resumed sound growth. Hotel supply is expected to soften beyond 2020, which should provide additional breathing room for hoteliers. Japan's hotel market is increasingly diversifying and maturing, strengthening its appeal to a wide range of investors.

MINPAKU

The new Minpaku Law[1] came into effect in June 2018 and introduced a new set of rules to regulate the rapidly growing peer-to-peer accommodation sector. The government was also cracking down on illegal operators even before the enforcement of the new law, which has helped provide a level playing field for those abiding by the rules. Just prior to the implementation of the new law, Airbnb reportedly delisted unregistered minpaku operators and reduced its listings in Japan from over 60,000 to less than 15,000 (Graph 2), a welcome consequence for hoteliers who were threatened by the emerging competition.

However, this reprieve may not last very long. Although disclosures by Airbnb in February indicate that listings remained substantially below pre-Minpaku Law levels last year, the total number of listings had rebounded to over 40,000 as of February 2019, indicating that the previous peak may soon be reached. Interestingly, the number of registered minpaku locations under the new law stood around 15,000 as of May, falling far short of the number of listings on Airbnb.

This gap may indicate that many operators are choosing to run their facilities as kanishukusho[2], common lodging houses, to evade the 180-day operation cap imposed on registered minpaku. The number of kanishukusho increased from 25,560 in FY2013 to 32,451 in FY2017, and many operators are seeing kanishukusho as an attractive alternative to registered minpaku given that there is no limit imposed on operating days and registration requirements are significantly less demanding than for ryokan and hotels.

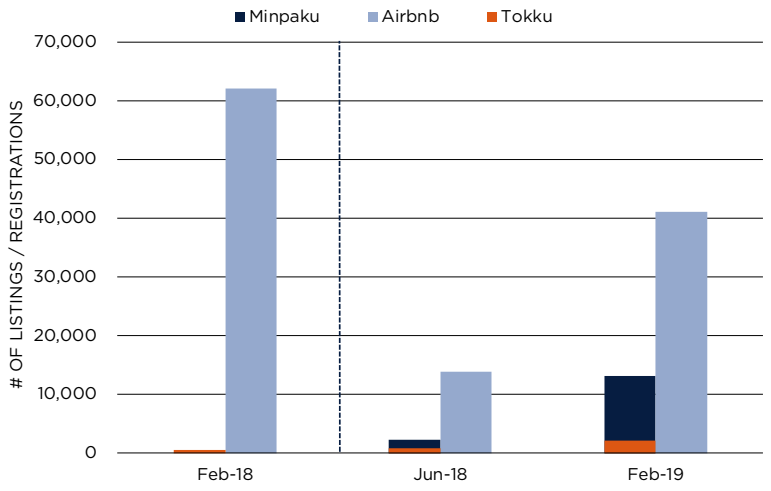
While the growth of this sub-sector may put some competitive pressure on traditional hoteliers, considering that kanishukusho are communal-type accommodations represented by youth hostels, mountain cabins, and capsule hotels, any impact would be limited to economy hotels that compete for budget-conscious guests. Further, the ease of establishing kanishukusho has created fierce competition in the sub-sector. Weaker operators in popular tourist destinations such as Kyoto have reportedly shut down as a result of an overconcentration of supply in some areas. Kyoto has also recently introduced much tougher restrictions on kanishukusho in response to "overtourism". Some market participants have indicated that the number of kanishukusho in the city could halve as a result.

Another tactic to elude the 180-day cap is to run minpaku in tokku, a national strategic special zone. Osaka City, for example, has tokku status and sees a particularly large number of minpaku facilities taking advantage of the relaxed regulations. As of May, there were 6,447 lodging registrations in Osaka City. Among these, 2,467 were tokku minpaku registrations, while there were 2,392

1 Minpaku is a loosely-defined term that describes peer-to-peer accommodation facilities. In this report, the facilities operated under the new Minpaku Law are referred as "registered minpaku," while "minpaku" includes peer-to-peer accommodation in other forms such as kanishukusho or facilities in tokku.

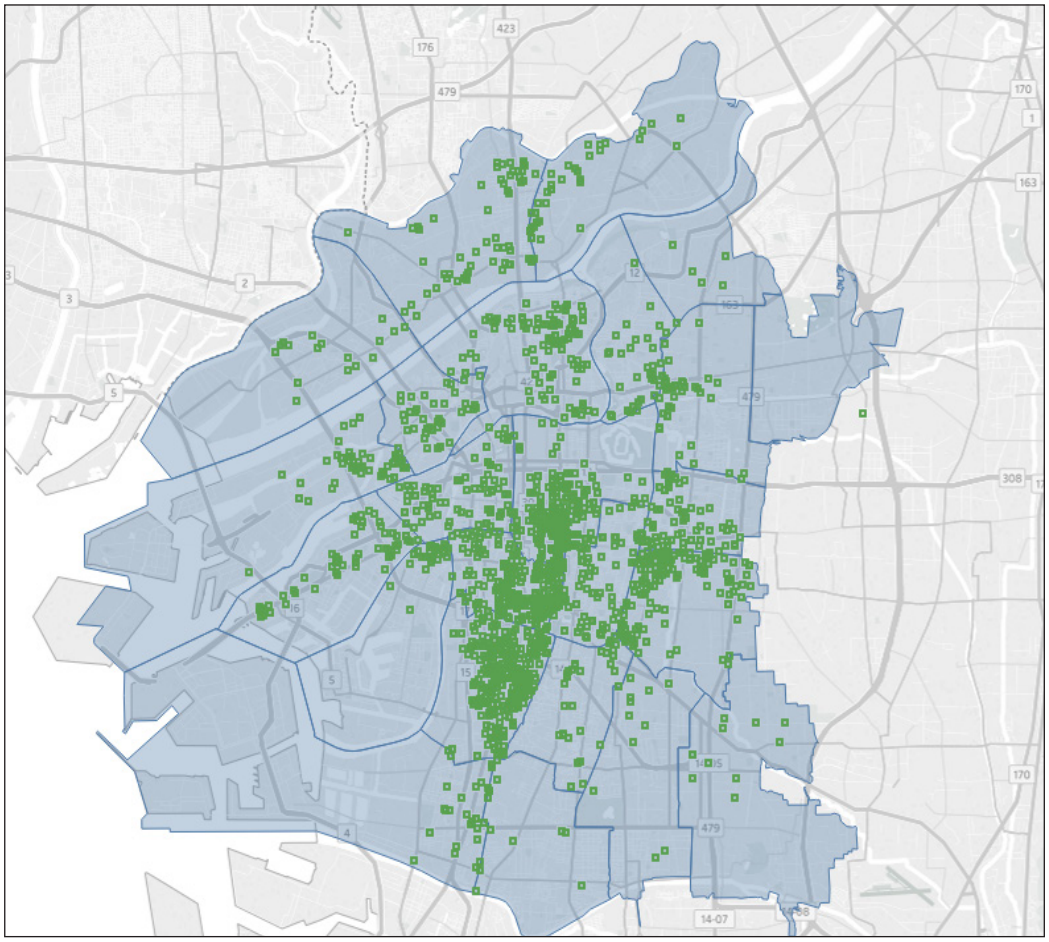
2 Kanishukusho is one of four lodging types subject to the Hotel Business Law along with ryokan (traditional Japanese accommodations), hotels, and gesyuku (boarding houses) and refers to "the business of running a facility mainly consisting of communal lodging spaces and equipment or furnishings shared by many people".

GRAPH 3: Airbnb Listings vs Registered Minpaku, February 2018 to February 2019



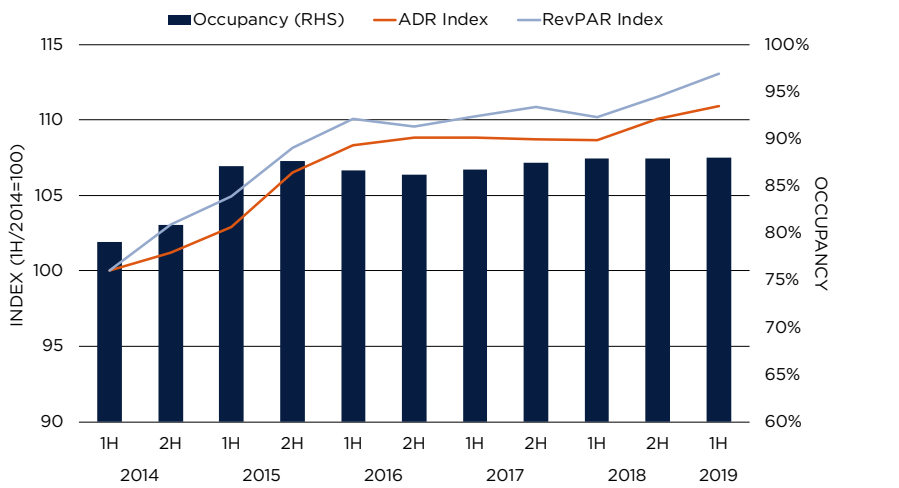
Source Airbnb, the Cabinet Office, the Ministry of Land, Infrastructure, Transport and Tourism, Savills Research & Consultancy

MAP 1: Registered and Tokku Minpaku Locations In Osaka, May 2019



Source Osaka City, OpenStreetMap, Savills Research & Consultancy

GRAPH 4: Trailing-twelve-month limited-service hotel performance, 2014 to 1H/2019



Source J-REIT disclosures, Savills Research & Consultancy

registrations under the new Minpaku Law and 1,588 under the Hotel Business Law.

Overall, the Minpaku Law raised the bar for minpaku operators, but those who are committed to the business appear to be adapting to shifting landscapes. While this could undermine the revenue generation of budget hotels in particular, a higher hurdle for opening should lead to fairer competition with traditional hotels.

JAPAN HOTEL MARKET

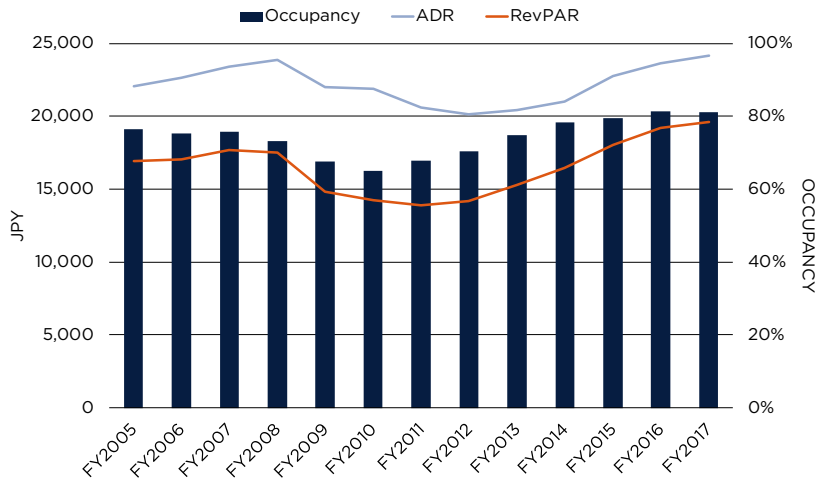
Savills tracks the performance of over 100 hotels owned by five J-REITs[3] to analyse market trends. Our analysis focuses on limited-service hotels; full-service and resort properties are excluded due to limited data. Given that a majority of the existing hotel stock is in the limited-service category,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

In 1H/2019, average daily rate (ADR) and revenue per available room (RevPAR)

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.

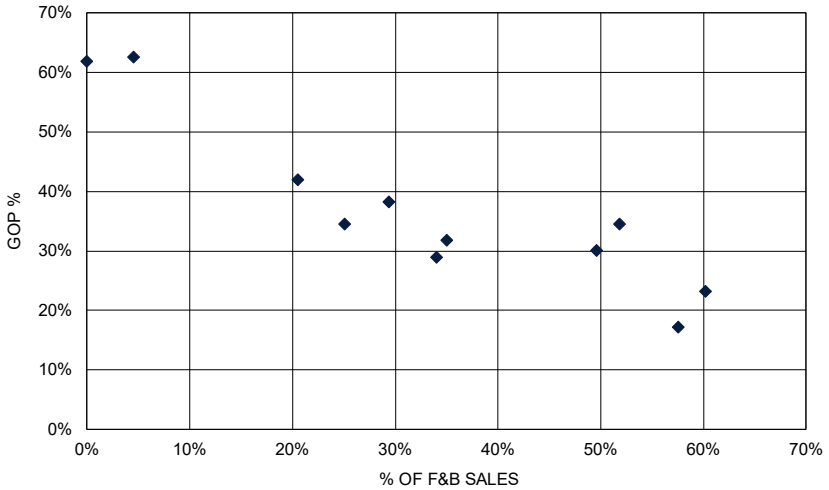
4 As of this report, Tokyo accounts for over 30% of the sample hotels while other Kanto prefectures and Kansai account for about 15% each.

GRAPH 5: Resort Hotel Performance In Okinawa, FY2005 to FY2017



Source The Okinawa Development Finance Corporation, Savills Research & Consultancy

GRAPH 6: GOP% vs F&B Sales%, 2018



Source J-REIT disclosures, Savills Research & Consultancy

indices rose by 2.3 points and 2.8 points YoY, respectively, while occupancy edged up by a slight 10 basis points to 88%. Considering that last year's supply is now likely to be in operation, this seemingly marginal growth is notable, indicating sound demand for investment-grade hotels.

While the performance of limited-service hotels has been trending steadily upward, diversifying portfolios by adding resort properties in promising regions may prove beneficial. For instance, Okinawa's resort hotels have been improving performance, with the average ADR in FY2017 exceeding the previous peak in FY2008. While substantial supply is expected in Okinawa in the coming years, ideal land for development is limited. As Okinawa gains further popularity among travellers, favourably located resort properties could appreciate in value, relatively insulated from supply. The remarkable growth of resort locations is also evidenced by the rapidly rising land prices in both Okinawa and Niseko in the national land value survey (Chika Koji).

INVESTMENT

Hotel investment in 2019 has had a strong start. In January, Japan Hotel REIT announced that it would acquire Hilton Tokyo Odaiba from Hulic for 64.2 billion yen with an appraisal direct cap rate of 3.9%. Hulic had acquired the property from Elliott Management in November 2017 for 60 billion yen. In the same month, Sekisui House REIT acquired a 40% interest in the Ritz-Carlton Kyoto for 17.8 billion yen. According to Real Capital Analytics data, hotel transactions of 195 billion yen took place across Japan in 1H/2019, a 10% increase YoY. In fact, it is the largest 1H volume recorded since 2009.

Encouraged by sound fundamentals, investor interest in the hotel sector remains strong. In July, H.I.S, a major travel agency, expressed its intention to conduct a takeover bid (TOB) of Unizo Holdings, a real estate company. H.I.S explained that the primary goal of this move is to increase its hotel

TABLE 1: Selected Investment Transactions Announced In 1H/2019

PROPERTY NAME	APPROX. PRICE (JPY BIL)	PRICE PER ROOM (JPY MIL)	CAP RATE	LOCATION	BUYER
Hilton Tokyo Odaiba	62.4	138	3.9%	Minato ward, Tokyo	Japan Hotel REIT
The Ritz-Carlton Kyoto (40%)	17.8	593	3.3%	Kyoto city, Kyoto	Sekisui House REIT
Hotel Hewitt Koshien	13.5	33	4.4%	Nishinomiya city, Hyogo	United Urban Investment

Source J-REIT disclosures, Savills Research & Consultancy

operation platform by absorbing the 25 hotels held by Unizo Holdings into its own portfolio, which the company aims to ratchet up to 100 hotels. H.I.S is offering to acquire Unizo Holdings' shares at a significant premium: over 50% higher than the historical average price per share in the months leading up to the announcement. The difference in valuation reflects the upside potential that H.I.S believes it can realise from integrating its hotel business with Unizo.

Furthermore, Daiwa Securities Group and Samty agreed to form a capital and business alliance in May, and their collaboration areas will include the formation of a large-scale hotel development fund, targeting JPY30 billion including borrowing, as well as the launch of a hotel REIT around 2020. Additionally, Daiwa Hotel Private REIT completed its second purchase since its inception in June 2018 and added four hotels for a total of JPY20.6 billion in February. The acquisition included a Henn na Hotel, which has been widely covered by international media for its quirky concept of robots serving hotel guests, for JPY6.4 billion.

As the real estate market has entered the late cycle, investors might consider increasing returns through value-add strategies. One such strategy is the conversion of food and beverage (F&B) or any underutilised space into additional guest rooms, which typically have high profitability in the current market environment. Indeed, as Graph 6 illustrates, when F&B sales increase, gross operating profit ratios tend to decline as the F&B unit typically has much lower profitability than the lodging unit.

Japan Hotel REIT has recently applied such a strategy, converting a portion of Hotel Centraza Hakata's public and meeting spaces into 27 guest rooms in order to boost profits. Older full-service hotels, which are seeing less demand for their banquet spaces due to the reduced number of wedding receptions, might be particularly apt targets for adding value through such conversion.

Rebranding can serve as another value-add strategy for Japanese hotels, as obtaining an international brand name could increase market visibility and allow for integration into a global room reservation system. Such opportunities appear set to expand as leading international brands, including Waldorf Astoria by Hilton, Kimpton by IHG, and W by Marriott, are now expected to enter the market.

OUTLOOK

Even though 2018 was a challenging year marked by natural disasters, Japan rapidly recovered and inbound tourism continued to show sound growth to date in 2019. While signs of slowing growth are surfacing, the Rugby World Cup, as well as the Summer Olympics, should provide sufficient ammunition to reach the 2020 goal of 40 million visitors. This should give some upside potential on hotel operating indicators.

Additionally, supply is expected to subside in the coming years and the new Minpaku Law has cultivated an environment of fairer competition. Upscale hotels are relatively insulated from supply impacts and will likely outperform budget hotels as long as favourable economic conditions remain in place.

Outlying areas in particular may leave much upside potential as repeat tourists tend to explore major regional cities. Although hotel performance in Osaka softened in the face of a high concentration of supply, the city is in the midst of a large-scale redevelopment phase and the upcoming World Expo, as well as a potential casino development, could be tailwinds for the hospitality sector. Considering that Kyoto hotels tend to be heavily booked and Nara is not as well established as a lodging area, Osaka's popularity as a base for travellers in Kansai is unlikely to wane.

Overall, the fundamentals of the hospitality sector are sound, and opportunities could be found for shrewd investors. However, risk is higher as demand growth is softening. Since hotels are highly dependent upon the characteristics of their locality, the positioning of assets based on a clear understanding of both micro and macro dynamics is essential.

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