
*“New perspective”
and “insights” for
next-generation hotel
management in the era
of uncertainty*



Introduction

Is it possible for the Japanese hotel industry to overcome its “challenges” and capitalize on “opportunities”?

Due to the recent spike in demand of inbound leisure and the boost in domestic travel of the elderly population, the hotel market is showing favorable progress. The lodging industry in Japan has great potential at present.

This is not a transient trend leading up to the Tokyo 2020 Olympics but is the result of a gradual recognition and appreciation of tourism resources in Japan such as the mild climate, culture and cuisine, with explosive growth in the middle-class population in Asia and relaxation of visa issuance.

On the supply front, even though construction costs remain high, an expansion of development is taking place mainly in metropolitan areas like Tokyo and Osaka. Some raise concerns of oversupply, though. Furthermore, the lodging industry demonstrates some sense of caution in the prevalence of the private rental lodging business, which brings a mixed view of pessimism and optimism. In addition, as more fundamental issues of the industry, labor shortages and low labor productivity are increasingly recognized as major hurdles; thus, robotization and introduction of IT development are drawing lots of attention as ways of solving these issues.

With respect to the environment mentioned earlier, a number of industries and companies have great interest in finding out what is waiting ahead of them with a calm attitude, sensing there is certain potential of the growth of the Japanese hotel industry. This Thought Leadership (definition: prophetic consideration on the hotel market) gives thorough thoughts and offers “opportunities” and “challenges” ahead of the management of the next generation lodging business in an era of uncertainty from various viewpoints (limited service hotel chains, real estate developers, Online Travel Agents, investors and private rental lodging businesses). Also, this Thought Leadership covers not only the trend of all related industries but also gives a sign of the change in the lodging environment of the future by leveraging business cases with pioneering ideas and survey results. We will be honored if this report can offer you some tips for your lodging business or lodging development strategies.

To prepare this Thought Leadership, we learned from and were inspired by the panel discussion at the “Hotel Management Forum 2016” organized by PwC Japan Group. An overview of the Forum is available in the last part of this report. We appreciate those of you who have cooperated and supported the preparation of the Thought Leadership and organization of Hotel Management Forum 2016.



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Business Strategy of Limited Service Hotel Chains

In light of the benefits enjoyed through the recent rise of in the number of inbound tourists, limited service hotels have recognized their ability to improve performance. However, given the trend of diversification of hotel guests, not all hotels should be satisfied with current external factors alone such as the strong lodging demand. The present situation requires hotel companies for enforcement of a customer base or marketing structure, which has not been attended due to the tailwind factors provided by the external environment so far. The hotel industry shall take an initiative to improve attractiveness as the lodging industry faces structural challenges due to its labor shortage. In addition, substantial improvement of service efficiency through IT development is necessary for the new era of Japanese hospitality industry.

Current performance and its background

Against the backdrop of the recent significant increase in inbound demand, limited service hotels are enjoying performance improvements. In 2015, the average OCC rose to the higher 80% range, especially in mega cities where demand was strong, an ADR- driven revenue improvement was recognized.¹ However, news reports and interviews with major hotel chains show the performance improvement has been slowing down since mid-2016.

The number of foreign visitors to Japan reached approximately 24 million in 2016, a year-on-year increase of 21.7%;² however; according to the statistics of the Japan Tourism Agency, the year-to-date percentage until November of 2016 represents the total number of lodging guests which increased by 9.0% from the previous year.³ As such, the rate of inbound tourist increase is not in sync with that of the number of lodging guests. The increase in arrivals via cruise ships with no hotel stay and users of private rental lodging may be an impact on this phenomena.

The total number of Japanese lodging guests decreased by

2.9% in 2016 from the previous year. Multiple reasons account for this, including the Kumamoto earthquakes in April 2016 and unstable weather in summer, as well as poor pricing strategies adopted by hotels. In cities mainly, hotels raised ADR that pushed up business travel expenses beyond the per-diem, resulting in pulling back on business trip frequency and the number of travelers. Moreover, a similar trend is recognized for personal leisure trips, leading to a reduction in the total number of Japanese guests.

The macro environment in relation to the foreign visitors coming to Japan continues to be favorable and demand of Japanese lodging guests is thought to be in the temporary adjustment phase in the changing market environment. Under such a market environment, hotels should set appropriate target strategies with products and sales plans matching their targets without depending too much on the strong inbound tourist demand.

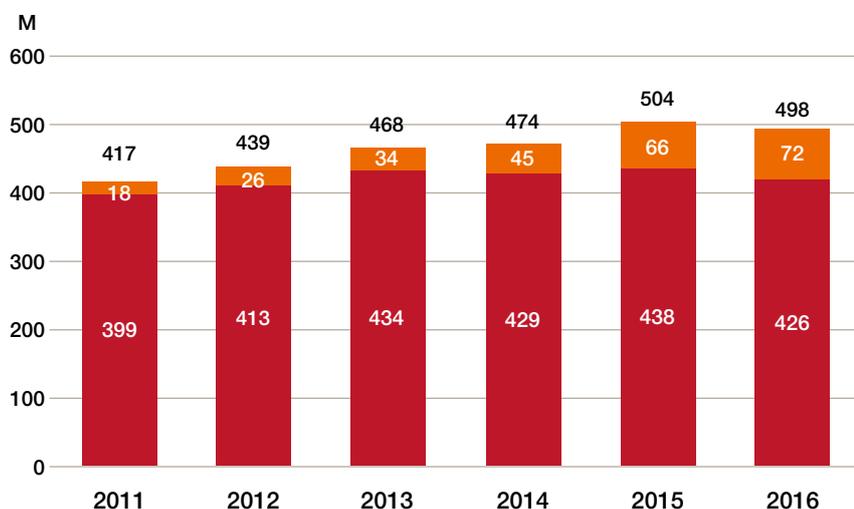
Source 1: STR's data edited by PwC
 Source 2: Japan National Tourism Organization(JNTO)
 Source 3: Japan Tourism Agency "Statistics on Overnight Stays"

The number of foreign visitors to Japan in 2016

About 24 million

(increase by 21.7% year-on-year) However, number of foreign guests was 9% growth from the previous year.

2011 - 2016 Number of overnight guests



Source: Japan Tourism Agency/Leisure Travelers Survey edit by PwC

Sales of OTAs reached over 1 trillion yen.

32% of total room sales further share expansion is expected.

Challenge and actions for sales strategy

For Japanese hotel chains, planning effective marketing and sales strategies using customer information is a major challenge. Recently, more Japanese hotel operators are taking advantage of referral business from international branded chains. Few domestic limited service hotel chains, however, are successful in retaining frequent guests with their own membership programs.

Given such circumstances, Online Travel Agents (OTAs) show significant presence as a sales channel, especially for limited service hotels. OTA business has been growing rapidly through the internet and web marketing. On-line lodging sales volume accounted for approximately 32% of the total sales in 2013, and on-line booking is expected to grow further with the proliferation of smartphones.⁴

Hotels may have different opinions than OTAs, but they may share a view that OTAs offer a better reach to the end clients. Hotels see OTAs as contact points and take advantage of them to allure hotel guests and try to retain such guests in their guest portfolio. Compared with international OTAs, domestic OTAs

currently charge lower commission rates. However, some people point out that if hotel operators keep overly relying on OTAs, even domestic OTA commission rates might increase in the future. In other words, the current environment requires hotels chains to enforce their own customer base to establish proper channel mixes while leveraging OTAs as one of the effective booking sources.

In fact, some domestic limited service hotel chains shifted their investments into PMS, for example, to develop databases and design applications to perform customer analyses and marketing activities. Also, to attract foreign visitors to Japan, more Japanese hotel companies are looking for their own booking channel by setting up sales offices in China and South East Asia as well as aligning with local travel agencies. Going forward, we should follow the outcome of such initiatives.

Source 4: Focus Light Japan



Strategy for a chain business to develop in the future

The system size growth is a major proposition for limited service hotels. Some chains are successful from pursuing specific target segments in focused geographical areas. However, limited service hotels have challenges in differentiating their facilities and service offerings from their competitors. Given such challenges, a basic strategy is for them to grow their portfolio and maintain market share, to enjoy economies of scale and to promote their brands.

In major cities such as Tokyo and Osaka, more hotel chains are developing their properties, and the markets are becoming more competitive. Major chains also see local cities as attractive for their hotel operations. Although the hotel performance in such cities is not as good as that of big cities, many of the existing hotels are privately owned small ones. Some branded competitors believe that such local cities may offer them lucrative opportunities. Also, other hotel chains plan to develop their properties by establishing cooperative relationships with local municipalities to promote local tourism and their properties as more inbound tourists are expected to visit regional destinations.

International hotel development is inevitable for Japanese limited service hotels in their mid and long term growth strategies. As the domestic lodging market for Japanese tourists is to shrink gradually in the mid and long term perspective due to the population decline, growing Asian countries should be recognized as an important market. Moreover, in Asia, the major source market for Japan, improving awareness of their brands helps Japanese hotel chains to be more competitive in winning international visitors in Japan.

Currently, some of the limited service hotel chains have started development outside of Japan, however, its pace of international portfolio expansion is not rapid at this point.



Going forward with aggressive development of new lodging properties, labor shortage is increasingly becoming a serious issue. Centered on limited service hotels, amid a series of new hotel openings, many hotel operators say that they find difficulties in hiring front desk, restaurant and housekeeping employees. An introduction of information technologies and automation technologies will be of some help to solve such challenges. Some of the routine work at the front desk and back of the house may be replaced by the new technologies to improve the service and labor efficiencies.

Likewise, for marketing and sales activities mentioned earlier, these new technologies, which other industries have already been utilizing, may be applicable.

Some limited service hotel operators emphasize their operational efficiency improvement using IT along with an enhancement of their brand equity and operational capacity as their important management agenda. This is expected to be a significant element in competing with other hotel operators down the road.

Business Strategy of Comprehensive Real Estate Developers

Comprehensive real estate developers run their business under a favorable environment at large and benefit from low interest rates to pursue good investment performance. However, at a time of sharp rise in construction costs, massive supply of office and residential buildings as well as the slowdown of domestic demand with population decline from the mid and long term point of view, the market outlook of real estate development is unpredictable. Under these circumstances, an increasing number of developers eyeing the potential of the booming hotel business are promoting their lodging business initiatives.

In the change of social structure, comprehensive real estate developers need to implement strategies in line with the new era.

This chapter provides perspectives on the trend of comprehensive real estate developers with the viewpoint stated above.

Business Environment of Comprehensive Real estate developers.

The current business climate of comprehensive real-estate development is in good condition overall. Interim financial results, ending in September 2016, of major real estate developers demonstrated a strong trend of increases in revenue and profitability, especially for companies mainly engaged in the leasing business. Some companies achieved record highs as first-half year closing results.

These favorable financial results are led by the openings of newly built properties and ultra low vacancy of high grade office buildings owned by such developers in Tokyo and other local cities. Furthermore, the low vacancy rate supports the increase of office rent and results in increasing real estate developers' office rental business revenue.

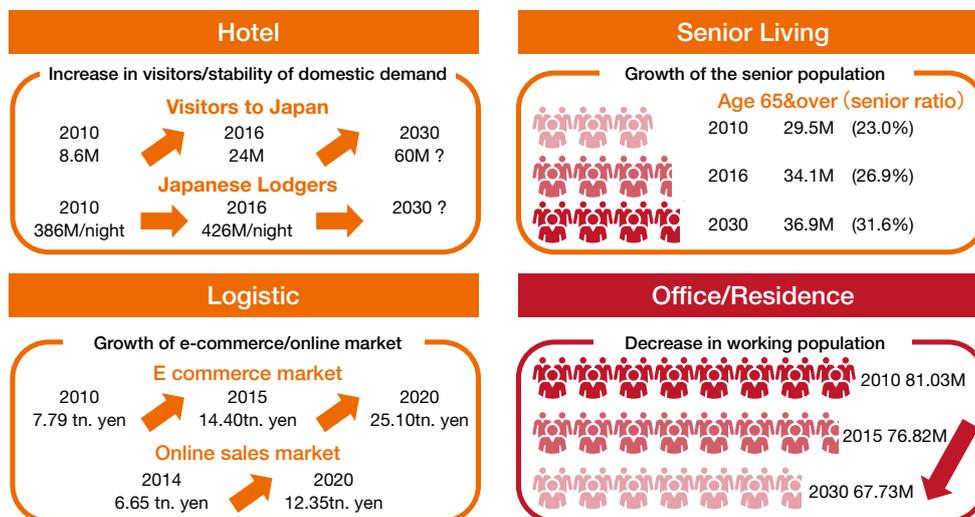
Many of these real estate developers have increasing interest-bearing debts due to a number of large area redevelopment projects in central Tokyo. However, current low interest rates offset their interest payment burden and support real estate developers to help carry out their investment activities.

Meanwhile, the current market situation does not necessarily look optimistic. According to surveys by Sanko Estate, Japanese real estate brokerage firm, the vacancy rate of office buildings in Tokyo is below 3%. However, annual new office space supply in 2018 and 2019 is expected to be significantly more than the average yearly supply of the past ten years, approximately 180 thousand tsubo per year. Therefore, the office vacancy rate is said to grow due to the excess net new supply, even assuming that future office demand will be robust.¹

The rising construction costs continue to be a major challenge. Some major real estate developers say that their unit construction costs have hiked by several dozen percent compared with that of the pre-Great East Japan Earthquake. Also, major general contractors say that construction costs will continue to hike. Increasing development activities for the Tokyo Olympic Games in 2020 is recognized as a major driver of the sharp rise in construction costs; however, its consequences are still uncertain, and real estate developers will need to be creative to manage their construction costs which directly impact their return on investment.

A large volume of supply and increase in vacancy rates is expected in Tokyo.

Source 1: Sanko Estate "Office Rent Data"



Source: Japan National Tourism Organization "Inbound Trend"
 Japan Tourism Agency "Survey of Leisure Travelers"
 Ministry of Economy, Trade, and Industry "EC Market Survey"
 Ministry of International Affairs and Communications "Population Trends and Future Population"
 All data edited by PwC

Hotel business initiatives by real estate developers

Given the business environment shown earlier, hotels are one of the asset classes that attract real estate developers' attention.

Traditionally, comprehensive real estate developers have not actively considered hotels as their an investment target. In the 2000s, developers introduced international branded hotels for value enhancement in joint development projects.

The focal point of this movement was more for a bonus floor area ratio associated with such functions, and hotel profitability as a stand-alone business was not in their attention.

The recent upsurge of inbound tourists has boosted lodging demands in Japan. Real estate developers have changed their position on the hotels and are reinforcing their hotel initiatives.

Each developer holds a different position for the hotel business, but the dividing point of such positions is whether the company should take hotel business risks as a business owner.

Some companies who have taken hotel business risks by launching their own branded hotels and aligned with international branded hotel operators are accelerating their hotel development and planning initiatives to develop new properties in resort areas and local cities to drive the hotel business to a pillar of their future growth.

Other real estate developers started the hotel business through mergers and acquisitions of hotel operators.

Some real estate developers who have traditionally limited their hotel related business to a pure ownership of their own hotel properties are changing their positions. Understanding the potential of the subject sites for hotel operation and working with domestic and international hotel operators, several developers are challenging hotel management.

The politics also support hotel development activities.

In June 2016, the Japanese Ministry of Land, Infrastructure and Transportation (MLIT) gave notice to local municipalities to relax floor-area ratios for lodging property construction plans up to less than 1.5 times the originally designated floor-area ratio of the subject buildings, capping at an additional 300% for those original plans to resolve the hotel guest room shortage associated with the sharp increase of inbound tourists to Japan.

In case of the development of public facilities, the floor area ratio relax policy can be applied together with another exemption for such contribution to the public interest.

In cities where lodging supply is tight, some detailed actions for easing standards in a timely manner are defined and implemented; thus, large hotel development will likely be accelerated in the future.

In other words, areas where abundant lodging demand is expected, return on investment for lodging assets could be relatively higher than that of other asset types.

On the flipside, as for such areas, real estate developers who do not consider hotels as their target asset types may have challenges in their site acquisition through the bidding process.

Understanding such changes, real estate developers who have not entered into the hotel related business yet may consider stepping into the hotel business in various formats to challenge new business models more flexibly without being bound by their traditional target asset types.

In fact, many real estate developers are taking actions such as letting acquisition teams study potential sites for hotels and establishing a designated unit for the hotel business and developers will continue to enhance their lodging related business.

Future business strategies of real estate developers

The Japanese population has already been shrinking, and the demographic change will inevitably impact domestic demand for offices and houses. In particular, such changes to their business structure are associated with certain hurdles. It is necessary for developers to address local characteristics in real estate supply and demand as well as legal systems and commercial practices in their target countries. The mid- and long-term demand for offices is expected to decrease due to changes in working style by better utilizing Information Technologies and improving space efficiency of offices usage such as no fixed office seat assignment in addition to a decline in the labor force.

According to the mid-term business plan of major real estate developers, they mention some key words such as hotel business, senior citizen related businesses and international development on top of an enhancement of core asset businesses

such as offices and residences. Based on the understanding of the market situation above, it is reasonable for them to look for business development targeting the growing market, and they are facing the time to change their business portfolio.

Additionally, they would need to consider operating their hotels by themselves and human resource development in some cases on top of developing good business concepts and selecting appropriate business partners to run operational assets like hotels and senior living spaces.

Business environments which they challenge are becoming more diverse and complex. Under such circumstances, the key to success is developing new business models and coping with the changing market climates from time to time.

Business expansion which flexibly responds to the market is necessary.



Future Business Strategy and Vision of Online Travel Agents (OTAs)

Domestic OTAs and international OTAs are expanding their businesses in accordance with the changing market by boosting the numbers of inbound tourists, an introducing private lodging and diversifying customer contact points through the internet. OTAs have been signifying their presence apart from hotel operators in terms of their roles, demonstrating their strength in approaching potential customers and creating travel demand. This chapter examines OTAs' trends from such viewpoints.

Market changes around OTAs

Recently, the OTA market has changed dramatically. With the sharp increase of inbound visitors to Japan, international OTAs have been rapidly expanding their market shares. The revenues of Japanese OTA players are also growing, and new players' and traditional travel agencies' entry to online business is stimulating the market.

According to Japan National Tourist Organization (JNTO), the number of inbound arrivals topped 24 million, an increase of 21.7%, in 2016.

Compared with 2015 when the number of inbound visitors grew more than 40%, the current growth rate is not as high as before; however, the trend shows consistent growth. The sharp increase of inbound visitors brought major changes to the traditional structure of hotel reservation channels. The increasing ratio of inbound tourists among all entire hotel reservations was initially recognized mainly in major cities, but the trend has spread to regional cities and resort areas popular among international travelers. Domestic chain hotels and independent hotels merely have international booking platforms, and international OTAs play a bridging role to help increase inbound reservations for such hotels.

The level of leveraging international OTAs differs among domestic hotel operators. Given the recent trend of expanding international visitors' footprints from major cities to secondary cities, international OTAs are expected to expand in such markets. Furthermore, for outbound tourism, an increasing number of Japanese travelers are expected to use international OTAs. Having said this, Japanese travelers still use more Japanese OTAs for their domestic travels.

While Japanese OTAs drive the growth of the online reservation market in Japan, they focus on gaining more share in inbound bookings by using their own distribution channels, building alliances with other companies, enhancing their marketing activities and supporting multiple languages of for inbound businesses. As for domestic businesses, newly entering players and multi-segment OTA entities are expanding the market while other players targeting more specified customer segments are increasing their presence.

Japanese and international OTAs do not just serve as lodging reservation sites but are also expanding into some relevant business areas such as restaurant reservations, experience program bookings, activity bookings, transportation

Japan hosted over
24 million
foreign visitors in 2016.



bookings and review sites and so on. Such vigorous expansion is not only found in the B to C market. Even for the B to B market such as business travel arrangements and corporate contracts and the C to C markets such as private lodging businesses, OTAs at home and abroad have been exploring their new business opportunities.

While OTAs are expanding their businesses, traditional travel agencies are trying to penetrate the online businesses at a full scale. As the proportion of online reservation for domestic travel is on the rise, brick-and-mortar travel agencies inevitably are enhancing their online reservation channels.

Strengths of travel agencies are their offline customer contact points through their domestic and international store network as well as their solid customer base. The issues that those agencies realize are their connectivity and consolidation of their offline based customer information and that of their OTA businesses. Their Omni-channel strategies focus on integrating the offline world with the online world, and how to use such large amounts of data, and further development of such strategies is expected in the future.

In the midst of diversification

and the complexity of the OTA business both in Japan and abroad, it is important for hotel operators to understand the market trend at all times and to develop the most suitable channel strategies. In association with the increase in sales channels, optimizing system connectivity to different sales channels will become more important ever. By optimizing system connection among PMS (Property Management System), CRS (Central Reservation System), GDS (Global Distribution System) and Channel Managers, more sales opportunities and operational efficiency improvement will contribute to further productivity enhancements.

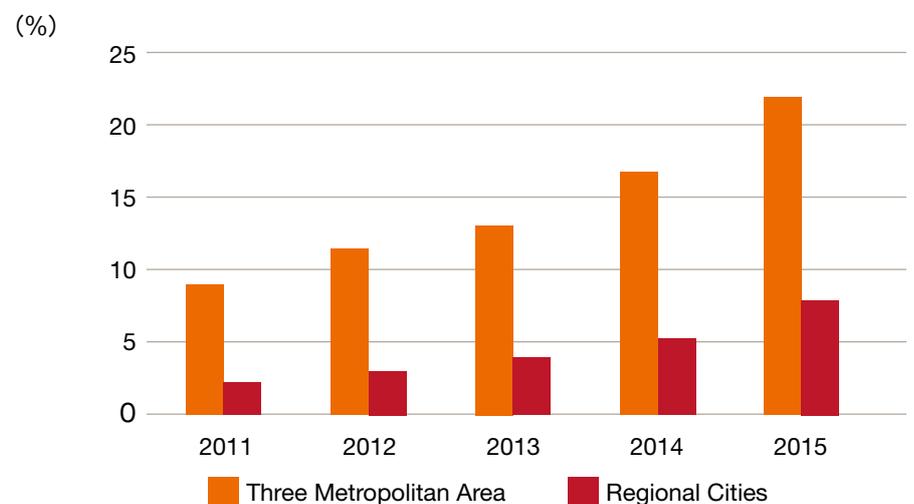
Relationship among OTAs and hotel operators

While hotels and OTAs are undergoing intensive changes, they are in a competitive relationship, but at the same time, they also complement each other. From a hotel operator's perspective, it is preferable to control the proportion of bookings through OTAs in their total booking volume to some extent due to increasing sales commissions.

From the viewpoint of customer

contact points, in some areas, roles of hotel operators and OTAs are clear cut. The use of OTAs provide hotel operators some benefits of approaching potential customers whom hotels have not reached on their own. For Japanese hotel operators, international OTAs play a big role in alluring inbound guests. Also, OTAs and travel agencies are good at spurring potential travel demand and promoting specific locations and regions.

Ratio of Foreign Lodgers among all the Lodgers



Three Metropolitan Area includes: Tokyo, Kanagawa, Chiba, Saitama, Aichi, Osaka, Kyoto, and Hyogo(8 prefectures)
Regional cities are all cities except Three Metropolitan Area

Source: Leisure Travelers Survey/Japan Tourism Agency edit by PwC

OTAs and hotel operators try to improve their exposure and awareness, acquisition of customer development and customer retention by increasing contact points during each phase of the customer journey, planning mid-travel and post-travel.

Diversifying customer contact points

While OTAs expand the online reservation market, contact points with customers are becoming diverse. For example, at the beginning of the reservation process, metasearch sites which allow customers to run price comparison across different OTAs are more visible.

On those meta search sites, customers' focal points are guestroom availability and their lowest rates.

When high room occupancy and high rates continue, customers find it difficult to book their rooms. This means that meta search sites are expected to be used more frequently as it is easy to find vacant rooms and the lowest rates through them.

The emergence of meta search sites may accelerate in directing customers from one OTA to another. It may also increase users who will not stick to the same OTA every time. For this reason, it is more important for OTAs to not only focus on trying to reduce differences with other OTAs in terms of room inventories and room rates, but also to focus on retaining and developing their existing customers.

Smartphones will play a more important role to design customer contact points and customer experiences in the future.

They have driven online hotel room booking and are expected to be used more often during travel. In fact, international branded hotels started to offer applications that allow guests to use smartphones for their check-in process and as their room keys. Starting with the use of smartphones, it will be interesting to see at how hotel operators and OTAs design customer contact points to materialize what customers experiences with much potential to grow.

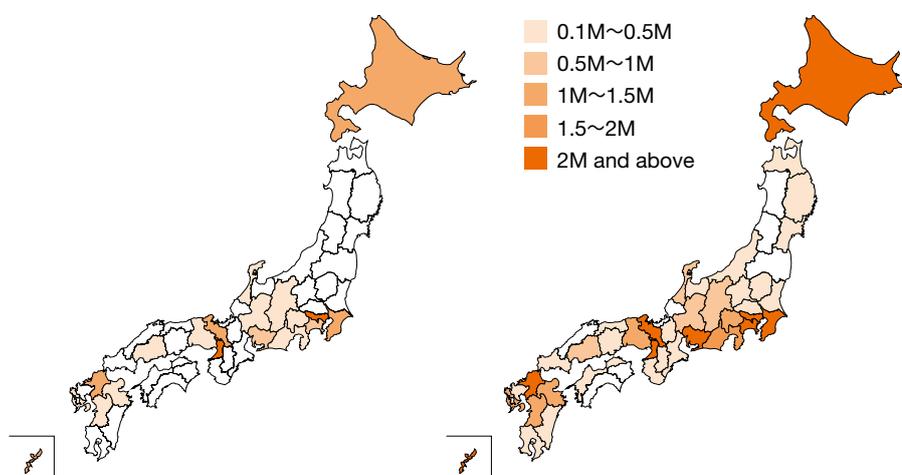
OTAs' Visions

OTAs are not only expanding their market shares within the current business fields but are also exploring new business fields and entering into private lodging businesses; thus, certain industry consolidation will likely take place. Once regulations for private lodging businesses are set out, more OTAs will start to offer private lodging in their service lineups.

Meanwhile, both OTAs and hotel operators will be more active in investing in Information Technologies that support big data, Artificial Intelligence, smartphone applications, interfacing, and integrating operational systems that become increasingly more complex.

Number of foreign lodgers(2011)

Number of foreign lodgers(2015)



Source: Leisure Travelers Survey/Japan Tourism Agency edit by PwC

Current Trend of the Investment Market and the Role of Investors in the Lodging Industry

With the active hotel market, hotel assets are drawing more attention as investment targets, and investment amounts are increasing. As hotel investment activities become active, the competition will become fierce, and it is necessary to develop hotel investment strategies to win the market.

This chapter talks about the background of the current active hotel investment trend and examines the outlook of hotel investments based on the trend.

Background of increasing focus on hotel assets in Japan

The number of international visitors to Japan has hit the highest-ever for the last four consecutive years.

The figure in 2016 exceeded 20 million which had been the target set by the government and reached a record high of 24 million, according to JNTO.

The rise in the number of foreign visitors to Japan is not a temporary phenomenon but is expected to continue due to the expanding outbound Asian travel market associated with the regional economic growth, Japan as a highly popular destination and Japanese government policies of establishing Japan as a tourist-friendly country. To this end, hotels accommodating the increasing number of international visitors are expected to grow massively in the future.

Also, hotel assets in Japan are drawing more attention because they are expected to achieve higher financial return than those in overseas.

Although Average Daily Rates (ADRs) in major Japanese cities show positive growth with the increasing inbound visitors to Japan and active domestic travels, the ADR level is still relatively low compared with that of other major cities such as New York, Paris, Hong Kong, and Singapore. In other words, further ADR growth in Japan has much potential, and hotel assets may grow their significance among asset types.

Looking at the ratio of branded chain hotels among all hotels in Japan, the rate in Japan is about 26%.

According to PwC's estimate, it is clear that the rate in Japan is lower than that of North America (approximately 66%) and Asia (approximately 43%), and this difference implies that Japanese hotels may not be managed in an efficient manner.

On the other hand, many of those Japanese hotels have room to improve operational efficiency through various initiatives such as running the hotels under the same brands. This may lead many properties to achieve better financial returns.

In addition, worldwide monetary easing measures and the foreign exchange level of the yen are expediting investment in hotel assets in Japan. Including Japan, investors see that the current environment allows them to finance easier than before as monetary easing is taking place in Europe and Japan. Hence, an expansion of investment targets is accelerating. Even investors who traditionally did not have hotel assets in their portfolios started looking at hotels. With the effect of Abenomics policies in 2012, the foreign exchange market has led to yen depreciation, and it has been considered to be a favorable investment environment for Japanese assets.

Ratio of chain hotels in each region



*A chain hotel is classified as a company that operates more than 10 hotels

Amount of hotel investment
+189% year-on-year
435 billion yen
(as of 3Q2016)

Source: Jones Lang LaSalle

Hotel investment trend

According to Jones Lang Lassalle (JLL), 2016 Q3, year to date real estate investment volume decreased by 18% to 2,790 billion yen, compared to the same period of the previous year (January thru September 2015). The investment amount by sector shows that the investment in hotels increased by 189% to 435 billion yen, describing that investment in hotels has become more popular.

Recently, J-REIT related hotel investment is becoming more distinctive. For instance, a certain REIT specialized in resort hotels are now acquiring hotels in other areas and also trying to acquire mainly limited service hotels in local cities, not just in Tokyo and Osaka, in order to balance its portfolio. This shows its shift to achieve stable revenue opportunities by holding a diverse and variety of portfolio. In addition, leveraging strong fund-raising capabilities, some REITs are actively acquiring large-sized properties, and others are purchasing large-scale property in local cities to target financial returns whilst owning hotels in different segments to maintain stability. A fund which has been investing in REITs specialized in office buildings has now begun REIT investing in hotel properties. Given such an active hotel market, the growth through property acquisitions will be accelerated.

With the growth potential of future hotel demands, investors are exploring many strategies focusing on internal growth. While securing cash flow stability through the fixed rent revenue, more investors use

a combination of fixed rent and variable rent for their hotels in order to enjoy upside in conjunction with the performance improvements. Furthermore, other investors make additional investments to their existing hotels to increase their ADR to drive their return on investment.

Future Hotel Investment

Investors can now expect stable hotel cash flow with the increasing inbound lodging demand.

This market fundamentally leads to a decrease in hotel properties put on the market, and hotel investors are facing challenges. According to Japan Hotel Appraisal's survey in November of 2016, the cap rate has continued dropping since September of 2011 to the current average level of 5%. Due to the spike of real-estate prices, property acquisitions are becoming increasingly difficult and, hotel investment will become more competitive.

With such a background, two major types of hotel investment strategies can be considered.

One is to “work on value up initiatives to justify the expensive acquisition”. In areas like Tokyo and Osaka where property prices are soaring while lodging demand is also high, investors maximize cash flow by having good hotel operators within their groups to secure stable lodging demands by employing the brands’ strategic sales strategies, capitalizing on brand awareness and substantial cost cuts by improving efficiency in operation.

In some cases, investors hold hotel operators in by each segment that their portfolio belongs to and outsource hotel operations to such operators to improve operational efficiencies.

Another strategy is to “discover and acquire properties with growth potential at relatively reasonable prices”. With this strategy, more investors may look at upside potentials by acquiring those rarely attended properties in local cities and cooperating with hotel operators with strong brand recognition to improve efficiency in sales& marketing as well as operations.

In accordance with hotel market changes, available properties on the market and cap rates continue to change. Also, investment policies and management plans for assets will become diverse. Understanding such changes, investors will need to plan strategic investments to secure stability and pursue growth.



Understanding the Current Situation of Private Lodgings and their Outlook

The Japanese government recently decided that private lodging businesses will be allowed to provide accommodations for up to 180 days a year. The rapidly-expanding business requires setting out a legal framework urgently, and we cannot overlook the issues associated with rampant illegal business activities. On the other hand, it is also a fact that private lodgings are well accepted especially among inbound tourists because of their values not found in hotels regarding service style, reasonable pricing for a long stay, and their local experience offerings. In order to accommodate 40 million to 60 million inbound travelers in the future, Japan needs to enhance its lodging capabilities, and hotels and private lodging facilities are required to co-exist and co-prosper by leveraging their characteristics.

In this chapter, we examine the trend of private lodgings from these perspectives.

Legal positioning of private lodgings and development of legislation –

Recently, the growing influx of international visitors is contributing to improved hotel performance especially. But at the same time, private lodging business is also quickly growing. Private lodging is a type of lodgings operated by private residents in their homes. However, while these accommodations are becoming increasingly popular, the legal framework of this business model remains unclear.

Firstly, the act of continuously attracting people who are not based in a specific location and renting the location for their stay for a fee (and the owner manages the space), requires statutory permits stipulated in the Inns and Hotels Law which was enacted in 1948. Many private residences posted on private lodging websites are not likely to be permitted properties and may not comply with the legal requirements.

In recognition of such circumstances, active discussions focusing on private lodgings have been taking place, and Ota-ward, Tokyo and Osaka Prefecture were designated as national strategic districts in 2016 to begin running private lodgings.

Although the permitted conditions, such as a minimum 6-night stay per booking, did not reflect the actual needs, the minimum stay requirement was eased to 2 nights, and the private lodging model has become more accepted in the market.

In June 2016, the Japanese cabinet approved the “Regulation Reform Implementation Plan” including a draft of the new law regarding the private lodging business model which does not fit within the framework of the traditional Japanese hotel business act.

The discussion regarding the new law is still underway as to the new law, but its basic framework has been shaped.

First of all, the definition of private lodging is “to offer accommodation by utilizing existing residences” and “to rent out for a fee and continuously on a daily basis”.

There are two types of operations: “a lodging service provided at a facility where its owner resides” and “a lodging service provided at a facility where its owner does not resides”.

As to the facilities where the owners do not reside, the owners are obligated to assign facility managers to maintain their guest lists and maintain safety and hygiene

*The new private lodging regulations allows the businesses to provide accommodations for up to **180 days** a year.*



measures on their behalf them. (As to the facilities where the owners reside, the owners as manage the property.)

In addition, certain requirements are to be set for the private lodging operations. The biggest issue among such requirements had been an upper limit regarding the number of annual operating days.

After a series of expert discussions, the cabinet decided that the annual operation term should be up to 180 days in December 2016. The annual operating term may likely create an extra drag on private lodgings as investment targets.

The new private lodging law continues to face challenges because of its tough interest adjustment among stakeholders. Yet, its legal frameworks have to be quickly put in place so that its long awaited execution through the ordinary Diet session can be implemented in 2017.

Background of the proliferation of the private lodging business

Two major reasons can be considered for the quick proliferation of the private lodging business in Japan.

Firstly, the sharing economies have grown worldwide. People have shifted their styles from excess production and overconsumption that the spread of smartphones offered the platforms such changes. The sharing economies have been observed not only in lodging shares and space shares, but also in many different areas such as sharing cars, clothes, accessories as well as labor forces.

In the accommodation sector, the web based private lodging platforms have already been in operation in most countries and have been popular among sharing friendly travelers especially in the millennial generations. With such backgrounds, it is inevitable that the private lodging accommodates various needs of foreign travelers. As the number of international visitors increases, their interests of lodging options widens.

The private lodging options may be well accepted among those who want to experience Japanese cultural and Japanese ways of life as well as interactions with locals. For such tourists, this lodging option may offer values of experience which is not possible with hotel stays.

Also, private lodging may be chosen due to its accommodation style and pricing.

According to a major private lodging site, circa 16,000 units were listed in Tokyo in October 2016. Roughly half of the listed units could accommodate over four guests, and their average nightly rate was 10,000 yen. International visitors' average length of stay in Japan is said to be for three to five days; however, travelers on a long leave or backpackers may stay longer. For group travelers or long stay international travelers, private lodgings may reduce accommodation costs significantly compared with hotels, and such travelers may find them reasonable.

- Impact of private lodging on the hotel industry and their co-prosperity -

With the proliferation of the private lodgings, the hotels have shared an ineffable sense of fear against it, and

the impact became evident in 2016.

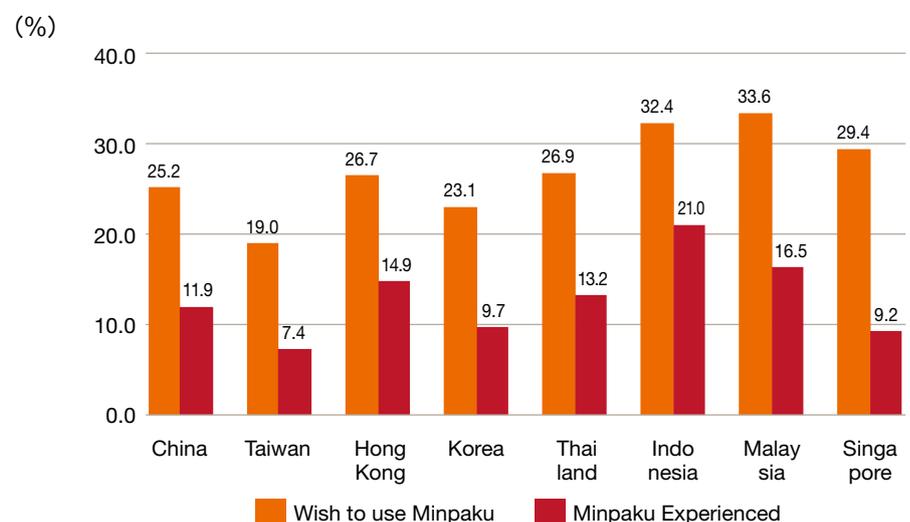
The number of international visitors in Japan increased by 50% year-on-year in 2015. We see it has slowed down; however, still a year-on-year increase of more than 20% has been observed.

On the other hand, the increase rate regarding the total number of overnight international visitors has been at a single positive digit since May 2016, and it turned negative on a year-on-year basis in August 2016. While more foreigners visit Japan by cruise ships which do not require lodging in Japan, the biggest driver of this peculiar statistical change is said to be staying at private lodgings which is not reflected in Japan Tourism Agency's statistics.

As described above, private lodgings have a strong affinity with experience focused stays, long stays of single travelers and group travelers and budget travelers. Hence, it is quite possible that private lodgings may become a more attractive lodging option than hotels for such visitors.

Source 1: Japan National Tourism Organization(JNTO)
Source 2: Japan Tourism Agency "Statistics on Overnight Stays"

Travelers who have used Minpaku/who wish to use Minpaku(by country)



Source: Development Bank of Japan's data edited by PwC

However, it is also obvious that hotels have many advantages which cannot be found in private lodgings. Many Japanese hotels provide a certain level of quality that is higher than that of private lodgings in areas of safety, security, facilities, and service. Especially, private lodging may not be focusing on several levels. When females, families and seniors, needless to say business travelers, choose their accommodations, hotels and private lodgings are not likely to be compared with the same measurements.

Of course, we cannot deny the fact that private lodgings impact inbound accommodation demand, which has the biggest growth potential in Japan and needs to deal properly with this situation properly.

For example, hotels could appeal to guests by sophisticating their strengths in the areas where private lodgings are appealing, such as beddings, amenities, bathing experience and meals. Hotels also have options of creating facilities suited to long-stay guests' needs that they have struggled to cope with.

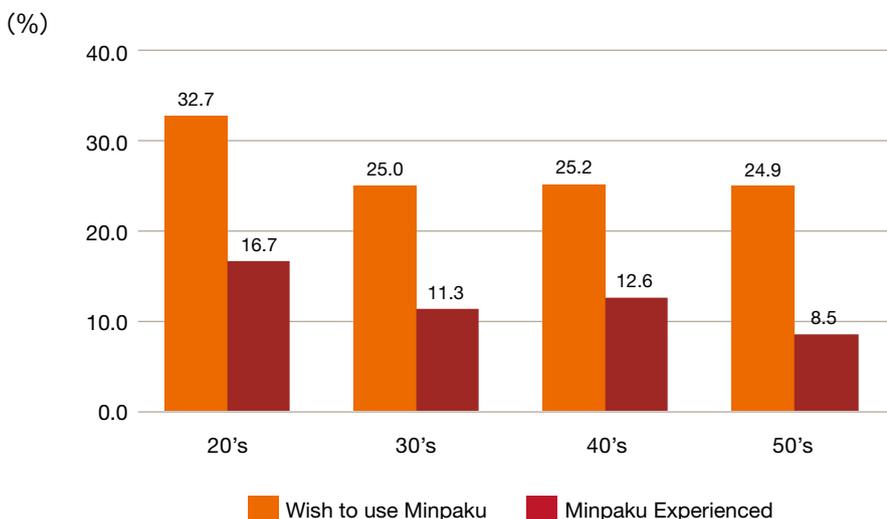
Hotels can also develop some products by fostering alliances with service providers which offer experiences sought by inbound travelers.

Hotels should strategically consider these initiatives to avoid each property's commoditization in the lodging market where new properties keep coming in, setting aside their competitive relationships against private lodgings.

As a solution to the shortage of accommodations in urban areas and to diverse lodging needs, the expansion of private lodgings has positive aspects. We need to urgently build legal frameworks for proper competitive relationships. Under such circumstances, both hotels and private lodgings should contribute to the growth of the lodging industry by exerting their own characteristics and attractiveness.

*Approximately **50%** of rooms listed in the private lodging webpages accommodate more than four guests. The average daily rate is about **10,000 yen**. Private lodging may have grasped the needs of long-term stay and/or families.*

Travelers who have used Minpaku/who wish to use Minpaku(by age)



Source: Development Bank of Japan's data edited by PwC

[Reference] Outline of the Hotel Management Forum 2016

On October 13, 2016, PwC Japan held the first 'Hotel Management Forum 2016' at The Ritz-Carlton Tokyo, welcoming around 300 participants, which went far beyond the total admission capacity. The recent market overview and hotel management initiatives of the next generation were the themes of this forum, and lively discussions were held by delegates from notable companies.

<Outline of the Japan Hotel Market!>

In the Asia-Pacific region, the growth rate of the Average Daily Rate (ADR) slightly decreased and the occupancy rate increased to some degree during January thru August in 2016. This trend reflects that hotels prioritize their room occupancies even by lowering their room rates. During the same period, however, the growth rate of the room supply surpassed that of room demand, and the trend implies that RevPAR has entered the uprising phase. Given that room occupancy rates in Asia Pacific hovered around the higher 60% range during the same period, the current overall occupancy rate in Japan hitting over 80% is quite high.

In Japan, ADR has grown for five straight years since 2012. Even though the room occupancy rates dropped during the period from January to August in 2016 when compared to those during the same period of the previous year, RevPAR has continued to rise because of ADR growth.

Regarding the numbers by cities in Japan, almost all of them experienced a decrease in occupancy and growing ADR compared to the same period of the previous year. On the other hand, what stands out is that the occupancy rate in Kyoto has grown from the 80% range of last year to the 90% range along with the ADR growth. Compared to RevPAR of 2008 as a baseline, Tokyo's occupancy rate has not returned to the baseline level yet, while Osaka grew so much that it ranked as one of the top 10 cities in terms of the worldwide RevPAR growth rate, and the Osaka RevPAR is still running at much higher than the baseline.

While the media continuously reports remarkable growth in the number of international visitors to

Japan, the hotel room occupancy has been slow this year. This slow down has been driven by higher growth in the number of foreign visitors who do not contribute to traditional accommodations regulated under the Japanese Hotel Business Laws against the growth of the overall number of inbound visitors. Other factors may be that Japanese demand in domestic travels has had set-backs due to the ADR growth lasting for the past five years as well as the earthquake and so forth.

<Overview of Each Panel Discussion>

Limited Service Hotels Session

The panelists had a deep dive discussion on a wide range of topics relating to limited service hotels. The session started with sharing of the panelists' views on the current hotel market, their sales strategies including how to capture inbound demand and utilize OTAs, and their IT investments.

Additionally, the discussion touched upon how hotel chains should be run in consideration with future hotel development.

Developers Session

Major real estate developers have started entering the hotel sector. This is a relatively new initiative for those who had previously focused on the conventional development such as constructing office buildings and residential premises for sale. During the session, panelists addressed various topics such as differences in office and residential developments and hotel developments, their approaches to operational assets, and their views on current and future inbound demand. The discussion demonstrated their great expectations in the growth of the hotel business.

Online Travel Agency Session

Each panelist shared the latest initiatives of each OTA and elaborated on factors of their business growth. Additionally they touched upon the increasing inbound lodging demands and private lodgings, and the outlook and challenges of the OTA sector. The session refreshed our views on customer expectations to the role of OTAs and the cooperative relationship between OTAs and hotel operators.

Real Estate Investors Session

Each panelist was quite proactive, engaging in an honest debate which started with the sharing of their assessments on the hotel sector, followed by lending trends, investment trends, and their investment strategies for becoming a winner in hotel investments.

Sharing Economy Session

The session focused on the expansion of the private lodging business.

Panelists engaged in lively discussions, including legal and regulatory trends, which attracted lots of attentions, regarding the market size and demand. In addition, the session touched on business opportunities and their potential collaborations with the hotel industry.

Source 1: STR

Conclusion

We have discussed the future ‘challenges’ and ‘opportunities’ that lie in next-generation hotel management in the era of uncertainty from our original viewpoints of limited service hotel chains, real estate developers, online travel agencies, real estate investors, and private lodging businesses. As mentioned in the introduction, the Japanese hotel industry now has enormous growth potential. On the other hand, urgent solutions to issues such as labor shortages and productivity improvements are necessary for Japan to become a tourism-friendly country and to compete with other global competitors. In leveraging

such clues with solutions such as robotics, artificial intelligence (AI), and big data, we believe that the synergies between the hotel and the surrounding industries will bring a ‘transformation’ for the industries. When such efforts bear fruit, Japan will be capable of addressing the diverse needs of international visitors, and we truly hope that this Thought Leadership report will continue to contribute to the prosperity of the hotel industry.

We would like to express our sincere gratitude to everyone who kindly cooperated in this publication.



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