Japan - February 2021

SPOTLIGHT
Savills Research

Japan Hospitality - Emerging Trends

savills

Distressed markets and credit markets emerging

Summary

- The testing market environment could result in distressed opportunities that will make great entry points into the market.
- Many investors are on the lookout for such distressed assets, and therefore opportunities could prove scarce.
- The trend of shifting toward management contracts appears inevitable and will accelerate as hotel owners run out of options.
- Banks may become tougher when dealing with existing loans to hotels, possibly leading to more distressed assets.
- In the long run, Japan's hotel market remains promising, and its famously high standards of public health will be an attractive factor as a new era of tourism is ushered in.
- Multiple upcoming positives for the hospitality industry include the roll-out of vaccines, a large "Go To" travel stimulus, significantly lower supply and pent-up demand for travel.

INTRODUCTION

The second half of 2020 brought only a little more hope to the hospitality sector than the first, and international borders have remained effectively closed to tourists. Prospects are certainly not expected to change significantly as long as the number of COVID-19 cases worldwide does not see a steep decrease.

Therefore, the prevailing circumstances could lead to the emergence of distressed opportunities, which will make great entry points into the market. Many international hotel operators and investors have maintained an interest in the promising Japanese hotel market and will likely see the downturn as an opportunity to buy up distressed assets.

The shift towards management contracts may also create opportunities for investors willing to take more operational risk. Although most owners currently prefer a fixed-rent lease, few operators presently have the financial capacity to undertake fixed-rent lease contracts. Investors who wish to take more operational risk may find struggling owners who are comfortable only with fixed leases but cannot find suitable operators.

That said, risk is mounting in the credit market. According to the Small and Medium Enterprise Agency, a majority of the pandemic loans to small and medium-sized companies have already matured or will mature between spring and summer 2021. If the current challenging operating environment persists, banks may reconsider forbearance. Even if refinancing is possible, favourable financing terms may not be applicable any more given the more uncertain market prospects. Although the distressed market has been quiet thus far, the emergence of a more active distressed market may be in the offing.

A DISTRESSED MARKET

Having been particularly negatively impacted by the pandemic, the hospitality industry will likely see increased bankruptcy rates, leading to a more active distressed market. Many international hotel operators and investors have maintained interest in the rapidly growing local hotel market and will likely see the downturn as an opportunity to snatch up properties that would not have been up for sale in a healthy market.

Presently, even several famous Japanese hotels have been closed or disposed of. However, their established brands and networks, as well as advantageous physical attributes will not disappear and will remain valuable to international investors with the financial wherewithal to survive the COVID-19 storm. Furthermore, multiple domestic players are active. One example is Prince Hotel, a hotel subsidiary of Seibu Holdings[1], that plans to expand its new brand, Prince Smart Inn, to 100 properties by 2030. Hence, given the ongoing activity in the market and this sector's continuing popularity, it would probably be better not to wait too long in anticipation of deeply discounted opportunities.

Other good targets could come from regions beyond major cities. Some owners in these regional areas are only thinly capitalised but possess lodgings with good value-add potential. While budget hotels generate forecastable profits and therefore become easy acquisition targets, the performance of Japanese traditional inns depends heavily on the operator at hand. As such, skilful operators could find underperforming properties and significantly improve their operating indicators. Moreover, regional markets have been more resilient to the negative impacts of COVID-19, thus making the wait-and-see strategy more effective than in urban markets.

Elsewhere, some hotels developed by condominium developers are likely to experience more difficult times as they tend to have a small number of rooms and are generally located in less favourable locations. As such, the prices of these hotels could be significantly adjusted to an economically viable level for potential buyers who wish to convert them into other uses such as serviced apartments, satellite offices for teleworking, or possibly subscription use. For this category of hotels, investors may want to wait long enough to see necessary adjustments materialise before acting.

Lastly, two and three-star hotels may resort to consolidation for survival. Many investors would like to acquire operating platforms in Japan, and because sizable franchises and chains provide more value, players who are able to bring consolidation to the table should enjoy portfolio premiums.

A SHIFT TOWARD OPERATING CONTRACTS

There is an increasing number of hotels without operators, typically those newly built by real estate companies. Although there were prospective operators during the planning stages of these hotels a few years ago, many of them have exited due to the pandemic. Currently, most owners prefer a fixed-rent lease, and occasionally accept a fixed-rent plus revenue sharing payment structure. However, few operators presently have the financial capacity to undertake fixed-rent lease contracts.

As a result, some hotel owners in desperate need of operators have started accepting management contracts. While hotel owners with other thriving businesses are still able to maintain a wait-and-see attitude regarding their empty hotels, the trend of

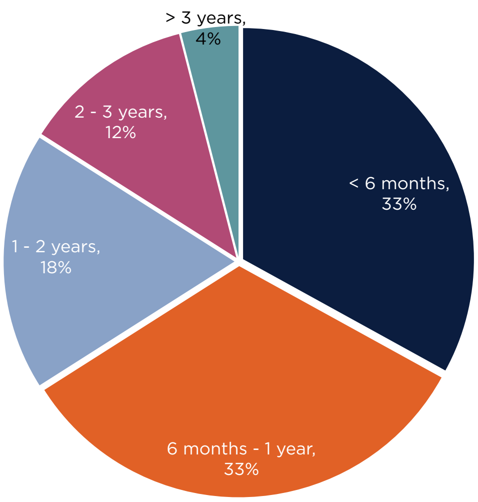
1 Seibu Holdings requested Mizuho Bank and the Development Bank of Japan to provide financial support for its main subsidiaries, Seibu Railway and Prince Hotel. The two banks provided 80 billion yen in preferred equity in total. Seibu Holdings announced a 63 billion yen net loss in the fiscal term ending March 2021.

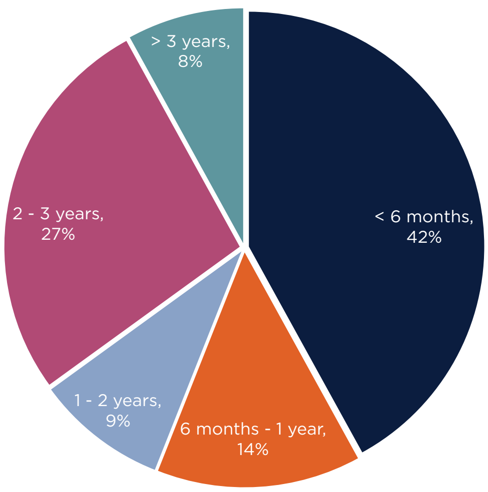
shifting toward management contracts seems inevitable and should accelerate if the pandemic persists and hotel owners run out of options. Some costs, such as FF&E will more likely be incurred by hotel owners rather than operators going forward, adding greater financial stress on the former.

This shift in the operating structure could create opportunities for experienced hotel investors who are willing to take more operational risk and feel comfortable with management contracts. These investors may also be able to find risk-averse owners and take their properties off their hands with some discount. Smaller owners with only a few hotels may be more willing to exit rather than opting for management contracts because they cannot mitigate increased operational risk by diversification.

The current difficult circumstances serve as a strong catalyst for the emergence of new trends and distressed opportunities. There are numerous keen investors on the lookout for such distressed assets, and therefore opportunities are unlikely to be as abundant as one might hope.

GRAPH 1: Forbearance Period by Public and Private Banks at the end of December, 2020





Source The Small and Medium Enterprise Agency, Savills Research & Consultancy

AN UNCERTAIN CREDIT MARKET

Thus far, banks have been generous and have shown some flexibility pertaining to existing loans due to the following reasons. Firstly, the allowance for doubtful accounts has still been within expectations. Secondly, given the rising US interest rates, the prospects of the yield curve look more favourable for banks. Thirdly, the government, the central bank, and financial supervisory agencies are all supportive in preventing the hospitality industry from collapsing.

However, lenders will be increasingly careful when extending loans given the more uncertain market prospects. Even if refinancing is possible, similar financing terms may not be applicable, and therefore require noticeably higher interest rates. Also, banks are likely to pay closer attention to operating cash-flows, rather than to the credit of operators/tenants. Although tenants who have managed to keep paying rents despite the pandemic are likely to receive better credit scores, banks will only become increasingly stringent. Budget hotels without key selling points will be in a more difficult position as new supply up to the pandemic was predominantly in this segment.

For investors, securing bank loans for investments will not come easily as lenders are taking a cautious approach and are being very selective regarding hotel deals. Hence, investors may need to ready a larger amount of cash or be prepared to accept higher interest rates than before. Next to the fierce competition for hotel acquisitions, this will be the second hurdle even for investors fortunate to have identified a potential candidate.

OUTLOOK

While the future of the industry remains in the dark, there are positives worth highlighting. The first is the progress made in rolling out a COVID-19 vaccine. Japan has started vaccinations and will likely expedite the entire process if the prospects of early adopters look promising. The second is the boost in domestic demand aided by the expansion of the "Go To" Travel campaign budget, which should help keep afloat operators savvy enough to adapt and seize opportunities. The third is the substantially lower supply in the pipeline along with hotel closures caused by increasing bankruptcies, which should prove favourable for hoteliers who manage to weather the storm. The last is the pent-up demand for travel in concurrence with the high levels of extra savings from self-quarantine. When the situation improves, this demand should help the industry's recovery, especially in the resort segment.

In the long run, Japan remains a promising hotel market, and its famously high standards of public health will be an attractive factor as a new era of tourism is ushered in. Furthermore, the global pandemic could be seen as an opportunity to reset the tourism industry and strike a balance between burgeoning inbound tourism, local sensitivities, and sustainability. These factors will bear increasing importance going forward, as some Japanese cities have already suffered from the side-effects of growing tourism that world-famous tourist destinations in Europe have. COVID-19 could serve as an impetus for the Japan market to develop into the next phase: a more sustainable and diversified tourism destination.

That said, with so much uncertainty remaining, it is possible that severe conditions will continue for the hotel industry. For instance, while the pandemic may abate to a degree, epidemics may break out in certain regions due to new variants of the virus. Under this scenario, the recovery of mass markets will be slower and may consequently lead to wider consolidation and more distressed opportunities. Well prepared investors can certainly take advantage of this downturn and try to expand their portfolios. Nevertheless, competition for such distressed assets is fierce, and therefore opportunities appear likely to be less abundant than hoped.

For more information about this report, please contact us

Savills Japan
Christian Mancini
CEO, Asia Pacific
(Ex. 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