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Japan

Spotlight
Japan hospitality

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"Though Japan faces some challenges in maintaining its stellar tourism growth, the outlook is positive and the government's efforts appear effective. Heightened competition is slowing performance growth in the limited-service sector, but strong tourism still offers upside potential, especially for regional and upscale hotels."

SUMMARY

- The number of overseas visitors to Japan has increased by 17.3% year-on-year (YoY) through July.
- Air transportation capacity must expand to keep up with exponential tourism growth.
- Attracting visitors from wider regions is also essential for sustaining growth.
- Hotel performance continues to improve, albeit at a slowing pace. Regional and upscale hotels may see upside potential.
- Transaction volumes have been stable, and J-REITs acquired several upscale and luxury hotels. Expected cap rates further compressed to 4.7% in Tokyo.

Introduction

Japan has experienced explosive growth in overseas visitors in recent years, and the breakneck pace continues. Year-to-date overseas visitors have increased by 2.4 million as of July, 17.3% higher than last year's figure for the same period. The current momentum is likely to continue as the country moves toward the Rugby World Cup in 2019 in Fukuoka, the Tokyo Olympics in 2020, and highly anticipated integrated resort development, on top of growing middle-class demand for tourism in neighbouring countries.

However, Japan faces several challenges for future growth.

Firstly, Japan's major airports are getting overcrowded. Two major airports in the Greater Tokyo area are nearing full capacity. Japan needs to improve the efficiency of its air transportation network by raising capacity at major airports and diversifying entry points for overseas travellers.

Secondly, Japan must attract visitors from a wider variety of regions to diversify its tourist base and sustain visitation growth. About 85% of visitors currently originate from Asia. Diversifying tourists should reduce the country's vulnerability to factors such as changes in tourist preferences and external political and economic conditions. Additionally, attracting more business travellers, especially from Europe, is likely to contribute to rate increases.

Air transportation constraints

As of 2016, over 70% of overseas visitors entered the country through three major airports: Narita International Airport, Tokyo International Airport (Haneda), and Kansai International Airport. These international airports were listed as congested airports by the Japanese government in 2000. Since then, the number of overseas visitors has quintupled, and yet Japan must still welcome an additional 16 million annual visitors to reach its target of 40 million by 2020.

TABLE 1
Annual airport capacity and usage, 2016*

Airport	Arrivals & departures ('000)	Current capacity ('000)	Usage %
Narita	243	270	90.2
Haneda	439	440	99.7
Kansai	178	230	77.6

Source: Narita International Airport, Kansai International Airport, Ministry of Land, Infrastructure, Transport and Tourism (MLIT), Savills Research & Consultancy
* The arrivals & departures figure for Haneda Airport is calculated by doubling the number of arrivals in 2015 as reported by the MLIT.

While Kansai International Airport still has some spare capacity, Tokyo International Airport and Narita International Airport are already close to their limits (Table 1). Pushing all three airports to 100% capacity would result in an estimated 80,000 additional flights per year. However, based on average passenger counts on international flights, this would result in just 6.5 million additional arrivals[1]. This is significantly short of the targeted 16 million.

In an attempt to clear this roadblock for its 40-million-visitor goal, the government plans to improve airport efficiency and fly another 80,000 flights through Haneda and Narita by 2020, on top of the current full capacity. Some discussed measures include introducing new flight routes and air traffic control systems. The government has furthermore decided

1 Based on MLIT airport management reports, we estimate the average passenger count per international flight is 190 at Haneda and 140 at Narita and Kansai.

to cut landing fees in half at regional airports in hopes of diversifying entry points for overseas visitors and redistributing burdens currently borne by Narita and Haneda. It is also encouraging Low Cost Carriers (LCCs) to open new routes and alleviate congestion.

The government is additionally forming official wide-area tour routes in regional destinations. This effort should support its attempt to increase regional airport usage.

Tourist diversification

Asian countries have led the exponential growth of international tourism. Between 2010 and 2016, the number of tourists from Asia increased by over 200%, compared to 66.7% from Europe and 73.4% from North America. Asia's share of total visitations was 76% in 2010; the figure has increased to 85% as of May 2017.

Relying too heavily on one region as a visitation source increases Japan's vulnerability to political and economic changes, as well as tourist preferences. To establish tourism as a strong pillar of the economy, it is essential to attract visitors from a wider variety of regions, including western countries, which the government is currently targeting. Since western leisure tourists tend to stay longer and spend about 30% more than the overall average of overseas tourists, the potential impact on Japanese tourism from increases in western tourists could be significant.

The Japan Tourism Agency (JTA) has created a new function focusing on launching campaigns to attract tourists from Europe, North America, and Oceania. It analyses each market and designs strategies to drive up demand from those regions. We believe this is a good strategy for growth.

In addition to geographical diversification, attracting business visitors should also contribute to sustainable growth. As of May, about 88% of international tourists visited Japan for leisure while only 6% came for business. This business figure is relatively small. For example, about 20% of visitors to Singapore travel for business.

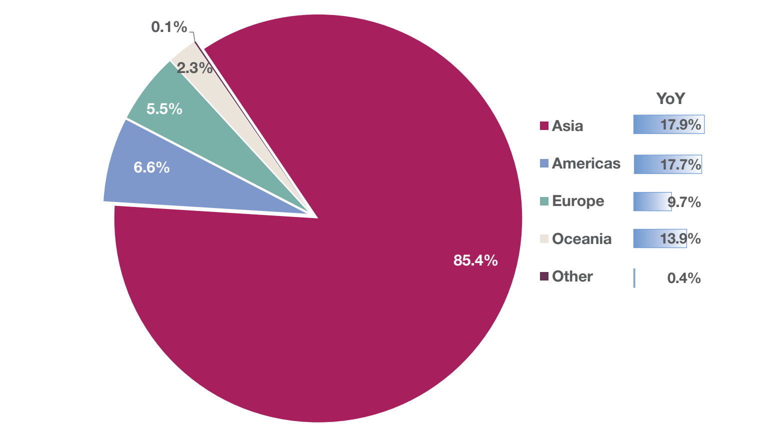
The Meeting, Incentive, Convention, and Exhibition/Event (MICE) industry is one area of focus for the government. According to the Japan National Tourism Organization (JNTO), the number of international conventions in Japan has increased by 30.2% over the past ten years, versus the global average of 26.9%. The government is actively supporting host cities and promoting unique venues in order to maintain competitiveness.

Increases in business travellers, especially from western counties, may also help hotel average daily rates (ADR).

Based on surveys conducted by the JTA between 2014 and 2016, travel expenses allocated for lodging generally differ based on visitor origins and travel purpose. Taking the average daily lodging expense of all leisure travellers from overseas as a base for comparison, we have calculated how much premium or discount travellers from different origins pay depending on their purpose of trip (leisure or business).

GRAPH 1

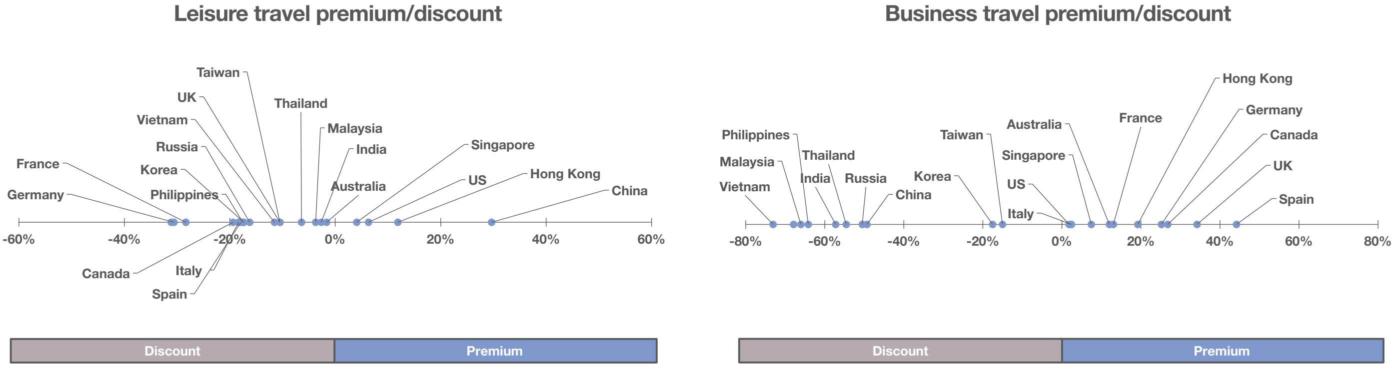
Breakdown of inbound tourists by source, May 2017 YTD



Source: JTA, Savills Research & Consultancy

GRAPH 2

Average daily lodging expenditure in Japan by origin and travel purpose, 2014–2016+



Source: JTA, Savills Research & Consultancy
+ Each origin's lodging spending was calculated based on lodging expense per person divided by average length of stay. Premiums and discounts were then calculated based on the average lodging expense of all leisure travellers regardless of origin.

Western business travellers pay large premiums for lodging. Travellers from Spain, the UK, Canada, and Germany especially pay more for daily lodging. One explanation for the high premiums paid by western business travellers is their high income levels, which could make them more likely to stay at upscale lodgings. Even leisure travellers from the same western counties tend to have lower income levels and usually pay less for lodging. Additionally, compared to Asian business travellers, western business travellers more frequently come to Japan for business meetings rather than for training. Business travellers from Southeast Asian countries that come for training are more likely to stay in corporate accommodations and generate more limited lodging demand.

Japan hotel market

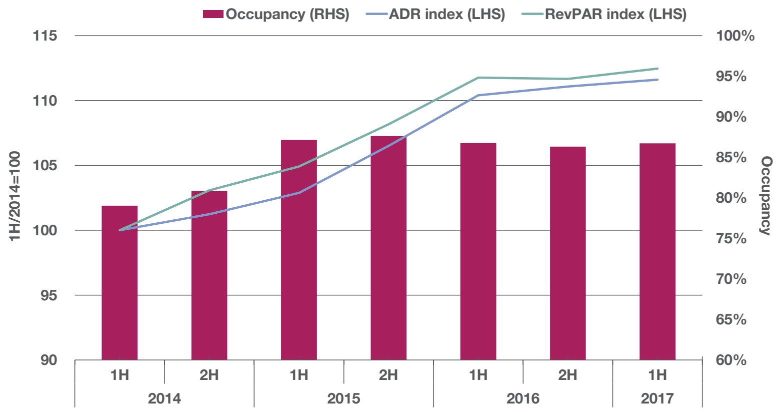
Savills tracks the performance of over 100 hotels owned by five J-REITs[2] to analyse market trends. Our analysis focuses on limited-service hotels; full-service and resort properties are excluded due to limited data. Given that a majority of the existing hotel stock is in the limited-service category,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

2 Five J-REITs include 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.

3 As of this report, Tokyo makes up 34% of the sample hotels while other Kanto prefectures and Kansai make up about 15% each.

GRAPH 3

Trailing-twelve-month limited-service hotel performance, 2014–1H/2017*



Source: J-REIT disclosures, Savills Research & Consultancy
* ADR and RevPAR indexes are computed using 2014 performance as base figures. When new samples are added, we assume that their performance was in line with that of existing samples and then use actual performance figures going forward.

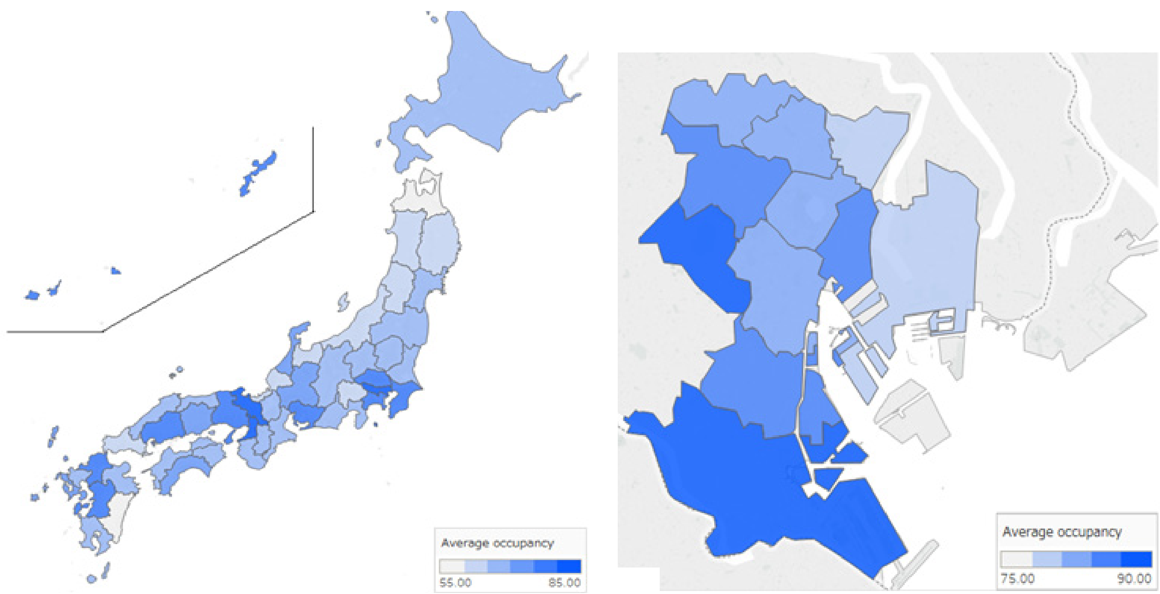
The ADR index of sampled limited-service hotels increased from 110.4 to 111.6 between 1H/2016 and 1H/2017. This growth is marginal compared to growth between 2014 and 2015, when the index increased by 5.3 points. Competition from rapid increases in new supply and minpaku (peer-to-peer accommodation) appears to be limiting rental growth in Tokyo and Osaka. On the other hand, hotels in regional cities such as Fukuoka and Sapporo have seen strong growth.

Limited-service hotel occupancy is tight at 87.4% in 1H/2017, slightly rebounding from declines in 2016. Data from the JTA indicates especially strong occupancy in the Tokyo, Osaka, and Kyoto markets (Map 1). In Tokyo, Ota had the tightest occupancy at 89.4%, followed by Shibuya at 89.2%. Proximity to Tokyo International Airport and affordability are likely the primary reasons for strong occupancy in Ota.

Overall, the revenue per available room (RevPAR) index of sampled limited-

MAP 1

Hotel occupancy in Japan and Tokyo, 1H/2017



Source: © OpenStreetMap contributors (www.openstreetmap.org/copyright), JTA, Tableau, Savills Research & Consultancy service hotels stood at 112 in 1H/2017, 0.7 points up from 1H/2016.

Individual full-service and resort hotels owned by J-REITs are also performing well on the back of growing lodging demand and somewhat limited supply [cover image: DoubleTree by Hilton Naha Shuri Castle].

In addition to increasing overseas tourists, a growing senior population may be sustaining demand for upscale hotels. According to the 2016 Leisure White Paper published by the Japan Productivity Center, the membership resort market expanded by 13.1% YoY and by 60% over the past decade to 355 billion yen as of 2015. The main customer base is people of over 50, who can afford to spend both the time and the money.

Some resort hotels have experienced particularly strong growth. For example, Resonare Atami increased ADR by over 20% YoY. Guestroom and public area renovation in 2016 largely contributed to the growth. Kai Izumo also recorded over 20% ADR growth YoY. Izumo Taisha, one of the oldest shrines in Japan, underwent a 10 billion yen facelift in 2013. Since 2013, the number of overseas visitors to Izumo has doubled while Chinese visitors in particular have quadrupled.

In the full-service segment, ANA Crowne Plaza Hotel Hiroshima and Fukuoka both increased ADR by over 9.0% YoY. In addition to growing lodging demand in these markets, guestroom renovations in early 2016 appear to have contributed to performance improvements.

Lodging pipeline

Exponential overseas visitor growth and improving hotel performance have been driving new hotel developments. It is not surprising that Tokyo has seen a glut of new supply, given the popularity of the city among international tourists. The number of new developments started picking up in FY2014 and reached 109 projects in FY2016. According to the Nikkei, there were 26,400 new rooms scheduled to be added in the central 10 wards[4] as of June. Minato is expected to see the largest increase at 6,300 rooms, and Chuo follows with 5,400 new rooms.

Osaka is another city that has seen significant supply growth in recent years. The city was lagging behind Tokyo until finally surpassing it in FY2016. Osaka is expected to see about 7% supply growth annually for the next three years, higher than Tokyo's expected growth of about 5.5%. This large supply is expected to flatten performance growth at least temporarily.

Furthermore, the home lodging business ("jutaku shukuhaku jigyo") legislation, which the Japanese government passed in June, has set a clear legal foundation for Japan's minpaku businesses and has given a green light for a number of companies waiting on the side-lines to enter the market.

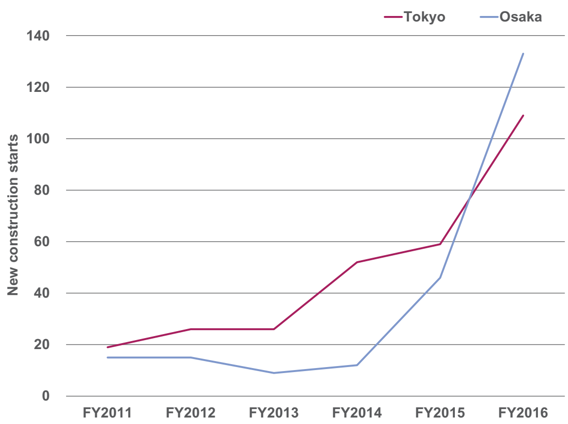
For example, Rakuten and Lifull have partnered to establish Rakuten Lifull Stay. In February, Keio Corporation announced its plan to enter the minpaku market and opened Kario Kamata, a property designated for minpaku users, in a special area permitting minpaku. These new domestic players may prompt more Japanese consumers to use minpaku services.

The new legislation and major market participants may level the playing field and encourage fairer competition. As a result, it is possible that individual operators, who currently dominate the minpaku market, are forced to combat increased competition. Furthermore, minpaku properties that are professionally operated by large companies may increasingly become an attractive alternative to budget hotels. If that is the case, low-tier hotels may suffer over the short term, especially in minpaku-rich cities such as Tokyo and Osaka.

4 Chuo, Chiyoda, Minato, Shinjuku, Shibuya, Koto, Sumida, Taito, Bunkyo, and Toshima.

GRAPH 4

New lodging facility construction starts, FY2011–FY2016



Source: MLIT, Savills Research & Consultancy

TABLE 2

Selected investment transactions, announced Jan 2017–Jun 2017

Project name	Price (JPY bn)	Price per room (JPY mm)	Cap rate	Location	Buyer
Sunroute Plaza Tokyo	26.8	38.5	5.9%	Chiba	Orix JREIT
Hommachi Garden City (Hotel portion)	17.2	107.5	4.0%	Osaka	Sekisui House REIT
Hilton Tokyo Narita Airport	13.2	48.4	5.6%	Chiba	Japan Hotel REIT

Source: Japan REIT, RCA, Savills Research & Consultancy

Investments

The number of hotel transactions has remained generally stable. Real Capital Analytics (RCA) data indicates that 29 hotel transactions occurred from January through June 2017. A majority of transactions were observed in the Kanto region, including Tokyo, Kanagawa, and Chiba.

The Real Estate Investor Survey by the Japan Real Estate Institute (JREI) reports that expected cap rates on economy hotels in prime Tokyo locations compressed an additional 0.1 percentage points (ppts) to 4.7% since October 2016. Cap rates in Osaka and Kyoto are both at 5.2%, representing yield spreads of 0.5ppts over Tokyo.

The largest transaction in 1H/2017 was for Sunroute Plaza Tokyo, at 26.8 billion yen, or 38.5 million yen per room. On a per-room basis, the hotel portion of Hommachi Garden City under the luxury brand St. Regis recorded the highest price at 107.5 million yen per room.

Underwriting is no longer so aggressive, likely reflecting the slowdown in rental growth and the large supply pipeline.

OUTLOOK

The prospects for the market

Japan has experienced exponential growth in overseas visitors over the past several years. In order to reach the government's ambitious goal, however, the country needs to improve air transportation efficiency by increasing major airport capacity and diversifying entry points for overseas travellers. Furthermore, for the country to establish a stable tourism industry, Japan must graduate from its heavy reliance on Asia and achieve a more geographically diverse mix of inbound tourists.

The good news is that the government has already laid out plans to address these challenges, and the hospitality market is likely to grow further at a steady pace. Given the government's efforts to send tourists to regional cities, there appears to be more upside potential outside of Tokyo.

Regarding minpaku, new legislation has levelled the playing field and opened doors for participation by major companies. Individual operators, who currently dominate the market, may be crowded out by the competition. It is possible that the entry of major companies could blur the line between budget hotels and minpaku. If this is the case, budget hotels may face more competition, especially in Osaka and Tokyo, which are expecting a large supply of budget hotels and already has a large concentration of minpaku locations.

Overall, Japan's hospitality market continues to exhibit strong upside potential. If the country can maintain its momentum, the hospitality sector should continue to expand. Budget hotels in Tokyo and Osaka are facing competition, while regional and upscale hotels are likely better off due to limited supply. However, abrupt changes in East Asia's geopolitical situation and the direction of global capital flow could potentially pose risks to our outlook for strong growth.

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