Japan - February 2024

SPOTLIGHT

Savills Research

Japan Hospitality

savills

New highs attained, but labour shortage problems persist

Summary

- The number of inbound tourists in Q4/2023 surpassed the previous peak of Q4/2019, even with the number of Chinese tourists at less than half of pre-pandemic levels, showing strong potential for further growth.
- The ADR and RevPAR indices have surpassed 2019 levels, although occupancy levels still lag behind.
- Hotel supply is forecast to be at its lowest since 2015, and predominantly consisting of budget hotels.
- Average spending per inbound tourist has increased notably, aided by the weak yen. While a stronger yen might dampen spending levels, the improved services and facilities in the country should help to keep them elevated.
- Investment volumes in 2023 have hit a two-decade high, with overseas investors playing a significant role in the market.
- The luxury hotel segment has been the focus of many large deals announced in 2023, and is expected to see greater levels of attention going forward as the country looks to lure more high-spending tourists.
- The labour shortage is improving, albeit slowly, and may dampen hotel supply plans.

INTRODUCTION

2023 was a standout year for the hospitality sector with the full reopening of borders, helping to pump growth to beyond pre-pandemic levels. Aided by the persistent weak yen, the number of inbound tourists has recovered rapidly. In fact, the number of foreign visitor arrivals in Q4/2023 was higher than that of the same period in 2019, even with only fractional recovery from Chinese tourists, showing that there is large potential for further growth.

Hotels have thus been able to continue on their path of strong growth in the second half of 2023, with hotel Average Daily Rates (ADRs) and Revenue Per Available Room (RevPAR) having increased considerably. Most hotels have attained levels equivalent to those of pre-pandemic times, and with many having surpassed them, even in terms of RevPAR. At the same time, occupancy rates still remain below pre-pandemic times, highlighting the labour shortage issue faced by many hotels, especially new ones with some service lines.

Nonetheless, all regions in Japan have reported stronger ADRs compared to a year ago, especially in inbound-tourist heavy areas. Tourists from South Korea and Taiwan have seen a particularly large resurgence, which has led to notable growth in their favourite Kyushu region. On this note, Fukuoka Airport is undergoing expansion work that looks to double the capacity of its international terminal by the end of 2025, gearing it up for greater levels of inbound tourism, meaning that the region should see more growth in the future. This is the case especially with more investment activity in Kumamoto, where TSMC is developing new plants, which is attracting multiple related businesses.

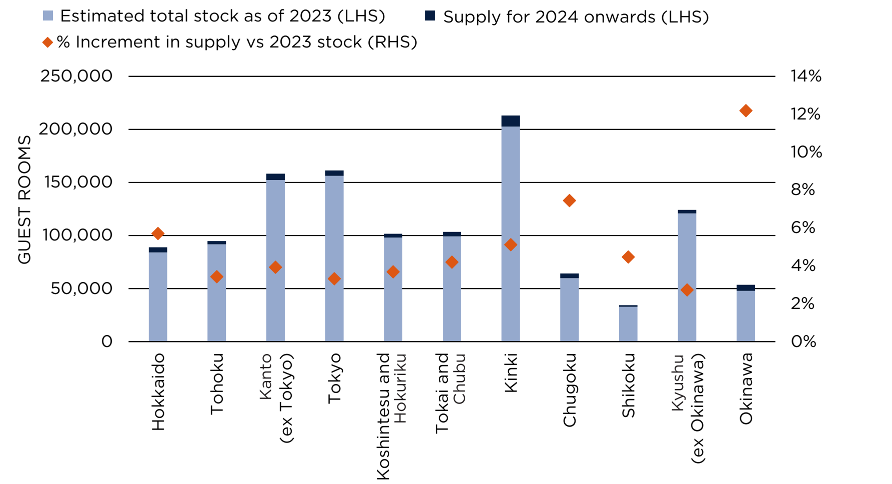
Luxury hotels have seen a large amount of attention and interest from investors, due to more high spenders visiting Japan, and the relative dearth of such hotels in the country. While there are definite opportunities within this sector, there are also challenges that must be addressed in order to succeed and compete.

HOTEL STOCK AND SUPPLY

In FY2022, the total stock of hotel and ryokan rooms was around 1.8 million, having increased by 13,000 from the previous year, according to data from the Ministry of Health, Labour and Welfare (MHLW). This increment was considerably smaller than those of pre-pandemic times, and it was even noticeably smaller than figures observed during the peak of the pandemic - FY2020 and FY2021 saw increments of 32,000 and 19,000 rooms, respectively. Supply has indeed been slowing down significantly, further confirmed by a survey conducted by Hoteres in 2023 forecasting the lowest supply of new hotels since 2015.

Indeed, the development of new hotels has been more selective through two main bottlenecks, with the first being skyrocketing construction costs, on top of increased land prices. According to the Construction Research Institute, construction costs for reinforced concrete hotels have risen by around 30% since 2017, and by around 10%

GRAPH 1: Hotel* Stock as of 2023 vs Upcoming Supply for 2024 Onwards by Region



Source Hoteres, MHLW, Savills Research & Consultancy
* excludes Ryokan

since 2022. This has likely undermined previous underwriting assumptions of many hotel projects, consequently resulting in the delay or outright cancellation of some, and stifling new supply arriving to the market. Secondly, labour shortages have been persistent, and have also likely played a role in constricting the supply of new hotels, especially in full-service hotels. While the hotel sector is booming now and eager to hire new employees, the recruitment and training of staff may be lengthy processes that will take time. As such, significant increments in near-term supply are unlikely for the time being.

Presently, about a third of Japan's hotel (excluding Ryokan) stock is concentrated in Tokyo, and Greater Osaka or Kinki, where multiple tourism hotspots such as Osaka, Kyoto, and Nara are located. However, supply forecast for 2024 onwards suggests that Okinawa will see the largest increment in the number of hotel rooms, with an additional 6,000 rooms currently in the pipeline, amounting to about 12% of its stock. Other regions that have a noticeable amount of upcoming stock are Chugoku, where Hiroshima is located, and Hokkaido. In contrast, the supply forecast for Tokyo and the rest of Kanto is below average, suggesting that some attention might have turned to areas beyond Tokyo. Elsewhere, Kinki looks to usher in a considerable amount of supply over the next few years, adding to the considerable amount of stock, especially budget hotels in Osaka. Budget hotels typically run on master-lease contracts and are more favoured by domestic owners and banks, which is likely one reason for their large upcoming supply.

The hotel market has hit a new high ADR level, and the luxury hotel sector is thriving with more high-spending inbound tourists. However, the labour shortage is proving persistent, and further improvements look to be gradual, particularly for full-service hotels. Nonetheless, the limited supply, especially that of high-end hotels, bodes well for the higher-end segment.

TRENDS IN INBOUND TOURISM

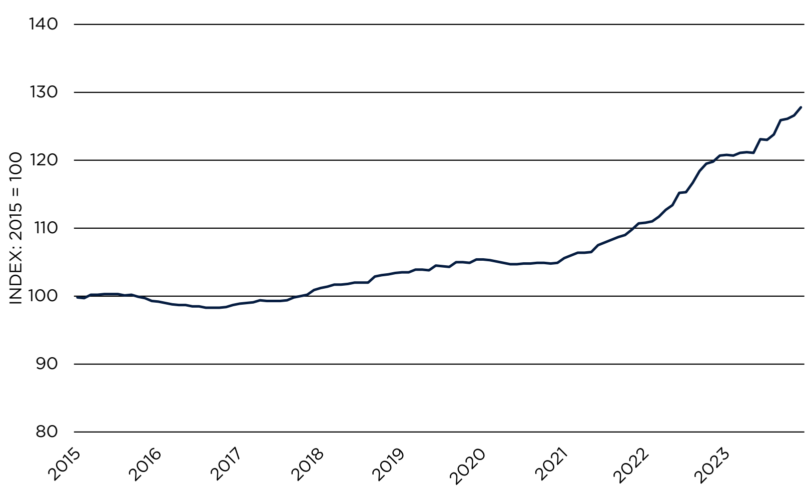
Until the 2000s, Japan was not on the radar as the global tourism hub at all. Entry into the country by many foreign travellers was cumbersome and prices were prohibitively expensive due to the strong currency. Japan was not geared towards the needs of international travellers, with foreign-language support scarcely available. However, that rhetoric has flipped, with inbound tourists having become an essential pillar supporting the tourism industry in the country.

Japan has seen a large rebound in inbound tourism, with the number of international visitors not only at around record levels as of Q4/2023, but also with the post-pandemic era seeing the average amount spent per visitor hit significantly higher levels than those observed over the past decade. A myriad of factors have contributed to this remarkable growth. For instance, Japan was ranked as a top destination to visit by multiple institutions, including the World Economic Forum in 2021, which contributed to building a substantial amount of pent-up demand to visit the country, which was released when the country opened its borders to visa-free inbound tourism in October 2022.

Secondly, the yen has significantly depreciated against most currencies as many countries, most notably the United States, have increased interest rates, in contrast with Japan sticking with its monetary easing policies. The weak yen has undoubtedly provided a considerable amount of additional purchasing power to most international visitors to the country. In this vein, with the Bank of Japan looking to end its negative interest rate policies, consequently strengthening the yen, there have been some concerns that the impact that spending trends will take a hit.

However, while currency fluctuations are certainly an important factor, a considerable proportion of growth is likely organic and unrelated to currency. For instance, visitors from Asia and the west (who represent most of the inbound tourists) generally saw over a 50% increase in spending, while the yen had only depreciated by around 30% compared to 2019. Indeed, Japan ran extensive marketing campaigns promoting higher-end

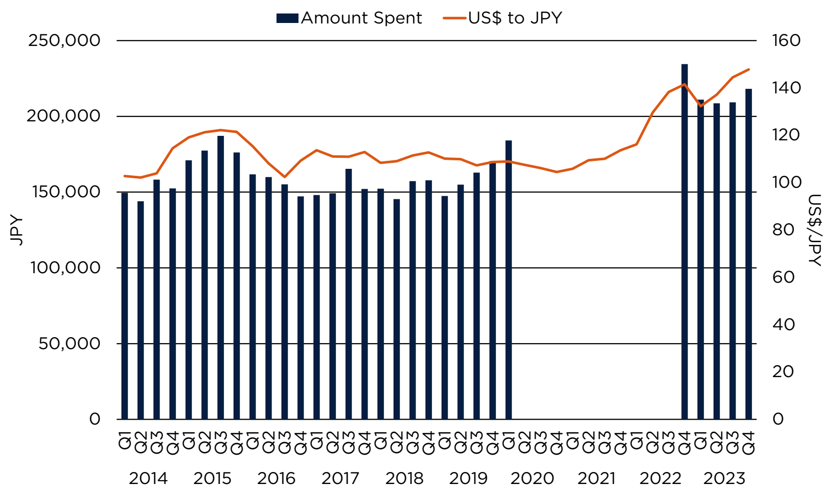
GRAPH 2: Construction Costs for Hotels in Tokyo, 2015 to 2023



Source Construction Research Institute, Savills Research & Consultancy inbound tourism in the country leading up to the 2020 Tokyo Olympics, and has also seen infrastructural improvements like an increased number of duty-free shops, and greater frequencies of direct flights into the country. In the private sector, examples of refined services to inbound tourists include Isetan Mitsukoshi doubling the number of staff that exclusively serve high-end customers, and also developing foreigner-friendly membership apps, which partly contributes to the record revenues. These activities can be quantified when looking at the budget of the Japan Tourism Agency and the amount of funds dedicated to improving and promoting inbound tourism (Graph 4). These factors have also played a significant role in improving Japan's status as a popular tourist destination and increasing the number of visitors, especially high-spending ones, and have likely assisted in increasing spending as well.

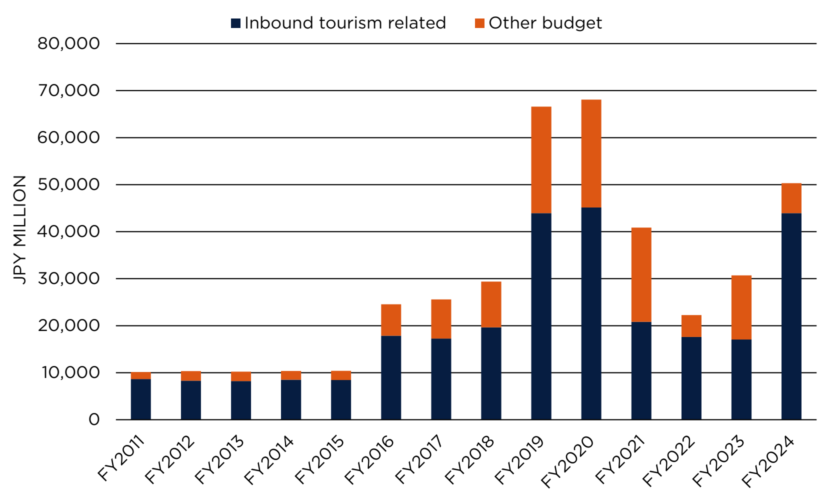
Japan's inbound tourism market is in its prime, and momentum looks strong with further room for growth. Admittedly, the average amount spent per visitor is unlikely to see significant increments in the short-term, especially when the yen appreciates. Nonetheless, there are multiple tailwinds for inbound tourism as a whole. Tourists from mainland China have yet to see a meaningful return, and events in the pipeline such as World Expo 2025 should help to prop up demand. Further down the road, the Integrated Resorts in Osaka could be a game changer for Japan and attract significantly higher spenders. Overall, the full potential of inbound tourism appears yet to have been unleashed, and still has greater business opportunities that can be explored.

GRAPH 3: Average Amount Spent by Each Inbound Tourist* vs US$/JPY Exchange Rate, 2014 to 2023



Source Japan Tourism Agency, Savills Research & Consultancy
* Data points during the pandemic are either unavailable or omitted.

GRAPH 4: Budget of Japan Tourism Agency*, FY2011 to FY2024



Source Japan Tourism Agency, Savills Research & Consultancy
* Budget for the Go-To Japan campaign is not included.
Note: Inbound tourism-related budget calculated based on budget items explicitly dedicated to inbound tourism.

HOTEL MARKET PERFORMANCE

Savills tracks the performance of approximately 100 hotels owned by five J-REITs[1] 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 budget segment market trend in Japan[2].

J-REIT hotels saw considerable growth in the second half of 2023, having benefitted from the lifting of restrictions on inbound travel. As seen in Graph 5, the ADR index for limited-service hotels has improved by 14.0 percentage points (ppts), and the RevPAR index by 8.5ppts, compared to the same period in 2019, with both attaining record levels since 2014 when this index was created, far outstripping pre-pandemic levels, with ADR levels remaining ahead. On a half-year-on-half-year (HoH) basis, the ADR index increased by additional 6.8ppts, and the RevPAR index increased by 5.6ppts, exhibiting the continued growth over the year. At the property level, those owned by Invincible REIT in particular appear to be performing exceptionally well on average, and seem to have made significant contributions to pushing the index to a new high. With inbound tourism looking to have even greater room for growth, especially in the case of Chinese tourists, hotels could see even better performance ahead, especially in the upcoming cherry blossom season.

Meanwhile, occupancy rates have made some progress in recovery, increasing by 3.3ppts over the past half-year to 81.8%, albeit remaining somewhat lower than pre-pandemic levels. The labour shortage is a chronic problem, and will take more time for solutions in place to be realised, as the training of staff is expensive and time-consuming. Nevertheless, the situation is slowly improving, and optimism is still high. Furthermore, the high ADRs are able to compensate for this shortfall in occupancy, meaning that hotels are in good shape overall.

Full-service hotels were generally performing better than limited-service hotels throughout the pandemic, and this

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

rang true even into 1H/2023. However, the second half of 2023 has bridged the gap between these two hotel classes, with the recovery in RevPAR of limited-service hotels even surpassing those of full-service hotels for some months. Indeed, the labour shortage problem is likely impacting full-service hotels harder, given the additional hurdle of training a larger number of staff to higher levels of service in line with the hotel branding, and the impact of this can be observed - the average occupancy of full-service hotels is notably lower than limited-service ones. Full-service hotels have also yet to see meetings, incentives, conferences, and exhibitions (MICE) and banqueting return in full. On the other hand, resorts have continued with their strong performance, with ADR and RevPAR having improved even more, and appear to have caught the attention of some investors.

INVESTMENT

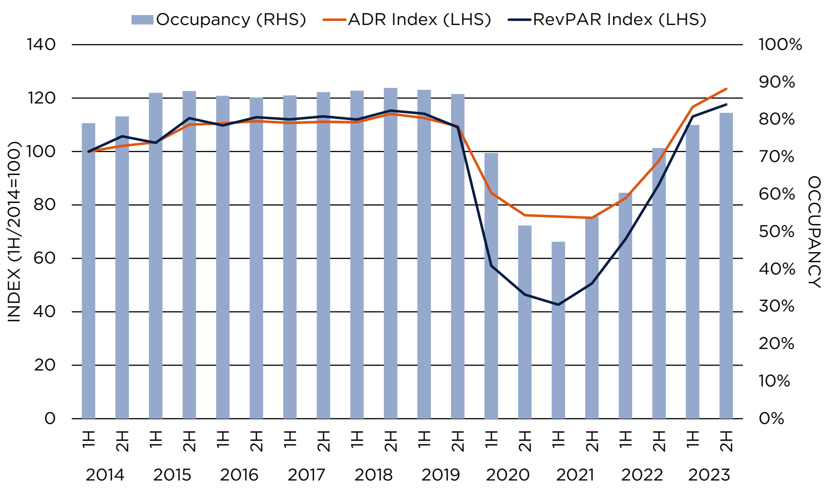
Hotel transaction volumes in 2023 have increased considerably, attaining the highest levels observed since 2019, reaching over JPY500 billion. This was more than 20% higher than levels in 2022, and almost 40% higher than the 10-year average between 2013 and 2022. Most interestingly, 2023 saw the highest proportion of overseas capital since 2008, hitting almost 60%. International investors have indeed been active in the second half of 2023 with multiple big-ticket announcments.

GIC is looking to sell the Hilton Fukuoka Sea Hawk hotel in Fukuoka at an asking price of JPY85 - 90 billion, working out to around JPY81 - 86 million per key, with the Hilton's management agreement reportedly expiring soon, which opens chances to introduce new branding for the asset. Meanwhile, one long-term project taking place is by Patience Capital Group, which has plans for a JPY200 billion transformation of Niigata's Myoko region into a high-end ski resort that features luxury hotels. There are presently no luxury hotels in Niigata, and if successful, Myoko will be the first area in the prefecture to host them.

Elsewhere, domestic players have also made big strides in the market, for instance, with APA Holdings acquiring all shares of Ooedo Onsen Asset Management, which manages the listed Ooedo Onsen REIT. APA Holdings reportedly has ambitious plans, aiming to nearly triple the AUM of the REIT to JPY100 billion by late 2026. This expansion should create more avenues for investors to gain exposure to the hotel market. J-REITs have also been active, with Star Asia REIT acquiring seven hotels for JPY45 billion from its sponsor Star Asia Group, Japan Hotel REIT acquiring three hotels for JPY19 billion from multiple sellers, and Ichigo Hotel REIT acquiring five hotels for JPY15 billion from its sponsor Ichigo Inc.

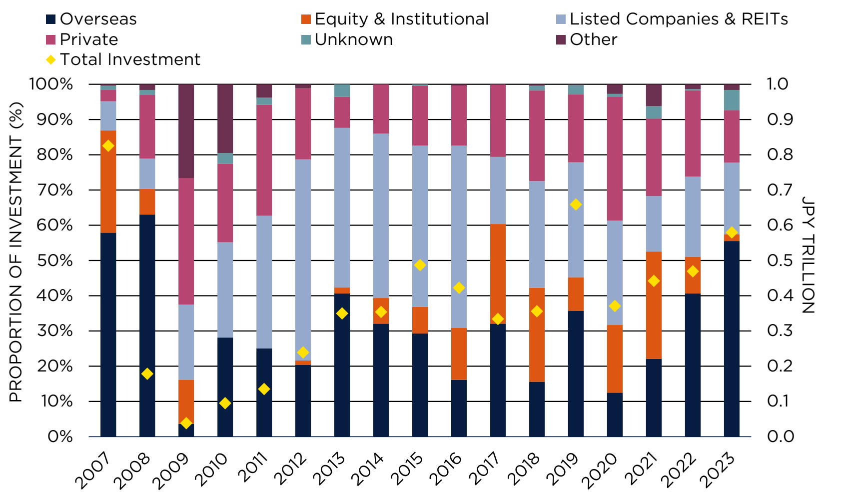
The hotel sector has seen a large amount of interest directed at it, and large transactions are expected to continue going forward. In particular, the luxury hotel sector should gain even greater traction given the relative lack of such hotels in the country. Indeed, the country is rife with potential to attract more high-spending tourists, and ongoing deals and projects surrounding luxury hotels appear to anticipate this.

GRAPH 5: Limited-service Hotel Performance, 2014 to 2023



Source J-REIT disclosures, Savills Research & Consultancy
Note: Occupancy is calculated based on the total number of rooms each month.

GRAPH 6: Hospitality Sector Investment Volumes by Investor Type, 2007 to 2023



Source MSCI, Savills Research & Consultancy

OUTLOOK

Hotel room rates have leapfrogged pre-pandemic levels to even greater new highs, boosted by the weakened yen and the continued growth of inbound tourism. According to the Japan Tourism Agency, inbound tourists stayed an average of 1.3 nights longer in 2023 than in 2019, on top of spending over 50% more on accommodations, showing that spending was clearly on the rise. Although demand is still at very high levels, one potential headwind on the horizon would be the Bank of Japan normalising monetary policy, and consequently strengthening the yen. This could be a twofold blow for the hospitality sector, with inbound tourists losing some purchasing power, and more Japanese

TABLE 1: Selected Investment Transactions Announced in 2H/2023

PROPERTY NAME	APPROX. PRICE (JPY BIL)	PRICE PER ROOM (JPY MIL)	CAP RATE	LOCATION	BUYER
Okinawa Prince Hotel Ocean View Ginowan*	22.0	64.7	4.1%	Okinawa	Kenedix Realty Investment Corporation
Koko Hotel Ginza Itchome	17.8	58.4	3.7%	Tokyo	Star Asia REIT
CapitaLand Ascott Trust Portfolio (3 Properties)	10.7	N/A	Undisclosed	Osaka	Undisclosed
La'gent Stay Sapporo Odori	10.0	46.0	4.3%	Sapporo	Japan Hotel REIT
Bespoke Hotel Osaka Shinsaibashi	8.5	33.0	Undisclosed	Osaka	CDL

Source J-REIT disclosures, MSCI, Savills Research & Consultancy
* This transaction was announced in January 2024

residents enticed to travel internationally instead of domestically. Nonetheless, even under such a scenario, demand should still remain elevated as the average amount spent by inbound tourists was already on a rising trend before the pandemic due to improved infrastructure and services to better accommodate inbound tourists, partly in preparation for the 2020 Olympics.

The labour shortage is another issue, capping the occupancy rates of existing hotels and strangling some development plans, especially in the case of luxury hotels where staff are expected to uphold world-class levels of service in catering to both international and domestic travellers. Wage growth in the sector will be a key determinant in attracting and retaining talent, and some operators could be incentivised to raise wages, and may have greater financial capability to do so given the strong market. Given the relatively low wage levels in Japan, especially in the hospitality sector, wage growth is expected to see more momentum gained. This is also in line with the nation-wise, as well as industry-wide trends, which should eventually strengthen the desirability of the sector as one to work in.

Upcoming hotel supply is expected to be limited, and concentrated in the budget segment. As such, high-end hotels in the pipeline, as well as those already on the market, have a bright outlook. Indeed, Japan has begun to attract larger numbers of high-spending tourists over the years, many of whom prefer to stay in higher-end hotels. As a result, multiple luxury hotels have started to emerge in major cities and resort areas. Due to the recent development and rapid growth of inbound tourism, Japan is beefing up the necessary infrastructure and services to welcome high-end tourists.

Overall, the hotel sector has hit a new peak, and looks to continue performing well on the back of the return of inbound tourism, even taking into consideration potential setbacks such as the labour shortage and a stronger yen. Elsewhere, average domestic spending has also increased to around pre-pandemic levels, which is a good sign for the market overall. The success and performance of hotels in this sector will depend on each operator's strategy for overcoming labour problems.

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