



Spotlight Japan hospitality

February 2018



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“The hospitality sector remains popular among investors as increasing tourism continues to support sound demand fundamentals. High supply levels may concern hoteliers, but new regulations on minpaku and strong demand fundamentals could mitigate the negative impact of heightened competition.”

Introduction

In 2017, the number of overseas tourists to Japan increased by 19.3%, to 28.7 million, from 24.0 million in 2016. While Asian countries such as South Korea, China, and Hong Kong led this growth, the US, Canada, and Australia recorded double-digit growth as well. Increases in tourism from these western countries help reduce Japan's reliance on Asian countries and build a strong foundation for long-term tourism growth. Total spending by overseas tourists was 4.4 trillion yen, a 17.8% increase from the previous year.

Inbound tourism to Tokyo and Osaka also continues to set records. In 1H/2017, the number of overseas visitors to Tokyo grew by 3.6%

compared to the same period in 2016. If growth continued at the same rate through the year end, Tokyo would have seen 13.5 million overseas tourists in 2017. Over 11.1 million overseas visitors travelled to Osaka in 2017, an 18.1% increase from 2016. According to a survey conducted by the Osaka Convention & Tourism Bureau, Dotonbori, Osaka Castle, and Universal Studios Japan ranked as the most popular destinations in Osaka.

An unprecedented supply of lodging space is expected to come into the market in 2018 and beyond, a worrying sign for hotel operators. In some cities, the number of hotels is estimated to increase by over 20% within the next few years.

GRAPH 1
International arrivals to Tokyo and Osaka, 2006–2017*



* Tokyo's arrival figure in 2017 is estimated based on 1H/2017 and 2016 data. Osaka's 2017 figure is actual.
Source: Tokyo Metropolitan Government, Osaka Prefectural Government, Savills Research & Consultancy

SUMMARY

- The number of overseas visitors to Japan in 2017 reached 28.7 million, a 19.3% increase over 2016.
- Total spending by overseas tourists in 2017 amounted to 4.4 trillion yen, up 17.8% from 2016.
- Hotel performance continues to improve due to tighter occupancy. Average daily rate (ADR) growth is essential to absorb the negative impact of increasing labour-related costs on cash flows.
- A glut of supply worries hoteliers, but demand fundamentals appear solid.
- New regulations surrounding peer-to-peer accommodations (minpaku) may reduce supply pressure on hotel operators.
- Investment interest in the hotel sector remains strong. Although the total transaction volume fell due to limited opportunities for acquisition, a few large transactions were recorded in 2H/2017.

However, unlike the surge in supply preceding the 2008-2009 financial crisis, solid demand fundamentals lie at the heart of recent supply growth. Following rapid growth in the inbound tourism industry, the annual number of overseas visitors has increased by over 20 million since 2012. According to the Japan Tourism Agency (JTA), room night demand accommodated by hotels¹ increased by 60 million room nights during the same period. Hotel occupancy increased by about 5 percentage points (ppts) as a result of demand outpacing supply.

Additionally, with the aging of Japan's lodging stock, new hotels are necessary to provide quality accommodation for high-spending tourists. A survey conducted by the Japanese government in 2012

¹ Hotels include resort hotels, business hotels, and city hotels based on the JTA's definitions

revealed that about 40% of surveyed hotels were built over 30 years ago and 43.5% of ryokan (Japanese-style inns) were built over 50 years ago.

Furthermore, in 2017, the Tokyo office market outperformed the expectations of market participants, despite initial concerns over large supply. If macro trends remain positive, the hotel market may continue to see growth similar to that of the office sector, where demand kept pace with increases in supply.

Minpaku regulations

In Q3/2017, the JTA conducted its first survey of peer-to-peer accommodation (minpaku) usage by overseas tourists. According to the survey, 12.4% of all tourists and 14.9% of leisure tourists used minpaku services during their stays. Of the 29 million overseas visitors who travelled to Japan in 2017, 3.6 million (12.4%) are estimated to have used minpaku. Airbnb also reported that it reached 4 million users in Japan in 2016.

According to the same survey, over a quarter of leisure visitors from countries such as Singapore, France, Indonesia, and Australia used minpaku. The survey also noted that minpaku users tend to stay 1.7 days longer but spend about 17% less on lodging.

Although the home lodging business (“jutaku shukuhaku jigyo”) legislation passed in June 2017 has set a legal foundation for minpaku businesses, many municipalities are imposing their own regulations on the industry. Ota in Tokyo passed a new regulation stipulating that the minpaku practice is not permitted in residential and industrial areas. Shinjuku prohibits minpaku operations in residential districts on weekdays. In an extreme example, the Town of Karuizawa is seeking an outright ban on minpaku operations within its jurisdiction. However, the central government may push back against overly strict regulations if enforcement of the national minpaku law is weakened as a result.

The Japanese government is also tightening the reins on minpaku to facilitate fair competition. As, according to a government survey, over 85% of minpaku locations are unregistered, the government issued a notification stating that minpaku listing websites must delist unregistered minpaku locations by 15 June 2018. The government is also making it mandatory to report the

accommodation days of each minpaku location to ensure that annual operation does not exceed 180 days, the limit imposed by the new minpaku law.

These changes are likely to dampen the explosive growth of minpaku services and lay the groundwork for fair competition, which could be a welcome breather for hotel operators. Airbnb has already announced that it will remove listings of non-compliant accommodations. Additionally, a comparison of overseas visitor and foreign lodging guest trends indicate that some demand returned from minpaku to hotels in 2017.

Despite the above, the minpaku sector remains popular, as illustrated by recent entries of major players such as Rakuten LIFULL Stay and

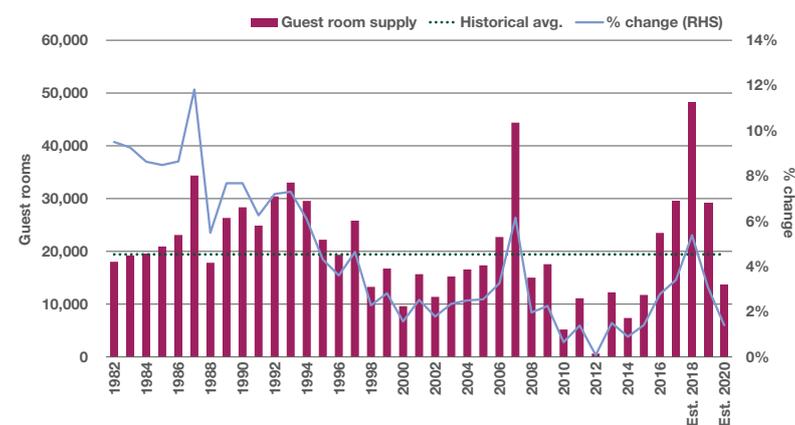
Recruit. Airbnb also plans to expand its operations and become a one-stop provider of minpaku services, from providing support for starting minpaku to managing their day-to-day operations. These companies are likely to drive the development of the industry and consolidate currently fragmented markets. Savills will continue to monitor the impact of the new regulation to discern whether minpaku services become a real threat to hoteliers.

Japan hotel market

Savills tracks the performance of over 100 hotels owned by five J-REITs² to

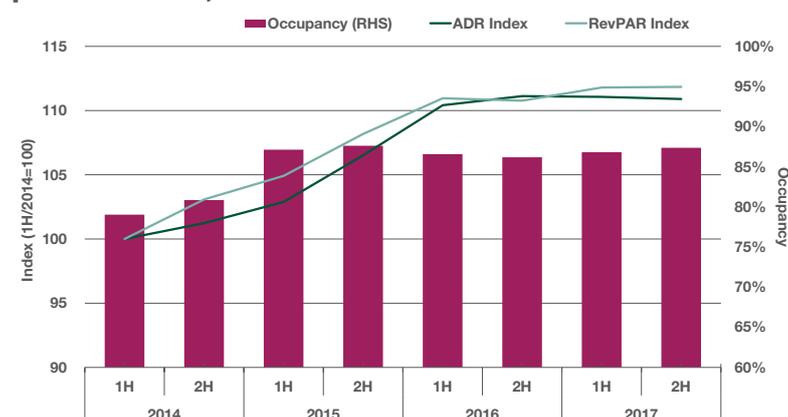
² The five J-REITs consist of Japan Hotel REIT, Invincible Investment, Hoshino Resorts REIT, Ichigo Hotel REIT, and Mori Trust Hotel REIT. Since new samples are added when J-REITs acquire hotels, the sample size and composition may change marginally between survey periods.

GRAPH 2 **Hotel guest room supply, 1982–2020**



Source: Hotes, news articles, Ministry of Health, Labour and Welfare, Savills Research & Consultancy

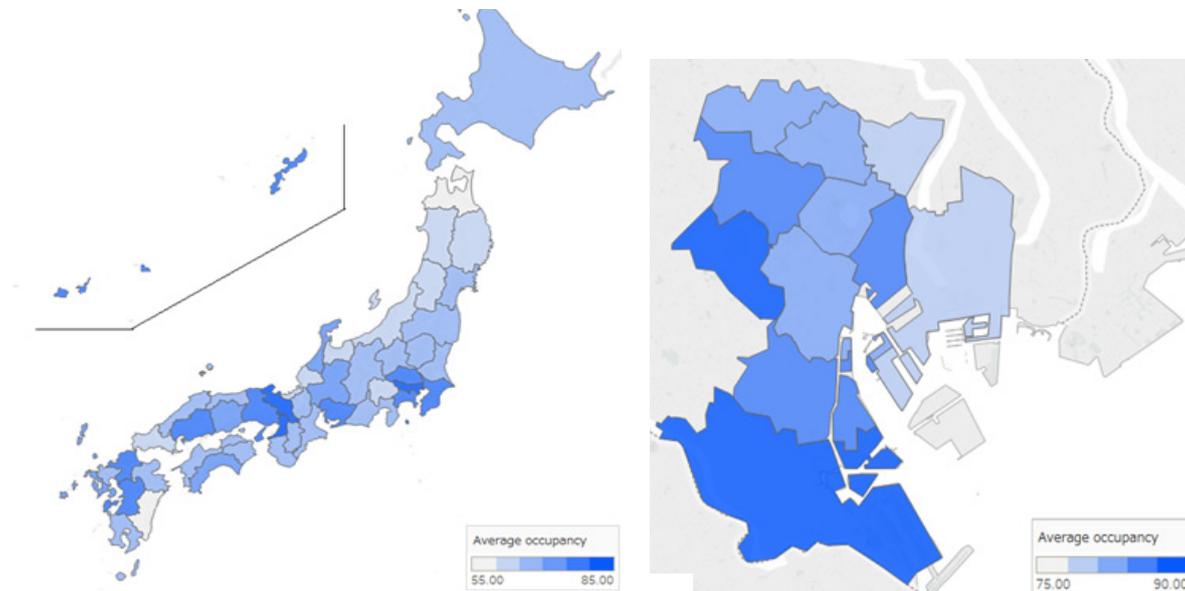
GRAPH 3 **Trailing-twelve-month limited-service hotel performance, 2014–2H/2017**



Source: J-REIT disclosures, Savills Research & Consultancy

MAP 1

Lodging occupancy in Japan and Tokyo, 2017*



Occupancy data is based on the data between January and November 2017. Japan's average occupancy is based on limited-service hotel performances. Source: JTA, © OpenStreetMap (www.openstreetmap.org/copyright), Savills Research & Consultancy

→ 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 Japan³.

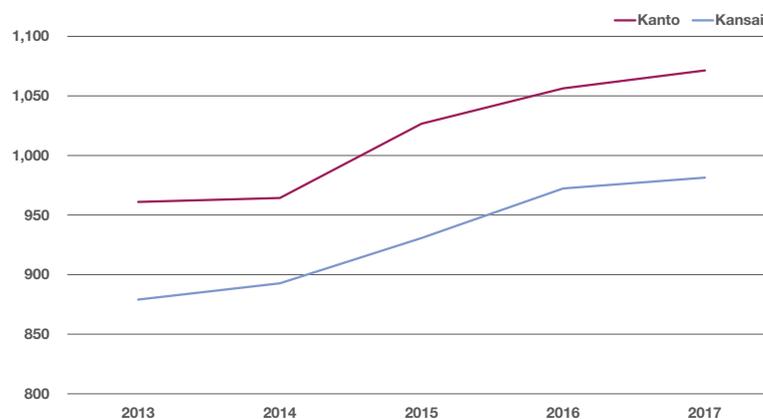
In 2H/2017, the revenue per available room (RevPAR) index of sampled limited-service hotels continued to grow modestly and stood at 111.8, 1.1 points up from 2H/2016. While average hotel occupancy further tightened from 86.2% in 2H/2016 to 87.4% in 2H/2017, the average daily rate (ADR) index slightly softened from 111.1 to 110.9 during the same period. Facing an influx of new supply, some hotels in major cities appear to be focusing on maintaining occupancy rather than raising rates. In contrast, upscale and luxury hotels are more insulated from supply increases and appear to be outperforming budget hotels. Regional markets also have more room for RevPAR improvement.

Data from the JTA indicates especially strong occupancy in the Tokyo, Osaka, and Kyoto markets (Map 1). In Tokyo, Shibuya recorded the tightest occupancy at 90.5%, followed by Ota at 89.8%. In addition to strong

³ As of this report, Tokyo accounts for 34% of the sample hotels while other Kanto prefectures and Kansai account for about 15% each.

GRAPH 4

Lodging staff hourly wages, 2013–2017



Source: Recruit Jobs, Savills Research & Consultancy

demand, limited supply in Shibuya keeps market occupancy very tight.

Increasing labour costs are a mounting concern for hotel operators. Due to the extensive labour requirements of hotels, increases in wages put significant pressure on the bottom-line cash flows of hotel operators. Based on data from Recruit Jobs, the average hourly wage of lodging-related workers has increased by over 10% since 2013.

To illustrate, assuming total labour-related costs including outsourced services are equivalent to 20% of

total revenue, a 10% increase in labour costs reduces cash flow by 2% of total revenue (20% multiplied by 10%). If the GOP ratio is 40%, the impact is a 5% loss in GOP (2% divided by 40%).

The challenges presented by labour shortages are expected to become more severe. Wages are likely to increase in order to attract labour, especially in the hospitality industry, as wage levels have been relatively low compared to other industries (Graph 5). Securing a workforce for new hotel developments will present additional

→ challenges for hotel operators. Based on the above, existing hotels should be a more attractive investment than brand-new hotels.

Successful revenue management may enable operators to control labour costs by reducing occupancy while increasing ADR and achieving equivalent or greater RevPAR. In recent years, hotel operators have appeared to be reluctant to raise ADRs out of fear of losing business to new hotels and minpaku. If new regulations weaken minpaku growth, hotel operators may feel more comfortable raising room rates.

Investments

According to Real Capital Analytics (RCA) data, transaction volumes of hotels stood at about 270 billion yen in 2017, down 33% from 2016. However, several significant transactions, including Sheraton Grande Tokyo Bay, Hilton Tokyo Odaiba, and Renaissance Okinawa, were conducted during the year. According to the Japan Real Estate Institute (JREI), expected cap rates on economy hotels in prime Tokyo locations compressed by an additional 0.2 ppts, to 4.5%, since April 2017, reflecting strengthening acquisition appetite.

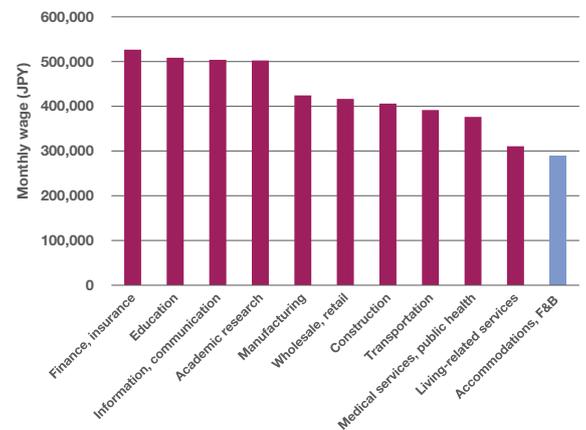
Surging hotel supply also reveals strong investment interest in the hospitality sector. While hotel transaction volumes began to decrease in 2016, total lodging project costs soared to over 900 billion yen in 2017 (Graph 6). It is also noteworthy that project costs per lodging are on the rise. This may reflect larger sizes and the improving quality of newly constructed hotels. With scarce opportunity to acquire existing properties, more investors may eye turnkey investment deals in cities such

as Tokyo, Osaka, and Kyoto. Owners have also become more flexible in offering turnkey opportunities rather than forward commitments.

Some new investors, in search of greater returns, are making forays into the hotel market. UBS Asset Management launched a \$400-million fund primarily targeting limited-service hotels in Japan. Tokyo Tatemono launched a new brand, the square hotel, and is actively acquiring sites for urban hotel developments. Nomura Real Estate Master Fund, a J-REIT, revised its investment guidelines to include hotels and acquired Watermark Hotel Sapporo in December 2017. The REIT's sponsor, Nomura Real Estate Holdings, also established Nomura Real Estate Hotels in October 2017 and will open its first hotel, Nohga Hotel Ueno, in fall 2018. In addition, Cosmos Initia established Cosmos Hotel Management in October 2017, which is focusing on developing "apartment hotels". Targeting group travellers, these hotels provide large guest rooms with kitchens.

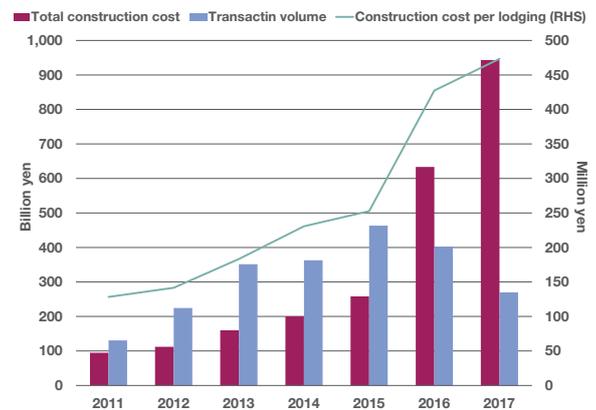
International hotel brands are also expanding their portfolios in Japan. Marriott opened millennial-focused Moxy Tokyo Kinshicho and Moxy Osaka Honmachi (cover photo) in November 2017. In 2018, Mori Trust will open IRAPH SUI, a Luxury Collection Hotel, Miyako Okinawa under the Marriott's Luxury Collection brand. In Osaka, Sekisui House plans to build W Osaka, a new hotel under Marriott's luxury W brand. New hotels affiliated with Hilton, Kyukaruizawa Kikyo, Curio Collection by Hilton, and Hilton Okinawa Sesoko Resort, are set to open in 2018 and 2021, respectively. The Okinawa resort will be the first project in Japan under Hilton Grand Vacations' timeshare system. ■

GRAPH 5 Monthly wages by industry, 2017



Source: Ministry of Health, Labour and Welfare, Savills Research & Consultancy

GRAPH 6 Lodging construction cost vs transaction volumes, 2011–2017



Source: MLIT, RCA, Savills Research & Consultancy

TABLE 1 Selected investment transactions, announced in 2H/2017

Property name	Approx. price (JPY bil)	Price per room (JPY mm)	Cap rate (%)	Location	Buyer
Sheraton Grande Tokyo Bay	97.8	96	4.9	Urayasu, Chiba	Invincible Investment & GIC
Hilton Tokyo Odaiba	60.0	132	N/A	Minato, Tokyo	Hulic & Fuyo Lease
Renaissance & Coco Garden Resort Okinawa	20.0	42	N/A	Kunigamigun/Uruma, Okinawa	Gaw Capital Partners

Source: Japan REIT, RCA, Nikkei RE, Savills Research & Consultancy

OUTLOOK

The prospects for the market

Investment interest in the hotel sector continues to strengthen, largely due to attractive yields and a positive outlook for demand. The recent entry of new developers and investors into the market indicates that the hotel sector is likely to remain a popular investment opportunity in the near term.

However, while the boom in tourism continues to support lodging demand, flat ADR growth and increasing labour costs may negatively affect cash flows for

some hotels. Increased supply in the coming years may pose a threat to hotel operators, particularly to those managing budget hotels.

Investors must increasingly look to whether properties can maintain competitive advantage by selecting better locations for new developments, or by improving branding and conducting renovations of existing structures. Additionally, if the regulation of the minpaku industry ultimately reduces supply growth, hoteliers may feel more comfortable raising room rates.

Yields on hotels are still attractive compared to those of offices. Increasing investment interest is likely to continue to compress cap rates on hotels with fixed leases. However, as upside potential declines and downside risk may soon loom into view, cap rates on hotels with variable leases might loosen.

Please contact us for further information

Savills Japan



Christian Mancini
CEO, Asia Pacific
(excl. Greater China)
+81 3 6777 5150
cmancini@savills.co.jp

Savills Research



Tetsuya Kaneko
Director, Head of Research
& Consultancy, Japan
+81 3 6777 5192
tkaneko@savills.co.jp



Simon Smith
Senior Director
Asia Pacific
+852 2842 4573
ssmith@savills.com.hk

Savills Hotels



Raymond Clement
Managing Director
Asia Pacific
+65 6415 7570
rclement@savills.com.sg



Tomotsugu Ichikawa
Director
Japan
+81 3 6777 5184
toichikawa@savills.co.jp

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