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Real Estate Insight

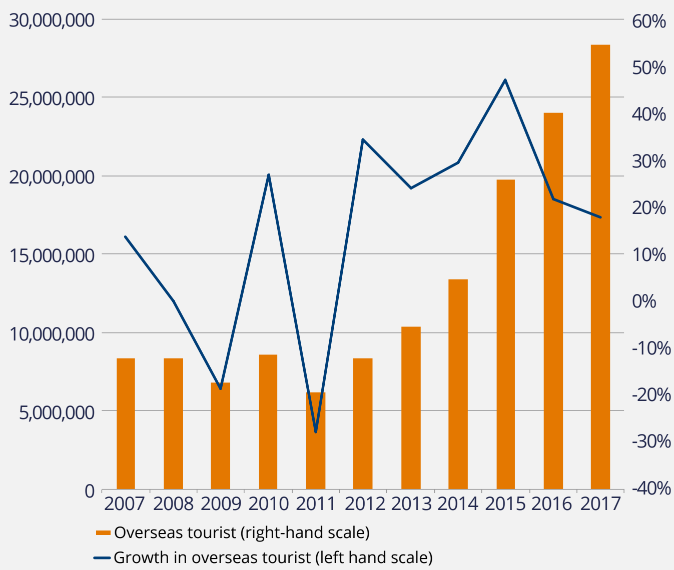


# Japan's hotel market: significant room for improvement

**Executive summary**


- Japan is experiencing a strong rise in inbound tourism. Given the country's proximity to large emerging markets, such as China, we see the potential for further strong growth in the coming decade.
- Demand from tourism is expected to increase for Japan's major cities and established areas of natural beauty, leading to higher demand for hotel beds.
- The supply of hotel beds is rising, and challenges exist from businesses like Airbnb, but these do not erode the incredibly strong fundamentals of the market.
- Reflecting very strong investor demand, yields on hotel properties are generally low and they appear expensive for income-producing assets.
- In our view, the main investment opportunities are in upgrading ageing hotels in areas of high demand and tapping into the structural growth trend of rapidly rising intra-Asian tourism.


**Chart 1: Japan's inbound tourism**




Source: Japan National Tourist Organization, March 2018

For real estate investors, Japan offers a wide range of investment opportunities because of its high population density and the concentration of income and wealth in major cities. Since early 2018, however, property yields on core assets have fallen below the previous trough of 2006/2007, making the market appear very expensive. Against a background of strong investment demand for Japanese commercial real estate, investors are more open to considering new market segments. We believe that the hotel sector should be explored given the tremendous structural rise of intra-Asian travel, particularly the growth of inbound tourism into Japan.

## Growing traveller demand in Japan's major tourism markets

Japan has witnessed a boom in overseas visitors since 2011 (Chart 1). Historically, Japan has not focused on tourism as an engine of economic growth but it is now playing catch-up with its Asian neighbours. In 2016, China had 60 million visitors, Thailand had 33 million, and Malaysia had 27 million. Japan reached 28 million last year, which is low given its economic size, quality of infrastructure, and the attractions of its unique and distinct culture (e.g. food).

The Japanese government has warmed up to tourism: it is now targeting 40 million visitors by 2020 and 60 million by 2030, using policy measures such as less stringent visa requirements. This implies a growth rate of 13% between 2017 and 2020, which is quite achievable in view of the following.

1. The structural growth in visitors from Asia's fast-growing emerging economies – and from China, in particular. Chinese tourists now make up 25% of all visitors to Japan. The increase in Chinese tourists will be a big driver of future growth, reflecting the emergence of a large middle-income class in the country (for more information please see the research paper 'Accommodating Asia's travel boom, July 2016'). That said, inflows from the rest of Asia have also been on a strong upward trajectory in recent years and they are just as important in explaining the tourism boom.

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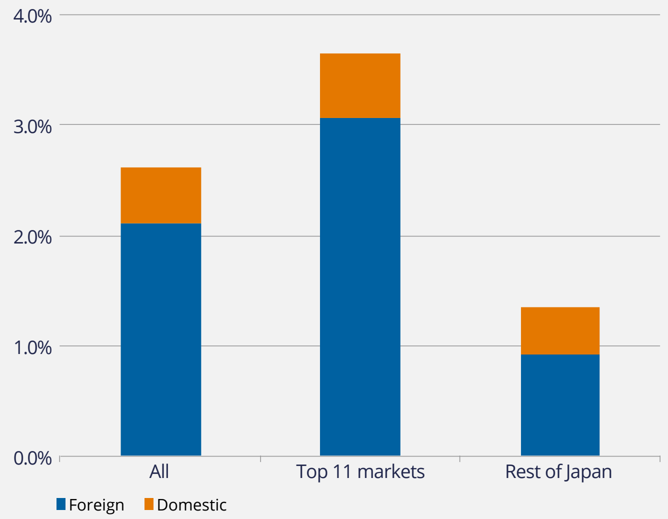
2. The establishment of integrated resorts (i.e. casinos) to mirror similar resorts in Macau and Sentosa in Singapore, should add substantially to tourism growth in the next decade – Tokyo, Osaka and Yokohama (a city south of Tokyo) are initial candidates for the first of these resorts. The government plans to have ten resorts across the country; they are likely to be focused on major locations with good existing transport infrastructure and amenities.

## Accommodation demand has stabilised after a strong run

Given that domestic tourism accounts for more than 80% of all hotel stays, it has the biggest influence on the overall demand for rooms. Domestic tourism was flat in 2017 and this mirrors the trend of the past five years (up just 3% over that period). An obvious negative is the drag from a declining Japanese population. Not so obvious is the positive demand for domestic tourism generated by the rise of wealthy retired people using their spare time to travel. However, this aspect has been held back over the past few years by a large spike in hotel room rates because of the boom in inbound tourism.

By location, hotel stays (domestic and foreign) are highly focused on major cities, such as Tokyo, Osaka, Fukuoka and Nagoya, but also traditional leisure destinations such as Kyoto, Okinawa, Hokkaido, Shizuoka (home to Mount Fuji) and Chiba (the location of Disneyland). The top 11 markets in Japan account for 55% of the market and they experienced strong growth in hotel demand of 3.6% a year from 2012 to 2017 (Chart 2). Foreign demand has been the most important driver of overall growth. Outside these markets, demand has been tepid with the exception of areas of natural beauty (e.g. hot springs), which have increased resort-style stays in specific countryside and coastal locations.

**Chart 2: Accommodation stays by type of visitor and location (% growth p.a. 2012-2017)**

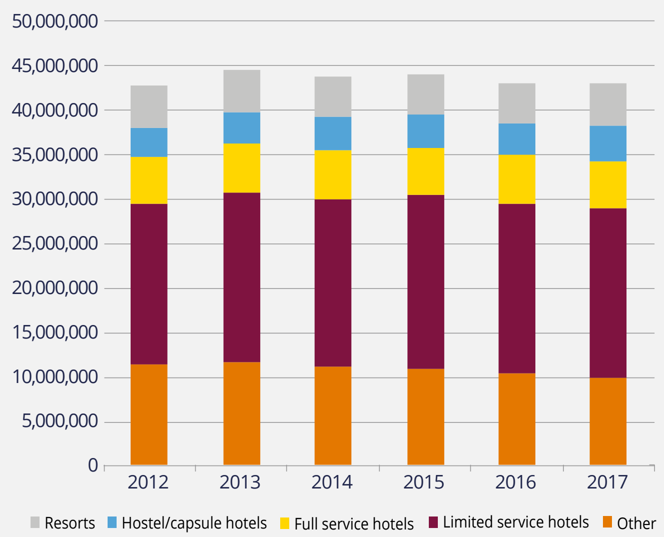



Source: Japan Tourism Agency. Top 11 markets with bend demand of 15 million or more per annum, are: Tokyo, Osaka, Fukuoka, Nagoya, Kyoto, Okinawa, Hokkaido, Chiba, Yokohama, Nagano and Shizuoka. March 2018

## Strong demand conditions limit the threat of new hotel supply

According to a survey carried out by CBRE, the stock of hotel rooms in major cities is expected to rise by 30% between 2016 and 2020. Although this sounds high, it implies an annual growth rate of around 7% per annum. Given the ongoing boom in inbound tourism, and likely renewed growth in domestic travel, we do not envisage an oversupply of the hotel market. Over the past five years, the number of hotel rooms has increased by just 1.3% per annum nationwide. The rise has been focused on budget hotels, such as limited service and capsule hotels, but offset by a sharp drop in other accommodation types (e.g. traditional Japanese inns). As such, hotel accommodation in Japan has shown little growth in recent years (Chart 3), even as demand has jumped.

**Chart 3: Number of accommodation beds**




Source: Japan Tourism Agency, November 2017

## China and Airbnb

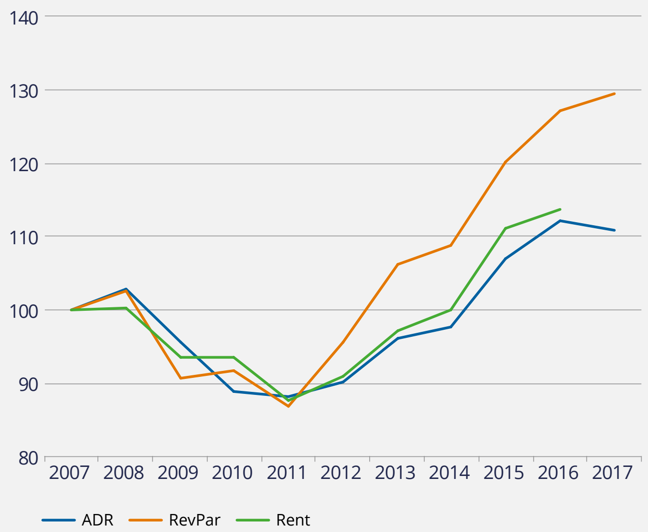
Tourism from China is a strong driver behind the overseas travel to Japan. As such, it is important that this enthusiasm for holidays in Japan remains strong. Surveys of middle/high income Chinese households indicate that Japan is their top overseas destination and this has been the case for many years. This reflects the relatively short distance between the two countries, which leads to low journey costs and travel times. Although this is positive for demand, a survey undertaken by UBS in late 2016 showed that 3% of Chinese respondents had used minpaku accommodation in Japan (minpaku being the generic Japanese term for private, Airbnb-type accommodation). The proportion of tourists planning to use this kind of accommodation is expected to increase.

There is a perception that the growth of minpaku could reduce the demand for hotel beds; in reality, this avenue has met demand that hotels have not been able to. In Tokyo and Osaka, Airbnb (and its equivalents) have a market share of around 15% (based on available rooms), although for Japan as a whole, we estimate a market share of less than 5% (across domestic and overseas tourists). However, most minpaku are illegal, as they do not fulfil the conditions of the Inns and Hotels Act (i.e. they are unregistered). Late last year, the government adopted a 180-day operating ceiling for minpaku facilities. The impact of the regulation will depend on the willingness of the local authorities to enforce the new ruling. In addition, since a shortage of accommodation exists, they may be willing to turn a blind eye in the short term.

## Income returns from hotels

Good information is not available on hotel rents. Figures from Japan's Association for Real Estate Securitization (ARES) indicate nominal rental growth of nearly 1% per annum over the past nine years, compared with -1.3% per annum for office properties. Hotel landlords have a variety of charging mechanisms, which include a combination of fixed and variable rents for management contacts. The lower the fixed rent component, the greater the owner's exposure to operating risk.

Chart 4: Hotel income and rental performance




Source: Japan Hotel REIT, The Association for Real Estate Securitisation, Jan 2018

The market has seen significant growth in room rates (ADRs), and revenue per available room (RevPar), which are up 4% and 6% a year, respectively, over the past five years to mid-2017. However, over the past decade, which captures the impact of the global financial crisis and the devastating Japanese earthquake of 2011, ADRs and RevPar were up 1% and 2.5% a year, respectively. The rise in ADRs over the past decade match the rise in hotel rents, indicating no deterioration in affordability for operators. We believe medium-term growth in ADRs of 2-3% per annum is achievable. Over the long term (beyond ten years), nominal growth is likely to be near 1% per annum as hotel room supply adjusts to stronger demand.

**Conclusion**

Japan is experiencing a strong rise in inbound tourism. Given Japan's proximity to large emerging markets, such as China (and also Vietnam, the Philippines and Indonesia), we see the potential for further strong growth in the coming decade. Japan's ageing/retired wealthy population also present a positive picture for domestic tourism, but they tend to travel to major cities and established areas of natural beauty. Not all locations in Japan will benefit from the tourism boom.

The supply of hotel rooms is rising and challenges exist from Airbnb, but they do not erode the strong fundamentals of the hotel property market. Most of the growth in room supply has been at the budget end, which is in direct competition with Airbnb. We see space for various types of operators in the market given the significant growth in inbound tourism. However, investors should avoid the budget end of the market, which is in danger of saturation over the next few years.

Investor interest in the market has been extremely strong in recent years and hotel yields are trading at historic lows. We believe the asset class is expensive at a time of significant new supply and potential medium-term increases in Japanese interest rates. The public markets have picked up on supply and competition concerns, with hotel-focused Japanese Real Estate Investment Trusts (JREITs) performing poorly relative to the broader listed real estate market.

We see the main investment opportunities in value-add assets. Investors should focus on well-located, older assets that can be rebranded and/or reconfigured to increase the number of rooms and revenue. Older properties are typically owned by corporate entities where hotels are not their main business line. Institutional buyers can look for opportunities to provide capital for upgrades and repositioning, while capturing the growth in foreign and domestic accommodation demand in major leisure destinations.

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