Japan - August 2021

SPOTLIGHT
Savills Research

Japan Hospitality

Hospitality sector awaits the recovery

Summary

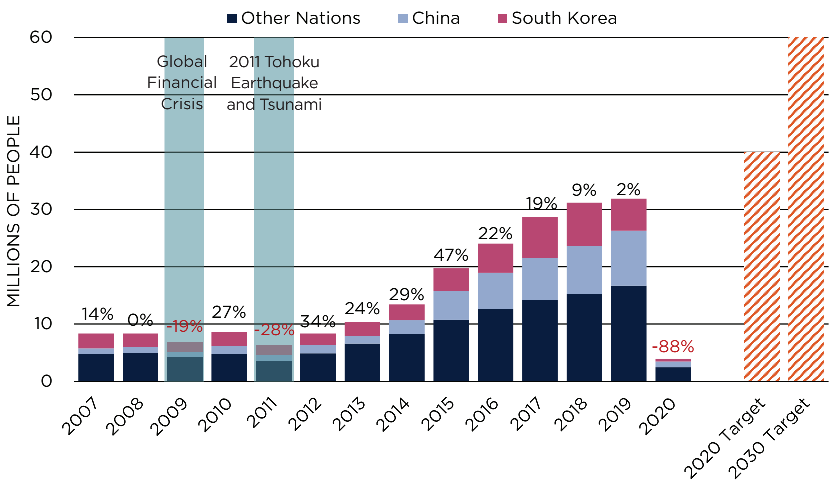
- Rising vaccination rates indicate that global travel demand should start returning, albeit slowly.
- The path to recovery for the inbound tourism industry is expected to be complex with many stakeholders involved.
- While inbound tourism should return, considering the problems that over tourism brought prior to the pandemic, Japan might need to reconsider its old strategy that had a strong focus on quantity, not quality.
- The domestic leisure segment is expected to be the prime contributor to early recovery, driven by pent-up demand, excess household savings, and the potential return of the "Go To" campaign.
- New work styles and the prevalence of online meetings indicate that demand for business travel may not fully recover.
- If lodging demand increases rapidly, some hotels may struggle to rehire laid-off staff, imposing strains on their operations as a result.
- Strategic and opportunistic investors are eyeing opportunities to take advantage of the anticipated recovery.

INTRODUCTION

While the long-awaited 2020 Tokyo Olympics finally began in July, it was certainly not what everyone had hoped it would be. With the country's borders remaining closed, and the games subsequently held without spectators, the hospitality sector, which was already in desperate need of tourists, did not receive the boost that the industry was looking forward to. As a result, there appears to be no immediate let-up of the grim predicament.

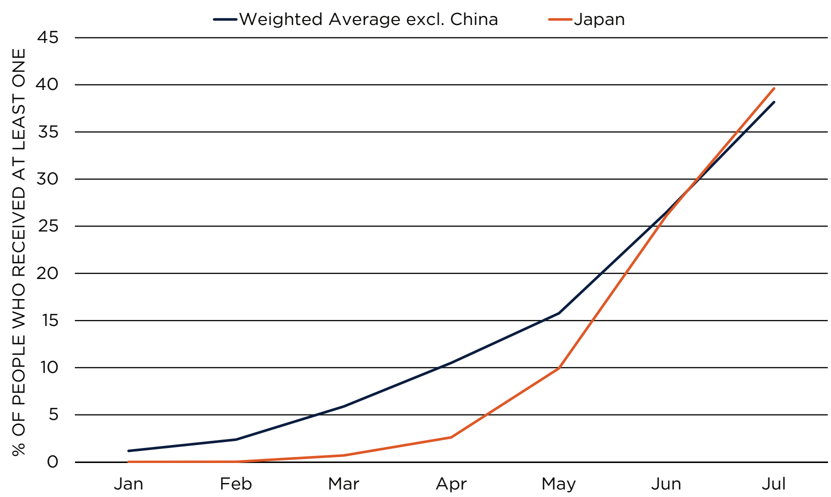
Against this gloomy backdrop, however, the ongoing vaccination rollout is gathering pace worldwide, particularly in Japan. Even though, when it comes to vaccination rates, Asia clearly lags its European and North American counterparts (where rates have already well surpassed 50%), there are reports suggesting that China and South Korea are planning to vaccinate 80% and 70% of their respective populations by Q3/2021. It is also worth noting that these countries have contained the pandemic relatively better. Given that this region has recently accounted for over 70% of all international visitors, vaccination rates in East Asian countries will be an important indicator of recovery for Japan's tourism industry. Furthermore, with Japan's potential introduction of vaccine passports across some regions to allow greater

GRAPH 1: International arrivals and annual growth, 2007 to 2020



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

GRAPH 2: Share of vaccinated population in Japan and other countries weighted by the number of visitors to Japan in 2019, January 2021 to July 2021



Source Our World in Data, Savills Research & Consultancy
*China is excluded form the original data souce due to limited data. However, as of 10 June 2021, China reportedly had a 43% vaccination rate, which is higher than the latest weighted average.

international travel, there is some hope that inbound tourism is inching closer to a recovery.

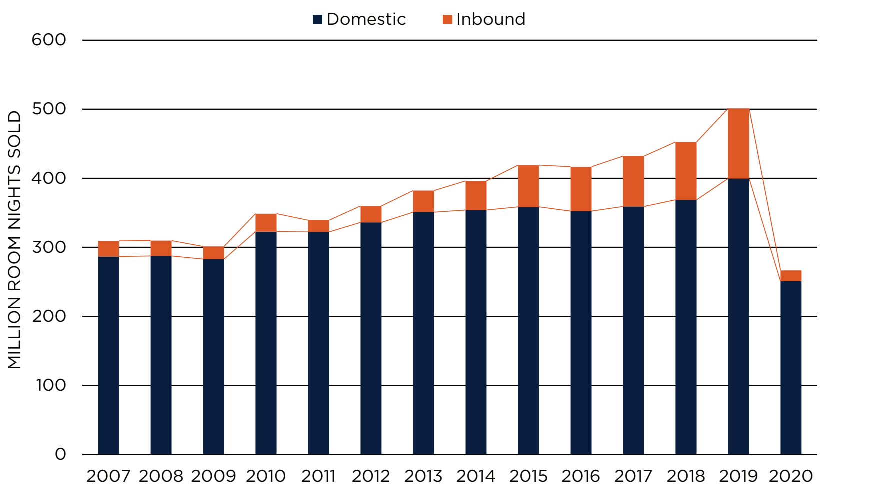
Nonetheless, uncertainties abound. Firstly, there will be bottlenecks in the vaccine rollout due to its limited supply, as already demonstrated in countries like South Korea. Additionally, some vaccines used in other Asian countries appear to be less effective compared to some prevalent in the west, presenting a complicated, and even diplomatic hurdle regarding the proposed vaccine passports. Meanwhile, even with a successful vaccination program, the risk posed by the virus will still need to be handled cautiously.

Here, Japan may still be hesitant to reopen borders on two fronts. Politically, memories of the backlash it received against the Olympics remain fresh while financially, it may have to weigh up the benefits given the limited contribution inbound tourism makes to the country's GDP[1]. At the same time, there are likely to be other obstacles facing eager consumers as the airline industry is likely to raise ticket prices in the short to mid-term, and travellers may need to incur additional costs such as travel insurance covering COVID-19 related medical expenses. Overall, therefore, the recovery looks to be a slow process with many potential roadblocks along the way. Indeed, a survey conducted among UNWTO's travel experts in May 2021 resonates with this view, with most experts expecting international tourism's full recovery only after 2024.

This report will focus on the mid-term prospects of the hospitality sector and attempt to shed some light on demand dynamics in the post-pandemic world. Through our analysis, we aim to identify the opportunities and risks that lie ahead.

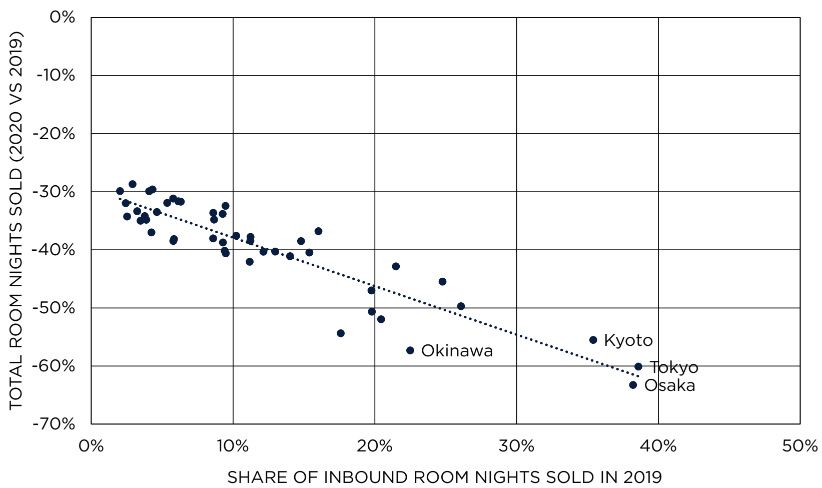
As more people get vaccinated, the return of travel demand is on the cards. Even so, considering the technical complexities in restarting global travel, and the uncertainties it brings, the path to normalcy is expected to be eventful. Nonetheless, this presents a great opportunity for well-prepared market participants.

GRAPH 3: Total room nights sold to domestic and inbound guests, 2007 to 2020



Source JTA, Savills Research & Consultancy

GRAPH 4: Annual change of total room nights sold (2020 vs 2019) and share of inbound demand by prefecture (2019)



Source JTA, Savills Research & Consultancy

BUMPY RECOVERY EXPECTED

While the recovery of the hospitality sector is within sight as more of the population is vaccinated every day, lodging demand is expected to return at varying rates depending on different demand segments. Given the unique aspects of this downturn, especially the freeze on international travel alongside workstyle changes, our analysis of lodging demand will be broken down into the following three segments: inbound, domestic leisure, and domestic business.

Inbound demand was the primary driving force behind the growth of Japan's hospitality sector for over a decade until 2019. When the pandemic hit in 2020, lodging demand from this segment virtually vanished (Graph 3). However, considering how much the country has transformed to become a global tourist destination, lodging demand is expected to return strongly once the pandemic passes.

Graph 4 compares each prefecture's share of inbound tourism using total lodging

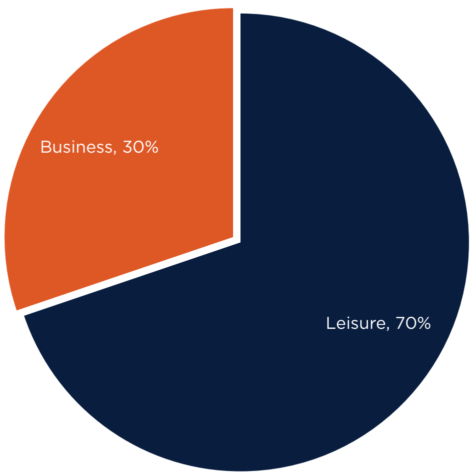
1 According to the Ministry of Economy, Trade and Industry, the economic impact of inbound tourism was only 0.9% of GDP in 2019.

demand with the change in total room nights sold between 2019 (pre-COVID) and 2020 (mid-COVID). As expected, the most popular prefectures experienced the largest drops in lodging demand in 2020, highlighting how the challenges faced by the sector are by no means uniform.

However, this means that the prefectures that experienced the largest falls in inbound demand are likely to see large rebounds once international travel returns. In particular, Tokyo and Osaka should see strong demand from the inbound segment because these cities are gateways to the majority of inbound tourists and are home to the most popular attractions and landmarks. Established tourist destinations such as Kyoto, Okinawa, and Hokkaido should expect a strong comeback as well.

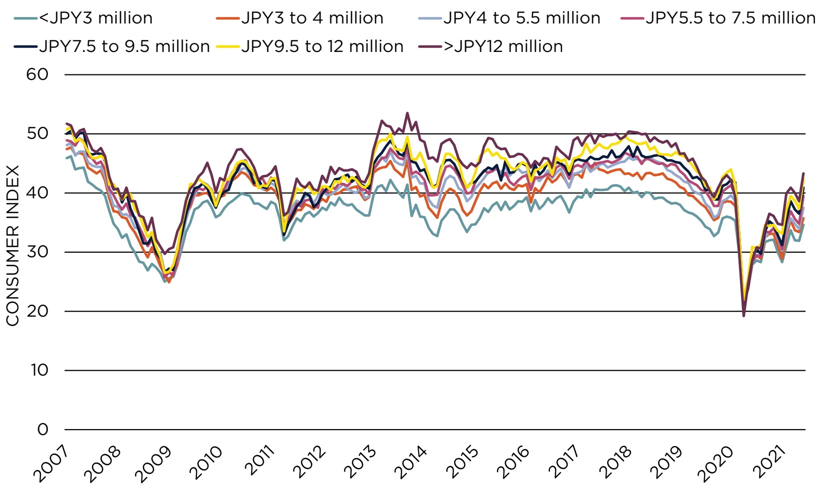
One new trend that could emerge during the recovery is the shift in focus from the quantity to the quality of tourists on the accommodation side. Before the pandemic, Japan saw an influx of tourists on a shoe-string budget, and in response, many limited-service hotels and minpaku lodgings opened to accommodate this surge in demand. However, the explosive growth of tourists has led to some cities facing problems of over tourism, and the limitations of increasing revenue by encouraging greater tourist numbers has become apparent. In a post-pandemic world, heightened cost pressures from additional travel insurance and higher airline ticket prices could discourage mass budget travel. As such, the future growth model may witness a transition from budget travellers to middle-income earners and the wealthy, especially as physical distancing introduced during the pandemic is expected to stay in place to some extent.

GRAPH 5: Lodging demand of domestic guests by segment, 2019



Source JTA, Savills Research & Consultancy
*Travels to visit families/friends were excluded.

GRAPH 6: Consumer confidence by income level, January 2007 to June 2021



Source Cabinet Office, Savills Research & Consultancy

While the COVID-19 pandemic has affected the inbound segment most severely, domestic lodging demand was also hampered by restrictions on domestic travel. Up until the onset of the pandemic, domestic lodging demand was rising by around 2% annually between 2010 and 2019 (Graph 3). However, the pandemic abruptly halted growth, and domestic demand plummeted 37% in 2020. Whether this lost demand comes back, and how quickly, will likely differ depending on the subcategory of demand, namely leisure and business (in 2019, leisure and business made up about 70% and 30%, respectively).

Although there is inconclusive evidence to prove that the pandemic has severely affected one more than the other, considering post-COVID scenarios, the domestic leisure segment should see a stronger recovery than the domestic business segment. This prediction assumes that people will likely resume leisure travel with the pandemic under control and economic conditions improving, whereas the workstyle shifts introduced during the pandemic are likely to have long-lasting or even irreversible effects on business travel.

Specifically, the prevalence of online meetings has lessened the need for in-person interactions, which has subsequently affected business lodging demand, especially from overseas. This change was expected to take place eventually, considering the growing push towards digitisation, increasing propensity to cut costs, and Japanese companies' shift to overseas markets. However, the pandemic has forced companies to immediately adapt to the circumstances, accelerating the move to digitalisation.

Domestic business travel, on the other hand, is unlikely to see a drastic decline. The importance of face-to-face meetings is still highly regarded. Even now, amidst the pandemic, some people travel to meet important clients and visit regional offices, albeit with some restrictions. However, as more communication moves online, less time is needed for travel, which should result in less lodging demand. Additionally, Japan's size and advanced transportation systems make day trips easily feasible.

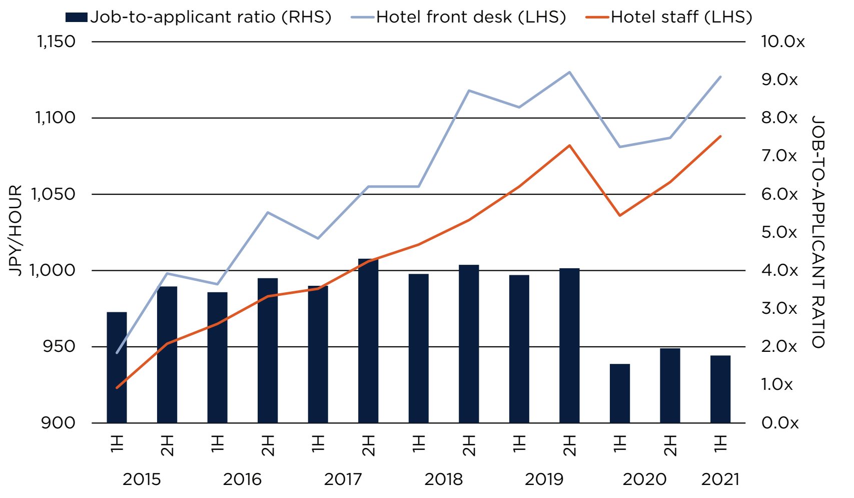
It is encouraging that although the pandemic has yet to pass, consumer confidence has started to return (Graph 6). Additionally, throughout the pandemic, Japan has recorded a relatively low unemployment rate, and households have maintained their spending power. As a result, the combination of these factors has resulted in some pent-up demand for leisure, which should subsequently support lodging demand post-COVID.

Furthermore, Japanese people spent about JPY3.7 trillion on leisure travel overseas in 2019. While borders remain predominantly closed, a part of this unmaterialised demand is likely to be spent on domestic travel, boosting domestic lodging demand during the recovery. It is also worth noting that the Japanese government budgeted an astonishing JPY2.7 trillion for the "Go To" Travel campaign. Although the campaign is currently on hold, half of the budget remains unused. If the government restarts the campaign, the domestic leisure segment will almost exclusively benefit from it.

We believe that overall lodging demand will start to recover at a steady pace as more of the population gets vaccinated towards late-2021. However, the recovery pace will likely differ depending on lodging type, building quality, location, and management ability. Inconveniently located, limited-service hotels that used to rely heavily on customers with tight budgets are likely to experience hard times ahead because their model that relies on high volumes and low rates may no longer work.

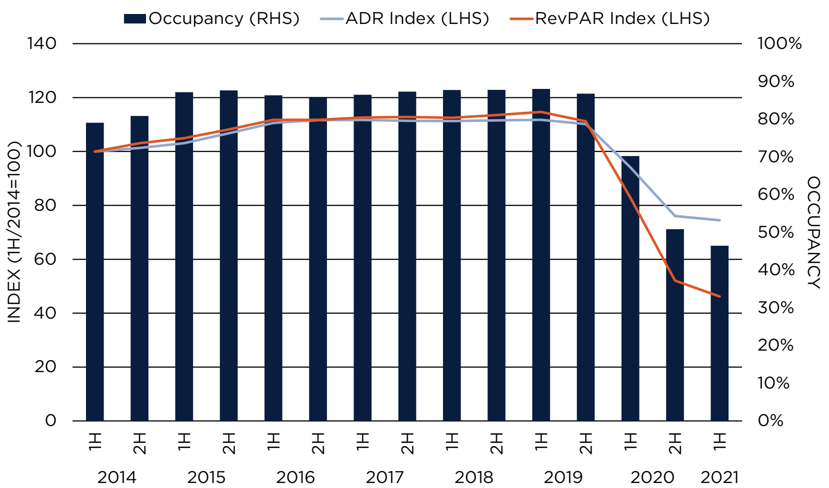
On the other hand, upscale hotels in gateway cities, such as Tokyo and Osaka, or other popular destinations, such as Kyoto and Okinawa, should see a more assured recovery due to strong pent-up demand. Upscale hotels should also have an opportunity to raise rates or upsell rooms by providing additional services. In order to execute these strategies effectively, management quality becomes particularly important.

GRAPH 7 : Hotel staff wages vs. job-to-applicant ratio for the hospitality industry, 1H/2015 to 1H/2021



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

GRAPH 8: Limited-service hotel performance, 2014 to 1H/2021



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

POTENTIAL RISE IN LABOUR COST

Another point which market participants should pay attention to during the recovery is the prospect of hiring or re-hiring staff. According to a labour force survey by the government, employment in the hospitality industry (including food and beverage) fell from 4.1 million in 2019 to 3.6 million in 2020. While it is not surprising that hotels had to lay off employees to survive the pandemic, this practice may negatively affect future performance during the recovery phase as some hotels struggle to secure sufficient staff to meet increases in guest numbers.

Up until the pandemic, wages for hotel staff were steadily increasing against a backdrop of tight labour conditions. While their wages dropped in 1H/2020, they started edging up soon after. Even if previously laid-off staff return to hotel work, the increase in wages may dent hotels' profits. However, it is also possible that some decide not to return to the industry due to the frustrations faced and the fears of infection. The industry was not popular because of its long hours and irregular shifts even before the pandemic. In this case, hotels may have to further increase wages to attract talent and incur additional staff training costs.

The labour shortage is expected to be particularly serious for upscale hotels where customer expectations for quality service are higher. These hotels have to be stringent with hiring talent, and it requires time to train new staff to meet certain service standards. This concern is especially large given that many developments in the pipeline are four-star or upscale hotels. As such, potential investors need to pay particular attention to the management company's size, reputation, and track record, all of which will help it to navigate the volatility expected during the recovery.

HOTEL MARKET PERFORMANCE

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 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[3].

As the pandemic continues to wreak havoc on the economy, hotel performance remains weak. Unlike 2H/2020, there was no demand induced by the "Go To" campaign, which further weakened performance. In 1H/2021, average daily rates (ADR) and revenue per available room (RevPAR) indices have fallen by 19.6 points and 36.6 points YoY, respectively.

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

INVESTMENT

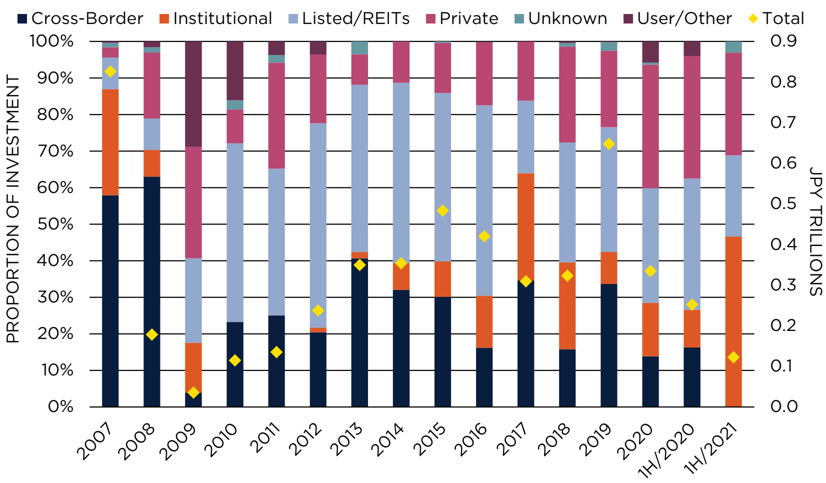
Despite the expected long recovery process and the remaining uncertainties, some investors continue to buy hotel properties in Japan, although transaction volumes have declined by 52% in 1H/2021 compared to the same period last year (Graph 9). In contrast to the pre-pandemic periods when overseas investors flocked to this sector, recently active players have been strategic domestic investors.

As an example, Samty acquired Aloft Osaka Dojima, which was originally owned by Goldman Sachs, from Mitsubishi UFJ Lease & Finance in April 2021. This acquisition is in the context of Samty's plan to launch a hotel REIT, which was positioned as one of its post-pandemic strategic pillars in its renewed mid-term management plan. The company also acquired 32% of Wealth Management, which has a strong focus on the development and management of high-end hotels, for JPY3.9 billion. Similar to Samty, strategic investors such as Hoshino Resort with a long commitment horizon should be able to seize acquisition opportunities.

Going forward, however, opportunistic overseas investors, such as Blackstone, could return once the market starts showing more signs of recovery and the availability of loans improves. Considering the nature of this downturn, the recovery could progress rapidly once the economy starts moving towards normalcy, which presents excellent opportunities for investors who seek large returns.

To further help acquisitions going forward, lending opportunities appear available for those with proven track records or sound financial standing. Lenders appear willing to lend based on operator credit. Although prices are still elevated as many hoteliers are holding up by borrowing short term, the prolonged pandemic will likely force some to exit, which may lead to more acquisition opportunities. For instance, Seibu Holdings is planning to sell some of its hotel and leisure facilities portfolio for around JPY100 billion. In terms of development opportunities going forward, many are likely to be upscale hotels over four stars which can take advantage of the potential growth of wealthy tourists. Challenges include the fact that this segment has a higher entry barrier while the potential labour shortage may also limit rapid increases in supply in the upscale segment.

GRAPH 9: Hospitality sector investment volumes by investor type, 2007 to 1H/2021



Source RCA, Savills Research & Consultancy

OUTLOOK

The situation facing the hospitality sector has not improved much since our last report in February 2021. As new variants of the COVID-19 virus continue to spread, Japan has seen another surge of new cases, not helped by the delayed start of vaccinations. Although the 2020 Tokyo Olympics began in July, it commenced amid a public outcry and a boon for hotels did not materialise as previously hoped. In addition to the complexity of normalising global travel, unexpected changes in travel patterns may also emerge. Given that many hotel employees were laid off, whether sufficient labour can be secured to meet increasing demand is another concern.

However, with progress in the vaccination rollout and the number of those vaccinated increasing in both Japan (where about 40% of the total population had received at least one dose by July 2021) and overseas, the recovery phase appears to be coming closer. Although this is expected to be

TABLE 1: Selected investment transactions announced In 1H/2021

PROPERTY NAME	APPROX. PRICE (JPY BIL)	PRICE PER ROOM (JPY MIL)	CAP RATE	LOCATION	BUYER
Kintetsu Group Hotel Portfolio	60.0	26	Undisclosed	Various locations	Blackstone
Tokyu Plaza Akasaka (50%)	11.8	N/A	4.3%	Minato, Tokyo	Tokyu Land
Grand Hyatt Fukuoka	7.7	21	4.6%	Fukuoka, Fukuoka	Hoshino REIT

Source J-REIT disclosures, RCA, Savills Research & Consultancy complex given the multitude of economic, social, and political factors involved, the pace of recovery could pick up quickly once the necessary arrangements are in place.

Japan's tourism industry was experiencing an unprecedented level of growth prior to the pandemic with strong support from the government. With so much invested in hard and soft infrastructure for tourism, the country was poised for further transformation. Inbound tourism should come back strongly boosted by substantial pent-up demand. As suggested by a large budget earmarked for the "Go To" campaign, the government also appears highly committed to facilitating the industry's return.

We believe that circumstances present an excellent opportunity for investors despite the elevated risks involved in investing in this sector. While prices for quality assets are still elevated, there could be more opportunities going forward if the pandemic persists, forcing more owners to sell. Investors with a sound financial standing and proven track record should be able to act fast since lenders are more willing to lend to such entities or hotels with high credit operators.

In order to mitigate risk, investors should pay heed to factors such as lodging types, building quality, location, and management aptitude. In particular, with a turbulent recovery expected, selecting an experienced management company is more important than ever. While the number of management contracts has not increased as much as previously expected, lease contracts with variable rents have become more common. Investors who can manage these more volatile terms should see more opportunities for the time being, although fixed-rent leases should become popular again once the market stabilises.

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