Japan - August 2023

SPOTLIGHT

Savills Research

Japan Hospitality

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Significant recovery observed, but with multiple challenges ahead

Summary

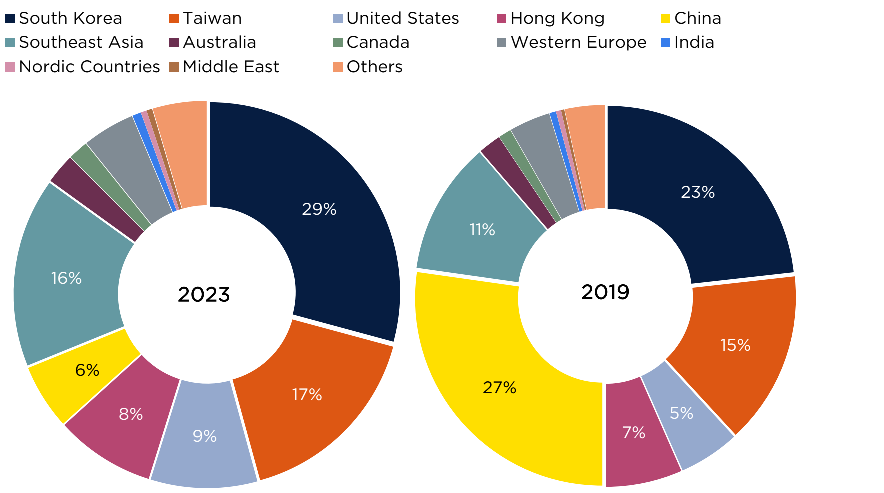
- The number of inbound tourists has recovered to around 65% of 2019 levels, and should continue improving as border control measures were removed, although further recovery will depend on the return of tourists from mainland China.
- The ADR index has improved significantly, and has surpassed 2019 levels in many cases, particularly high-end ones.
- Total spending by domestic tourists has recovered to 2019 levels, although the number of tourists, especially day trip ones, has declined. Per-person spending of overnight tourists has increased by around 10%.
- Average per-person spending of inbound tourists has increased by more than 50% for many nationalities - a result of robust pent-up demand and a greater proportion of wealthy tourists.
- The overall ryokan market is vast, but also fragmented and without dominant players, which has led to growing interest in the luxury ryokan segment.
- Investment volumes in 1H/2023 surpassed that of 1H/2022, and there were a number of large transactions that took place this year, with more deals expected going forward.
- The hospitality sector has been robust, but MICE events and banqueting have yet to return in full, and the sector also faces challenges, primarily labour shortages and rising operating costs.

INTRODUCTION

Japan has progressed to a post-pandemic society, and the hotel sector has continued to improve in the first half of 2023. Inbound tourism has also continued to see recovery, with the number of international arrivals in 1H/2023 reaching almost 65% of the same period in 2019. Furthermore, COVID-19 border control measures were removed in May 2023, which should help inbound tourism to recover even further going forward.

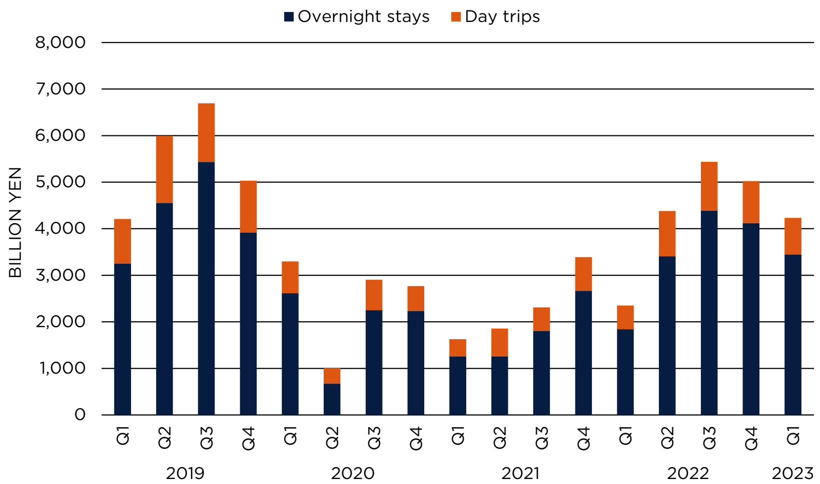
At the same time, the composition of inbound tourists so far in 2023 bears noticeable differences to that of 2019. Firstly, mainland Chinese tourism has seen a drastic decline, with 1H/2023 arrivals only around 13% of 1H/2019, owing mainly to China's belated border reopening and the imposition of travel restrictions. Furthermore, the country's economic slowdown as well as diplomatic tensions, on top of the limited number of flights available, suggest that it will take some time for recovery to be observed. On the other hand, the number of inbound arrivals from many countries in the West and in Southeast Asia has approached close to pre-pandemic levels, or has even surpassed them in the case of countries like the United

GRAPH 1: Proportion of Tourists by Country/region, 1H/2023 vs 1H/2019



Source Japan National Tourism Organisation, Savills Research & Consultancy

GRAPH 2: Total Domestic Tourist Spending, Q1/2019 to Q1/2023



Source Japan Tourism Agency, Savills Research & Consultancy

States and Vietnam. Secondly, the average inbound tourist in the post pandemic era is significantly wealthier than the average pre-pandemic tourist, which will be analysed more closely in the next section.

The hotel sector has seen considerable recovery over the past half-year, with Average Daily Rates (ADRs) having recovered for most hotel J-REITs, and many high-end hotels seeing record-high rates, supported by the influx of wealthy tourists. However, occupancy rates remain relatively subdued due to labour shortages that continue to weigh on the industry. Furthermore, while room rates have soared, hotels still face shortfalls from other revenue streams such as meetings, incentives, conferences, and exhibitions (MICE) events and banqueting. As such, full-service hotels look like they will take a greater amount of time to see a full recovery. Overall, while there are many improvements underway, there are still hurdles facing the industry in the coming months, although performance will be highly dependent on the hotel grade and market in question.

Hotel room rates have recovered significantly, even leapfrogging pre-pandemic levels in the case of luxury hotels due to the release of pent-up demand from wealthy travellers. Nevertheless, MICE events and banqueting have yet to recover in full, and the hospitality sector still has hurdles to overcome, such as labour shortages and rising operating costs. Overall performance will likely remain strong but also dependent on the hotel grade and market.

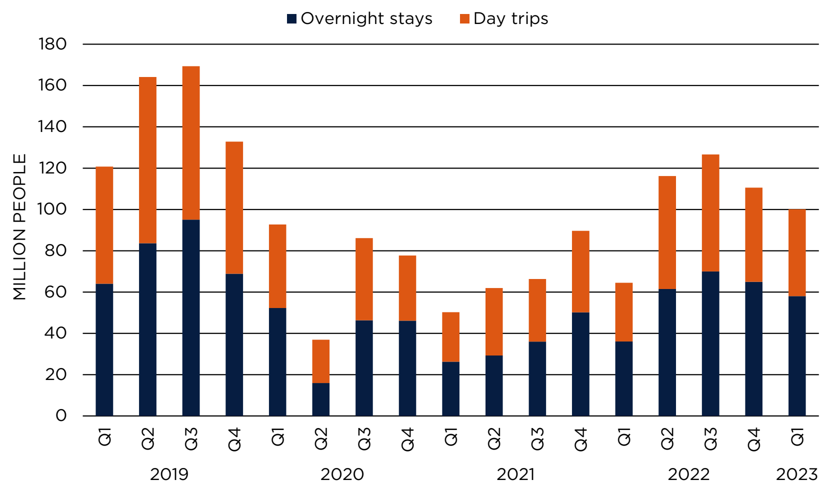
ANALYSIS OF TOURISM SPENDING TRENDS

The hospitality sector has recovered in earnest over the past few months. Aside from average room rates, another metric is the total amount of tourism spending. According to data from Japan Tourism Agency (Graph 2), total domestic tourist spending in Q4/2022 and Q1/2023 have recovered to the same levels observed in the respective quarters of 2019, with a greater amount spent on overnight stays rather than day trips. While higher hotel prices have likely contributed to some of these spending increments, the total amounts spent on discretionary spending such as shopping, F&B, and entertainment have reached or surpassed pre-pandemic levels, which is an encouraging sign for the overall hospitality sector.

At the same time, the number of domestic tourists has not seen the same level of recovery. In fact, the number of domestic tourists in both Q4/2022 and Q1/2023 were about 17% lower than their respective quarters in 2019, although it should be noted that the number of day trip tourists shrank noticeably more than the number of overnight tourists. As such, the recovery of total tourism spending was due to significant increments in per-person spending. Looking at Graph 4, it can be seen that overnight tourists have been spending around 10% more in both Q4/2022 and Q1/2023 than in their respective quarters in 2019. The primary factor that has likely contributed to this is the continued boom in luxury tourism propelled by wealthy Japanese residents that had a heightened propensity to travel and spend domestically due to travel restrictions and the weak yen. Furthermore, high energy and material prices have caused the average Japanese household to reduce discretionary spending, hence slowing down budget tourism, which can be observed in the overall decline in the number of trips. Going forward, with travel restrictions greatly loosened worldwide, a larger number of wealthy Japanese are likely to gradually set their sights on resuming overseas travel, which should consequently dampen some domestic spending, especially for higher-end hotels. On the other hand, wage growth has seen considerable progress in 2023, especially for younger employees, and budget tourism should also look to gradually fare better if this momentum continues as expected.

Meanwhile, there have also been notable changes in the average inbound tourist profile since Japan reopened its borders to visa-free tourism in October 2022. Firstly,

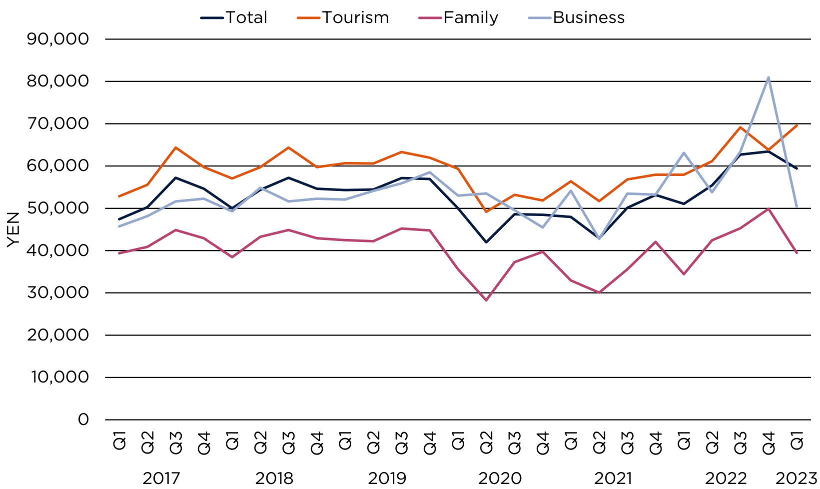
GRAPH 3: Total Count of Domestic Travellers, Q1/2019 to Q1/2023



Source Japan Tourism Agency, Savills Research & Consultancy

although the total number of inbound tourists in 1H/2023 was only around 65% of the same period in 2019, the total amount of inbound tourism spending recovered to more than 90% of 1H/2019, showing that the average amount spent per person is significantly larger in the current post-pandemic era. Looking at Table 1, it can be observed that a majority of nationalities have seen per-person spending increase by more than 50%, with China recording a massive 140% increase due to strict travel restrictions that effectively only made it possible for the wealthy to travel overseas. Many luxury hotels in Japan saw room rates soar significantly higher than peak levels in 2019, further fuelling the narrative of a notably greater proportion of wealthy inbound tourists in a post-pandemic era. Going forward, global inflation and the economic slowdown may likely continue to weigh on budget inbound tourism, and the average amount spent per person should remain elevated. Japan remains a top tourist destination for many people, and is a relatively affordable place to travel overall for a highly developed nation, especially with the weak yen. It will likely continue attracting high spending inbound tourists for the meantime, but the average spending per person should taper off as more budget inbound tourists return, perhaps in late 2023.

GRAPH 4: Average Spending Per Domestic Tourist by Purpose of Travel (Overnight Stays), Q1/2017 to Q1/2023



Source Japan Tourism Agency, Savills Research & Consultancy

RYOKAN

Ryokan is a type of accommodation considered to be unique to Japan, with many designed, constructed, and equipped in a typically traditional Japanese style. Japan's relative lack of five-star hotels thus far is partly attributed to the significant role that upscale ryokan has played in the luxury market. The overall ryokan market is vast, but also fragmented and without dominant players. Instead, most establishments are independently owned and operated, and many are dealing with financial or succession pressures, which should present many opportunities for new entries into the market.

The ryokan industry has long been struggling due to the economic slowdown since the end of the Japanese bubble period, and the subsequent collapse of the "banquet boom" model of domestic tourism. As such, the number of establishments has fallen from nearly 72,000 in 1995 to under 39,000 in 2017, with the 2008 global financial crisis and the 2011 East Japan earthquake expediting this decline. Conversely, hotels have grown in popularity over the same period, and have largely displaced ryokan especially in urban areas. For a more in-depth overview, please refer to our "Ryokan Market June 2023" report.

Following a period of stagnation, the luxury ryokan market seems to have regained its lustre among wealthy domestic guests, and looks to attract greater attention from inbound visitors. The overall ryokan market is vast, but also fragmented, with numerous small and independent operators, many of whom are experiencing financial or succession issues. There are numerous prime locations for ryokan in major hot

TABLE 1: Average Amount Spent Per Inbound Tourist by Region, 1H/2019 vs 1H/2023

NATIONALITY	AVERAGE AMOUNT SPENT (YEN)		
	1H/2019	1H/2023	INCREASE
China	195,825	476,460	143.3%
Australia	201,042	313,878	56.1%
Europe	175,937	261,807	48.8%
North America	160,246	252,351	57.5%
Hong Kong	139,433	214,200	53.6%
India	139,206	201,946	45.1%
Southeast Asia	121,680	172,207	41.5%
Taiwan	99,694	167,092	67.6%
South Korea	62,878	99,777	58.7%
Other	174,774	278,038	59.1%

Source Japan Tourism Agency, Savills Research & Consultancy

spring towns, resorts, and urban areas across Japan. Overall, there also appears to be an abundance of value-add opportunities in the market that have potential for robust growth for well-researched players with deep pockets and operating acumen. The ryokan segment appears to be undergoing a transformation from a product of the past into one of the future.

The inbound tourism boom over the past decade has brought more spotlight on traditional ryokan, with many international tourists looking to gain a more authentic experience while traveling in Japan. Meanwhile, the pandemic significantly limited access to international travel, and upscale ryokan were able to capture a significant proportion of luxury demand from wealthy Japanese travellers in recent years. A renewed interest in ryokan has encouraged players in the hospitality sector to look to the segment for strong returns, and many are aiming to make entries in the near future.

On top of established and growing domestic players, major international players have also been drawn to the ryokan segment. Hyatt Group, which has a long, established presence in the luxury hotel sector in Japan, recently announced its collaboration with hotel and ryokan operator, Kiraku to develop its upscale ryokan brand ATONA. The venture is Hyatt's response to the shockwaves caused by the pandemic, and the company aims to cater to the growing demand for authentic Japanese experiences through modern onsen ryokan.

Sentiment is high, particularly in the luxury ryokan segment, and as inbound tourism continues to pick up, we predict further entries by large operators and a continued expansion of the market. Given the vast array of opportunities and the notable lack of competitors, it appears that many established players are making moves to capitalise on the plentiful opportunities in the market. Successful operators will have the capacity to offer more attractive wages to staff and carry out efficient group management of multiple properties in the same area, which can help them respond to fluctuations in demand and seasonal workforce needs. In addition, they will be able to implement "measurement" and "visualisation" systems to capture, record, and analyse operating figures, like the emerging ESG initiatives, which should serve as an invaluable asset in aiding operations. Overall, the ryokan segment appears to be transforming into a promising product of the future.

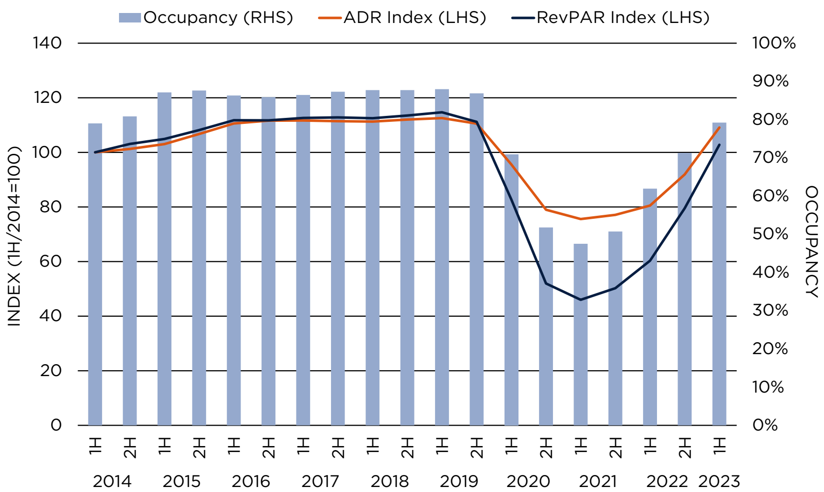
HOTEL MARKET PERFORMANCE

Savills tracks the performance of approximately 100 hotels owned by four 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].

1 The four J-REITs consist of Japan Hotel REIT, Invincible Investment, Hoshino Resorts REIT, 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.

GRAPH 5: Limited-service Hotel Performance, 2014 to 1H/2023



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

Japan has moved to a post-pandemic state, and restrictions on both domestic and inbound travel have been lifted, which has allowed the number of hotel guests to recover close to 2019 levels. As such, J-REIT hotels have continued on their path of recovery in 2023. Looking at Graph 5, the ADR index has recovered 17.2 percentage points (ppts) half-year-on-half-year (HoH), and is almost on par with the 1H/2019 levels. RevPAR has recovered in a similar vein, increasing 23.3ppts HoH, and is also almost on par with 1H/2019 levels. In fact, the ADRs of many properties have surpassed those of pre-pandemic times in some recent months, especially during the peak cherry blossom season.

At the same time, while occupancy levels have also recovered in their own right, they have also remained around 10ppts below pre-pandemic times. Indeed, the chronic labour shortages that plague the industry remain a key bottleneck in increasing operational capacity; long and irregular working hours, below-average wages, and the instability experienced during the pandemic have made the hospitality industry a comparatively unpopular one to work in. Presently, the industry faces serious labour shortages, and this is even before Chinese tourists have made a comeback. Furthermore, the pent-up demand for post-pandemic revenge travel has allowed many hotels to focus on increasing ADRs. Occupancy levels will likely remain lukewarm for the time being, while many hotel operators are scrambling to hire and train more staff. Additionally, the government has reportedly begun taking steps to tackle this problem, such as providing subsidies for hotel renovations and upgrades, in hopes that this would translate into higher hotel revenues, and consequently, higher wages for staff.

Overall, limited-service hotels are in the best shape they have been since the pandemic, and optimism is high in the market. Meanwhile, hotels on the higher end are performing even better in general. The Savills Japan hotel index primarily covers hotels in the budget-to-middle segment, meaning that the sentiment of the overall market should be higher than our index. That said, there are challenges for the industry, and many hotel J-REITs have seen dips in share prices over the past few months, with labour shortages weighing down further improvements in hotel performance. Full-service hotels are also experiencing other challenges - while leisure tourism has seen a strong rebound, the MICE segment is still lagging behind, which is a lingering effect of paradigm shifts that materialised during the pandemic. In addition, banqueting was the most profitable segment in pre-pandemic times, but recovery has been slow. As such, this revenue stream of full-service hotels will likely require more time before it sees improvement, and hence drag down overall recovery.

INVESTMENT

The surge in demand from inbound tourists has resulted in noticeable price hikes for hotels in the first half of 2023, with many hotels seeing ADRs rise well above pre-pandemic levels, especially in the cases of luxury hotels and resorts. Hotel transaction volumes in 1H/2023 have already surpassed those of 1H/2022 by more than 50%, and these figures are preliminary and likely to increase.

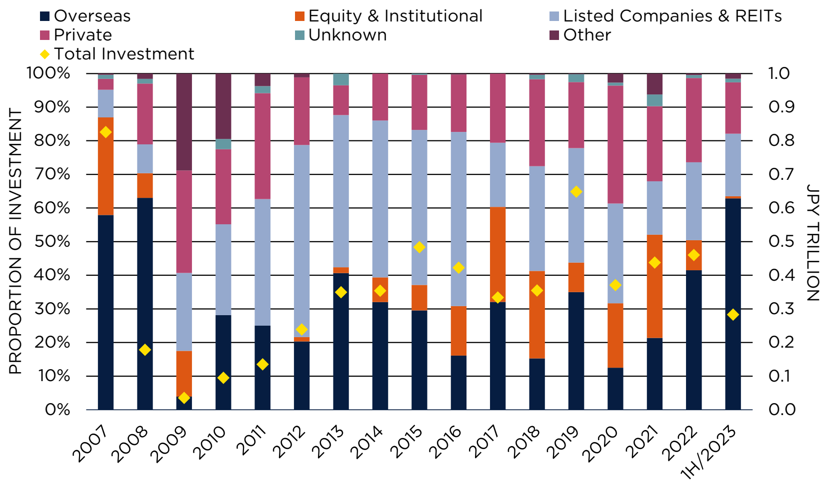
Transaction volumes of 2022 have also slightly exceeded those of 2021 by around 6%. International investors appear especially keen, with overseas capital comprising around 60% of transactions as of Q1/2023.

A number of major transactions by international investors were announced over the past half-year. For instance, a joint venture formed by SC Capital, the Abu Dhabi Investment Authority, and Goldman Sachs Asset Management acquired a portfolio of 27 resort hotels in Japan from Daiwa House that have a total of over 7,000 rooms for US$900 million. An SPC invested in by KKR announced in March 2023 that it would be acquiring the Odakyu Century Building in Shinjuku, which houses the Hyatt Regency Tokyo, for 57 billion yen from Odakyu Electric Railway, with the seller reportedly citing profit recoverability and rebuilding its business portfolio as reasons for the sale. BentallGreenOak also acquired the newly opened 167-room Ritz Carlton Fukuoka in June 2023, although the transaction price was undisclosed.

Meanwhile, many domestic players have also been acquiring hotel assets in Japan. For instance, in July 2023, Invincible REIT announced the acquisition of six hotels and resorts in Japan for 57.2 billion yen. Furthermore, in May 2023, Hoshino Resorts REIT announced the acquisition of two assets in Tokyo and Matsuyama for 7.5 billion yen. Elsewhere, other major players including APA Group have also made acquisitions in the market, with some large-scale renovation plans in the works. Indeed, domestic investors also appear to be more confident in the sector, also bolstered by large banks, becoming increasingly open to financing hotel-related transactions.

Overall, the hotel sector is in the best shape it has been since the pandemic began. More transactions are likely to continue taking place going forward as many buyers see further growth potential. Furthermore, the uncertain outlook on interest rates means that more investors may look to assets in the hospitality sector, whose yields are affected less by interest rate changes. At the same time, investors will need to be conscious about the challenges that the sector faces, including the shortage of labour and the global economic slowdown that

GRAPH 6: Hospitality Sector Investment Volumes by Investor Type, 2007 to 1H/2023



Source RCA, Savills Research & Consultancy

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

PROPERTY NAME	APPROX. PRICE (JPY BIL)	PRICE PER ROOM (JPY MIL)	CAP RATE	LOCATION	BUYER
Daiwa House Resort Hotel Portfolio	125.7	-	Undisclosed	Various	SC Capital, Abu Dhabi Investment Authority, Goldman Sachs AM
Odakyu Century Building (Hyatt Regency Tokyo)	57.0	76.4	Undisclosed	Shinjuku, Tokyo	SPC invested in by KKR
Fusaki Beach Resort Hotel & Villas	40.2	101.0	5.1%	Ishigaki, Okinawa	Invincible REIT
Ritz Carlton Fukuoka	Undisclosed	Undisclosed	Undisclosed	Chuo, Fukuoka	BentallGreenOak

Source J-REIT disclosures, RCA, Savills Research & Consultancy might delay overall tourism growth. Nonetheless, the market is improving, and the luxury hotel segment in particular is expected to see greater attention given the relative lack of luxury hotels in Japan, on top of the current tourist makeup.

OUTLOOK

Hotel room rates have seen a dramatic recovery over the past half-year, especially with the droves of wealthy inbound tourists that have flocked to Japan, and many high-end hotels seeing record high ADRs. While this burst of pent-up demand may have petered out, room rates should remain elevated for the time being when considering the robust tourism demand and limited supply of hotels in upcoming years, and especially when Chinese tourists begin to return in earnest. This will likely be especially apparent for some markets and hotel grades, where only a few new entrants are expected. On the other hand, other markets might see large supply which may have an impact on the local market.

Nonetheless, there are still many challenges facing the hospitality industry going forward. The labour shortage has effectively capped the utilisation rates of many hotels at around 80%, and operating costs have also increased significantly. Furthermore, full-service hotels also have not seen as dramatic a recovery in MICE events and banqueting. As such, the industry will need to tackle these issues on both the demand and supply side.

Within the hospitality industry, ryokan is an asset class that has seen greater attention from investors. The industry is vast but fragmented with few major players, and many owners face business continuity issues, meaning that there are potentially multiple opportunities for acquisitions available. Luxury ryokan have generally performed extremely well during the pandemic, and have tremendous potential for further growth. Ryokan is an asset class of the future for savvy investors that are able to integrate innovative technological analyses together with successful operations.

The hotel sector has undoubtedly seen significant recovery. ADRs look to remain elevated, and occupancy is likely to keep climbing as hotels continue hiring and training a larger workforce, leading to further RevPAR improvement. However, the sector may face an uphill climb going forward in further growth, as domestic demand from wealthy Japanese will likely taper off as many look to overseas travel, and as labour shortages may linger longer than expected, and mass inbound tourism might take some time to return due to global inflation and the economic slowdown. That said, budget tourism will likely make a gradual comeback, especially if wage growth continues. Overall, hotel supply is rather limited, while some markets may see large supply that could slow ADR growth. Ultimately, the performance of each hotel will depend on the hotel grade and market.

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