



*Overview of the Japanese Lodging
Industry and Its Investment Trends
– Past, Present, and Future*

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Despite widespread waves of Westernization that have infiltrated modern Japanese culture in the post-World War II era, the Japanese lodging industry has generally managed to keep its shroud of “foreignness” intact. While neighboring Asian countries have boasted a host of American and European lodging developments in the past twenty years, Japan has predominantly stuck with the Japanese lodging model of ryokans (traditional inns), Japanese-branded hotels, and its own invention of capsule hotels. However, recent changes in the second half of the present decade have indicated a changing tide of sentiment, as investors reassess their traditionally held views of Japanese real estate, seeing the potential of tapping into the third-largest economy in the world. The barriers to entry into this decidedly Eastern and Western hybrid market are beginning to erode, and Western hoteliers and investors alike are poised to benefit from this opportunity.

External Factors

The Influences of Culture

It is essential to understand the impact of Japan’s unique culture upon its economy and travel trends. Prior to Commander Perry’s trip in 1853, demanding that Japan open itself to the Western world, the country led a traditionally isolationist life, typical of several island nations of the same time period. Under Emperor Showa’s rule in the first half of the 20th century, Japanese citizens were schooled in their unique heritage, and nationalist sentiments reached their apex during World War II. Japanese school children are still taught about Japan’s unique cultural heritage dating back thousands of years, which is a far cry from most Western cultural traditions that are present today. This has led to an inherent belief of the Japanese race’s unique needs, which pervade key aspects of daily life such as food and lodging.



Western businessmen in Japan have often commented upon the interesting hybrid of East-meets-West culture that is found in Japan: Japanese businessmen wear Western-looking suits, drink beer, and sing popular Western songs at karaoke like typical Western businessmen (perhaps save for the karaoke tendencies); however, business “bonding” often takes place while sitting cross-legged and shoeless on a *tatami* (woven bamboo) mat floor as beer is poured for *sempais* (seniors in the office seniority poll), and a Western meal is ended with a bowl of rice. And heaven forbid the blatant clashing of cultures when that Western businessman is asked to join his Japanese colleagues in the nice, relaxing comfort of the *onsen*, a hot spring bath where no clothing is permitted (although, in an effort to be more aware of Western traditions, some Japanese businessmen have been taught to offer a small washcloth for modesty). The jokes abound as to interesting and regaling tales of the miscommunication between cultures that have resulted from this meeting of two worlds; however, one fundamental difference that must be noted is the adherence to Japanese custom and tradition. Japanese people believe strongly in their ancestry, which they trace back thousands of years. Furthermore, there are very few places that are as homogeneous as the island nation of Japan. The shared history, culture, and ancestry for these thousands of years of the common populace have bred a strong sense of pride and uniqueness among the Japanese in the midst of our modern Melting Pot world.

This storied history and pride plays out in the Japanese lodging market in two forms: Japanese comforts are sought after and demanded, and Japanese brands or independent Japanese hotels are associated with understanding the needs of this unique culture. In general, Japanese baths are preferred to Western bathtubs and showers. Japanese bathtubs (*furou*) have greater depth, to allow for lengthy soaking, and a shower area that is not connected to the bathtub is also preferred, as Japanese people only enter the bath after having cleansed themselves. For those seeking true Japanese lodging, as are found in ryokans, Japanese require bedding mats on *tatami* floors, and bean pillows. A growing number of Japanese people now have Western-style beds, and several Japanese hotels also have them. But a “Japanese” hotel also often offers other Japanese comforts, such as a low table for sitting on the floor, slippers so as not to walk in the room with outside shoes, a bidet in addition to a toilet that is either Western or Asian (i.e., a squat toilet), and a Japanese breakfast of rice, miso soup, and fish. While it certainly makes sense that an American hotel brand would understand all these cultural desires and offer a product that caters to these special needs, one can also understand, at the same time, why Japanese people have historically been hesitant to believe



that a “foreigner” could get all of it right. Hence, the favoritism for Japanese brands and hotels has traditionally remained intact for the past thirty years.

The Influences of Economy

After experiencing an incredible boom in the 1980s and early 1990s, Japan’s economy slowed notably in the mid-1990s after its economic bubble burst, slumping into a recession that de-valued the yen and stymied travel. Consequently, real estate investment was virtually nonexistent, especially from foreign-based companies and investors. While cultural unfamiliarity had kept most foreign hotel real estate investors and operators at bay in the 1970s and 1980s, along with skyrocketing real estate prices, this undesirable investment and operating climate successfully warded off the majority of new ventures in the 1990s.

Japan’s economy has recovered promisingly in the past few years, starting in 2003. This economic strength has encouraged outside investors who are looking to diversify their portfolios to delve further into Japan, and hotel real estate investors have all followed suit. However, it must also be noted that Japan still possesses the world’s largest public debt at over 180% of its GDP, which is a bright red flag of caution for several potential investors. Although economic stability does appear to be established, the nation’s debt is a factor that cannot be ignored.

Introduction to the Japanese Hotel Market

Historical Overview

Japan still suffers from a lack of standardization in its lodging industry. There are no standard operating procedures or Uniform System of Accounts by which to govern and regulate the industry. There is also no centralized data-gathering company, such as Smith Travel Research, which provides benchmark figures for daily hotel operations and profitability in the United States. Similar to the American Hotel & Lodging Association (AH&LA), the Japan Hotel Association is a member-based organization that indicates certain standards of quality and service among its members; however, much like AH&LA, it is not a regulatory body, and not all hotels are members. These factors make it difficult to compare hotel performance and attribute certain profits or losses to market characteristics or individual hoteliers’ practices.

The origins of Japan’s modern hotels came into being from different factors, compared to those that shaped the lodging industry in the United States. The modern hotel in the United States arose from both traditional European-origin inns, established in major cities or at common stopping points along major trade routes, and also from the extensive interstate highway system



that began in the late 1920s and boomed in the 1950s, with Eisenhower's Federal-Aid Highway Act of 1956. The proliferation of automobile travel in the United States necessitated a whole new breed of lodging accommodations. In Japan, the railroad played a similar role in the development of local hotels. Japan's various railroad companies began establishing hotels at major stopping points on its rail system. For example, Seibu Railway owns the Prince hotel chain, Tokyu Railway owns the Tokyu chain, and Kintetsu Railway owns the Miyako chain. The airline industry also emerged as a major player in the Japanese hotel ownership industry, for similar reasons. All Nippon Airways (ANA) and Japan Airlines (JAL) are notable owners of hotels in major airport markets.

Hotels today have also taken on a unique community function in several Japanese markets. Hotels are often chosen as common venues for weddings, meetings, and reunions – to a greater degree than is found in the United States. Consequently, the banquet and food and beverage departments are significant components of Japanese hotels' profitability, and should be taken into consideration by potential investors. Because the Japanese are constricted by space, parties and gatherings are usually held at public establishments, as opposed to at their own homes. Hotels have emerged as a logical choice for such needs in a country where restaurants are not built to seat 200, and temples and shrines are not places of common congregation, like Western churches.

The traditional view of hotel real estate valuation in Japan is another interesting point of differentiation between American and Japanese hotel real estate investment. The income approach to value, which is the preferred valuation method for hotels in the United States, does not take precedence in Japan. Japan has a notorious lack of development space in its major cities. Since most major hotels are similarly located in such crowded markets, they are also susceptible to the prevailing mindset that all buildings will appreciate with time. Japanese investors have historically believed that improvements, such as a building structure, can only contribute to the overall value of land. While American valuation techniques do adopt the viewpoint that land cannot depreciate over time because it has inherent value, Japanese real estate thought has dictated that the same is true for its improvements. As such, hotel real estate is often valued on a graded appreciation basis that is based on the cost approach, ignoring the profitability generated from operational cash flows. This discrepancy has proven difficult for foreign investors looking to understand the appropriate level of return that can be expected on a hotel investment.



Categories of Lodging Facilities

The Japan National Tourist Organization classifies Japanese lodging facilities into five main categories: hotels, ryokans, youth hostels, guest houses, and minshuku. Based on this classification, and combining information from various outside sources, seven categories are further described for the purpose of this article: first-class hotels, business hotels, ryokans, minshuku, pensions, capsule hotels, and love hotels. The first category, *first-class hotels*, consists of full-service hotels that would be ranked at a three-star level or higher in the United States. These hotels have an international focus, with staff that speak English and restaurants that provide a variety of both Western and local cuisine. First-class hotels are often found in major metropolitan areas near major international airports. The next lodging category consists of *business hotels*, which are characterized by lower rates, smaller room counts, and fewer food and beverage facilities than are found in first-class hotels. Business hotel staff usually do not speak English, and the hotels are often located near railway stations. Given these characteristics, business hotels cater mainly to domestic business travelers. *Ryokans*, the third lodging category, are traditional Japanese inns. Ryokans have very small room counts, often consisting of a dozen rooms or less, and comprise the largest number of lodging facilities in Japan, with an estimated 58,000 establishments, according to the Japan National Tourist Organization. These lodging facilities offer traditional Japanese furnishings, such as a tatami floor, a low table, shoji (sliding screen) doors, and zabutons (cushions) for sitting on the floor. Bedding consists of floor futons, and baths are often shared. Japanese toilets are also the norm. Not surprisingly, the majority of ryokans do not employ English-speaking staff. The fourth category of lodging accommodations, called *minshuku*, are economical alternatives to hotels and ryokans, and consist of rented rooms in private homes. Guests usually sleep on futons. Minshuku are often found in resort areas. *Pensions* are another type of lodging facility, and are generally seen as a higher-priced alternative to minshuku, with more amenities than are found in minshuku. Pensions are often located in ski resort areas.

Although not listed by the Japan National Tourist Organization as a separate category, *capsule hotels* have emerged as a new lodging category in the past few decades. Capsule hotels are commonly found in business hubs, near railway stations or airports, and offer small sleeping cells that can be rented by the hour. Capsule hotels have also catered to weary guests who are looking for a few hours of sleep as they wait for morning train service to resume. There are no frills or extra amenities for capsule hotels, but they have



developed a strong following, attributable to their fulfillment of a previously ignored niche of guests seeking accommodations.

Finally, *love hotels* are another recent development that has proven to be quite successful, not only from a marketing niche standpoint, but also from an investment point of view. A November 2007 Reuters article estimated that there are 25,000 love hotels in Japan. Love hotels cater to by-the-hour clients, as well as couples looking for a hideaway from their crowded apartments and homes, where entire families commonly live together (parents, grandparents, children, etc.). Love hotels range from seedy to adventurous, offering various themes (Hello Kitty, Arabian Knights) and amenities (in-room waterslides). In a nod toward the sector's promising growth, Japan Leisure Hotels, which owns five love hotels, marketed itself in its IPO on the London Stock Exchange in November 2007, with hopes of expanding its assets by 14 times to 300 million pounds (\$623.9 million) in five years. Love hotels are estimated to generate nearly three trillion yen in annual sales (\$29.2 million). Investment groups have traditionally avoided investing in love hotels, given their not-so-shiny reputation and their frequent association with organized crime. However, recent investment groups have noted that the changing investment climate has provided more financing opportunities than were available previously, which has allowed such investment groups to diversify into the profitable love hotel realm.

Western Presence in Japan

Emergence of Western Brands

Given the various facts and characteristics outlined above, Western hotel brands have not historically made much headway into the Japanese lodging market. Japan possesses one of the largest number of lodging establishments in the world, attributable to its numerous small-scale facilities, such as ryokans and minshuku; of these, only a fraction are designated as Western branded hotels. Based on data published in the 1999 Japan Hotel Almanac and Arthur Andersen calculations, Western brands represented just 0.66% of all Japanese hotels in 1999. The tide has been changing since the turn of the millennium, however. A cursory glance at Western hotels operating in Japan reveals the following breakdown estimates:



Brand Presence in Japan as of May 2008

Brand	Number of Hotels
Best Western	6
Choice	43
Hilton	8
InterContinental ANA	42
Marriott*	7
Radisson	1
Ritz-Carlton	2
Starwood	14
Wyndham	0

**Excludes the Ritz-Carlton brand*

Since 2007, both Best Western International and Choice Hotels International have made notable strides in hotel development in Japan. In late 2007, Best Western had only three hotels in Japan; by May 2008, this number had jumped to six, with five more hotels planned to open by August 2008. Best Western announced in March 2008 that it expects to have 30 hotels in Japan by 2010, with hopes of becoming the largest hotel chain in the country. Best Western representatives cited strong visitor arrivals to Japan and a 70% overall average occupancy at its existing hotels as the impetus for the planned developments. As of May 2008, Choice Hotels offered 43 hotels in the country under its Comfort, Sleep, and Quality brands; twelve of these hotels opened in the period from January 2007 through May 2008. These vast expansions represent changing sentiments among Western hotel brands toward the Japanese market, and among investors who are no doubt eyeing the potential from Japan's baby boomer generation and strong foreign visitation numbers.

W Hotels announced its foray into the Japanese lodging market in November 2007. The W Yokohama is slated to open in 2010 with 245 guestrooms, over 10,000 square feet of meeting space, two restaurants, a lounge, and a spa. There is currently only one W Hotel in Asia, located in Seoul, South Korea. The W Seoul opened in early 2003. Five other W hotels in Asia have been announced for opening dates prior to that of the W Yokohama, which is reflective of the challenges that have plagued Western real estate developers in Japan's elusive hotel real estate market. However, the announcement of the W Yokohama is also a sign that tides of change are working in Japan's lodging industry, as more foreign brands and investors become confident of the market's profitability and accessibility. Starwood's luxury brand, the St.



Regis, is also slated to enter the Japanese lodging market in 2010, with the development of the St. Regis Osaka, mirroring similar investor sentiments.

Partnerships with Western brands have also emerged in recent years. In October 2006, airline company ANA announced a capital partnership with InterContinental Hotels Group (IHG) to create IHG ANA Hotels Group Japan LLC. In addition to IHG's existing portfolio of hotels in Japan, the new partnership company began operating the 31 hotels that ANA owned in Japan (although it sold 13 of these assets in December 2006), taking advantage of IHG's global distribution and reservation systems. These hotels became subdivided into three brands, with each company's moniker: ANA-InterContinental, ANA-Crowne Plaza, and ANA-Holiday Inn.

Emergence of Western Investments

In combination with Japan's recovering economy, the number of hotel investment transactions began to rise significantly in 2003. KPMG noted that such trends were attributable to several factors: asset portfolio restructuring following the anticipation of the widespread adoption of impaired-asset accounting, which began in April 2005; stagnant revenue earnings during Japan's economic slump; and the increase in the number of companies looking to improve operations by liquidating excessive debt. Real estate prices were at a notable low after the economic bubble burst; in 2003, as the economy started to recover, investors began to snatch up hotel assets at discounted prices because of this trend. Moreover, the number and variety of hotel assets in Japan have increased in the new millennium, providing a greater range of opportunities for investors looking for these economic benefits.

A 2007 report published by the Japan External Trade Organization (JETRO) indicated that ryokans and guest houses continue to decline in profitability, while hotels have grown in both scale and number. The growing importance placed on hotels has led to increased merger and acquisition activity of regional hotel assets since 2000. This increased activity has led to more established and uniform hotel financing practices in recent years, which has in turn attracted foreign investors who were historically wary of investing in the Japanese lodging market. Information provided by Thomson Financial indicated that 25 hotel/lodging facility merger and acquisition transactions occurred between 1990 and 2000, valued at \$341 million; from 2000 to 2006, 173 such transactions occurred, at an estimated price of \$2.79 billion. Several Western investment companies, the most notable being Goldman Sachs and Morgan Stanley, have invested in both Western-branded and Japanese-



branded hotel chains with increased vigor since 2000, as the Japanese economy began to show signs of promising recovery. Morgan Stanley has also branched out into the hotel management industry, forming Panorama Hospitality K.K. in 2005 to manage its Japanese hotel investments, due to the noticeable lack of hotel management companies in Japan. Furthermore, Dallas-based investment fund Lone Star purchased a portfolio of Japanese hotels in 2002 from bankrupt real estate developer Chisun Co. and created Solare Hotels and Resorts Co., Ltd., which boasts 55 hotels and resorts throughout Japan. Lone Star tried to sell Solare in November 2007, but the fund withdrew its sale offer in March 2008, citing low bidding prices from potential buyers like Blackstone and Goldman Sachs.

Another recent addition that has facilitated foreign investment was the establishment in February 2006 of Japan's first real estate investment trust (REIT) dedicated solely to hotel investment. Japan Hotel & Resorts (JHR), this first hotel REIT, is sponsored by the Goldman Sachs group. A second hotel REIT emerged in June 2006 – Nippon Hotel Fund Investment Corporation (NHF). These two players have helped pave the way for future investment by foreign entities seeking the shelters provided by REITs.

A Look to Japan's Hotel Future

National Trends

The Japanese hotel industry's future is on the brink of major expansion, owing to a variety of factors. One is the mass retirement of the nation's baby boomers, which began in 2007. The Japanese are well known for their love of travel, and the resultant boom in domestic travel from the estimated 6.7 million baby boomers should ensure healthy hotel profits in upcoming years. Secondly, Japan's Asian neighbors have emerged as major economic powerhouses in the new millennium. China and South Korea have increased overall wealth indices, thereby boosting the number of travelers available for overseas travel. JETRO's 2007 publication on Japan's hotel industry also indicated that measures to waive short-term visas for travelers from China, South Korea, Taiwan, and other East Asian countries will also impact international visitation numbers to Japan. Finally, visitation from all of Japan's top ten overseas markets has increased notably since 2003. These markets include the previously mentioned East Asian markets, as well as the United States, the United Kingdom, Australia, and Canada. Such trends should support continued overall lodging market health.



A Final Note

For companies attempting to establish a brand presence in Japan, it is advisable to look at those Western businesses that have enjoyed the most success in Japan. Starbucks has flourished in Japan, which is a formidable achievement in a country whose majority population does not own coffee makers and instead prefers instant coffee or tea. Starbucks has tailored its products with new items such as Matcha (frothy green tea) Frappuccinos, and has reduced its drink volumes per size choice so as to avoid associations with the overindulgent tendencies of Americans. McDonald's is also a huge hit, no doubt predominantly due to its Western allure, which resonates with the nation's young culture. However, one of the most popular choices on the menu is the Teriyaki burger, and the company also offers smaller drink and fries sizes for Japanese consumers. Things like double-Quarter Pounders are also noticeably absent from the menu. Finally, the 7-Eleven convenience store is hugely successful in Japan. Now, rest assured that you will not find huge Slushee machines churning at the front counter. Instead, you will find a warmer filled with Japanese *mans* (hot bread dumplings) whose fillings feature an assortment of flavors, including beef, fish, and even pizza. There is also always an admirable variety of onigiri, or triangular-shaped rice cakes, surrounded with dried seaweed and stuffed with salted salmon. One can also rest assured that such an offering was not devised from observing the local 7-Eleven in Bartlesville, Oklahoma.

Japanese pride themselves on their ability to embrace globalization while keeping intact their sense of culture and heritage. The Japanese have managed to take certain aspects of Western life and traditions and adapt them into their own culture and habits. In the end, this sort of hybrid approach is what will ultimately prove to be successful for Western companies. While Western brands are forging ahead with developments in the next few years, it is also prudent not to overlook the impact of those 6.7 million Japanese baby boomers, and to therefore create a product offering that is tailored to their lodging expectations.

Finally, while taking into account the qualitative factors such as culture and anthropology that go into hotel development, trends in the global real estate market must also be considered. The subprime credit crisis that has jolted the U.S. real estate market has also had notable impact abroad, affecting investments in Europe and Asia alike. Japan REIT (J-REIT) index values have tumbled, falling 40% from the highs reached from May 2007 to February 2008 on the Tokyo Stock Exchange. Although much of the real estate investment world is sitting around with a "wait-and-see" attitude while the credit crisis



rides itself out, this may be the perfect time to develop a formula for success in Japan's hotel market by studying the nation's cultural habits and tendencies and creating a hybrid hotel brand – or modifying an existing brand – that embraces Japan's dual Eastern and Western tendencies.