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THE PRESIMA GLOBETROTTER

Konnichiwa! Tourists Rediscover Japan

Mount Fuji, as seen from the Arakura Sengen Shrine. Source: imgarcade.com

In May 2011, in the wake of the 9.0 magnitude earthquake and resulting tsunami that struck Japan, we visited Tokyo for a research trip. Most of the stocks in our Japanese coverage universe were down 25-50% from pre-tsunami levels and most investors worried that the stocks had more to fall. In Tokyo, rolling blackouts, limited air conditioning, and truncated train schedules were the norm.

Fast forward to a few months ago, well before our most recent research trip to Japan, when we got a call from a research partner of ours in Tokyo. She nervously asked "Have you booked your hotel yet? You know, Tokyo is very busy these days." All of the data suggested that hotel demand was rising, and when we started exploring room availability, we appreciated how tight the market had become. At many hotels, space was already limited and prices were on the rise for the first time since the financial crisis.

While the search for a reasonably-priced hotel room posed a short-term challenge, it highlighted a series of investment opportunities in Japan's tourism trade. Over the span of two weeks, we had the chance to visit assets and meet with senior management of real estate companies and local real estate agents to better assess the beneficiaries of the strong trend.

PRESIMA

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Key Takeaways:

1. Abe's "Three Arrows" have spawned a tourism boom
2. Tourism boom is generating knock-on demand for tourism-related office space
3. Hotels are full and profitable
4. Retail is hot - in spots

Prime Minister Shinzo Abe has pushed tourism as a strategy to revive Japan's economy.
Source: galleryhip.com

Takeaway #1

Abe's "Three Arrows" have spawned a tourism boom

Japan's economic turnaround can be attributed in large part to Prime Minister Shinzo Abe's aggressive "Three Arrows" plan. His plan is a mix of fiscal stimulus, monetary easing, and structural reforms that is designed, as The Economist magazine put, "to jolt the economy out of suspended animation that has gripped it for more than two decades."[1]

Abe wasn't short of ambitions for Japan's Ministry of Land, Infrastructure, Transport and Tourism. In early 2013, he stated that by 2020, 20 million foreigners per year would visit his country, which would represent a 141% growth in only 7 years. Recent trends have turned his doubters into believers. In 2012, the year of his election, 8.3 million tourists visited Japan[2]. In 2013, Japan welcomed 10.4 million tourists, 25% more than in 2012 and a new all-time record at the time. Then in 2014, 13.4 million tourists visited Japan, a 29% increase in foreign tourist visits in Japan relative to 2013 and yet another record.

As the table below shows, most of the growth came from China and Southeast Asia. While 69% of all Japan inbound tourists were from Asia in 2005, that same proportion reached 81% in 2014[3]. Given the momentum, higher goals are emerging from the Japan Tourism Agency, calling for 25 million visitors per year by 2020 and 30 million beyond 2025.

So how did they do it?

Since his election, Prime Minister Abe and high level cabinet members have met regularly to develop strategies to make it easier for foreign tourists to get to and around Japan. Visa requirements have already been relaxed for visitors from China, Thailand, Malaysia, Indonesia and Vietnam, and more is on the way. Officials are gradually implementing measures such as faster access from Narita international airport to Tokyo, more flights into and out of Haneda airport (now rebranded as "Tokyo International Airport"), 24-hour buses, trains and subway services in major urban areas as well as information in several foreign languages at popular tourism destinations. In parallel, low inflation and a significantly cheaper yen seem to indicate that Japan is "on sale" for many foreigners.

Kabukicho, the entertainment district in Shinjuku, often referred to as the "sleepless town".
Source: japan-expert.com

[1] Abe's Master Plan, The Economist, May 18, 2013.
[2] Japan Tourism Agency, Ministry of Land, Infrastructure, Transport and Tourism.
[3] Center for Aviation - CAPA, Aviation analysis, January 2015.

Tourist Arrivals in Japan, 2014

Rank	Country	Number (people)	% change from 2013
1	Taiwan	2,829,800	28.0%
2	South Korea	2,755,300	12.2%
3	China	2,409,200	83.3%
4	Hong Kong	925,900	24.1%
5	United States	891,600	11.6%
6	Thailand	657,600	45.0%
7	Australia	302,700	23.8%
8	Malaysia	249,500	41.3%
9	Singapore	227,900	20.4%
10	United Kingdom	220,100	14.8%
	All countries	13,413,600	29.4%

Sources: Japan National Tourism Organization, 2013; Japan National Tourism Organization, 2014
http://www.jnto.go.jp/jpn/reference/tourism_data/visitor_trends/pdf/2013_14_tourists.pdf

Takeaway #2

Tourism boom is generating knock-on demand for tourism-related office space

We had the opportunity to meet with a number of economists from large Japanese banks during the trip. With them, we explored the implications of positive tourism trends. They unanimously agreed that the impact on economic growth would be "significant," especially if the trend is sustainable. Most attempted to put a number around the impact of foreign visitors spending on GDP growth. Their estimate was that each trillion yen of additional spending directly grows GDP by 0.2%[4]. In 2012, travel spending by visitors was slightly above 1 trillion yen while the same number surpassed 2 trillion yen in 2014, therefore equivalent to more than 0.4% growth in GDP[5]. As the economists suggested, the number might sound low, but after accounting for the peripheral positive impact on employment, the benefits magnify.

Interviewing management teams of small and large office landlords, we also got the chance to dig further into the recovery that is currently taking place for offices in Tokyo. According to Miki Shoji, the Tokyo office vacancy rate steadily fell from 7.34% at the end of 2013 to 5.31% at the end of February 2015[6]. When we explored which industries and tenants are hiring and expanding, the answers mainly pointed to pharmaceuticals and cosmetics, food and beverage, leisure, transportation and technology companies.

These expanding industries are in a strong way related to tourism. Airlines and railways directly benefit from an increased demand for transportation into, out and within the country. Food and beverage as well as pharmaceutical and cosmetic products figured among the top items purchased by tourists in Japan over the last few years. Moreover, since October 1, 2014, these products have been classified as duty-free goods for foreigners with a minimum purchase of 10,000 JPY[7], or roughly 83 USD. As for technology companies, number of Japanese local municipal governments are expanding Wi-Fi networks for them to be more helpful for foreign travelers. A good number of software and network developers are apparently very busy with this vast enterprise and therefore expanding headcount.

Overall, from a real estate standpoint, we have the impression that unlike the 2003-2007 Tokyo office recovery that was mostly led by expanding financial institutions, this pick-up in occupancy and rents is driven by different actors and dynamics. The good news is that these new leaders appear sensitive to the current tourism boom. In our view, a sustained upswing in arrivals could provide support to the office market and to landlords beyond current investor expectations.

Office demand in Tokyo is pushing densities higher. Source: net-marketing.co.jp

[4] Daiwa and SMBC Nikko estimates from our meetings in November 2014 and January 2015.
[5] Japan Tourism Agency, Ministry of Land, Infrastructure, Transport and Tourism website, 2015.
[6] Miki Shoji Office Reports, February 2014 and March 2015.
[7] Japanese Customs Services website, 2015.

China Blue Restaurant at the Conrad Tokyo Hotel, overlooking central Tokyo.
Source: japantimes.co.jp/life

Takeaway #3

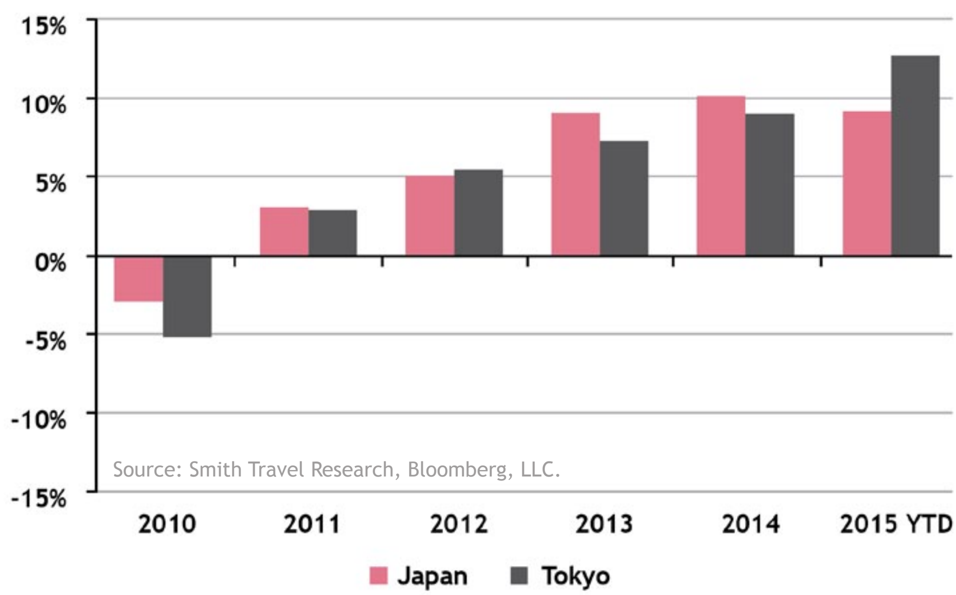
Hotels are full and profitable

An obvious beneficiary of the tourist boom is the hotel sector. But the financial impact is magnified for hotels, since amongst the various real estate sectors, hotels generally have the highest level of operational leverage. They have high levels of fixed operating costs, mostly labor, and make little or even lose money at low levels of occupancy. But above a certain breakeven profitability level, hotels' profit margins expand quickly with occupancy gains. Tokyo's hotel industry appears to have reached that tipping point.

Our research partner was right. Our hotel was extremely busy. Meetings with real estate agents and hospitality focused J-REITs confirmed that assessment. They stressed that the Tokyo and Osaka lodging markets have been, and continue to be on a solid growth path since mid-2011, post-tsunami. The market now exhibits the strongest fundamentals of the overall Japanese property space. As we anticipated, the improvement is led by both occupancy gains and average room rate increases, sending 2013 and 2014 Revenue per Available Room (RevPAR) percentage growth in the double digits for the luxury segment and in the high single digits for the mid-scale segment. Interestingly, while the Tokyo and Osaka office markets are still estimated to be between 30% and 40% below their 2007 peak, the same hospitality markets have surpassed the same mark in 2014[8].

To explore further, we spent a full day with a hospitality J-REIT we have been covering for many years. The REIT operates middle of the range hotels, mostly branded as MyStays and Flexstay Inn. We met with their senior management team and visited three assets they own or have a preferential right to acquire. Two properties we saw are located in the heart of Tokyo in the Kanda and Asakusa districts while the third one sits near the Haneda Airport and mostly caters to travelers in transit. Management highlighted that since the visa requirements have loosened, the company's fastest growing guest segment is the emerging middle class of China and Southeast Asia. These travelers now have enough disposable income to visit Japan, but are focused on value for their

Japan Hotel Revenue per Available Room (RevPAR), 2010-2015



[8] Japan Hotel Market Overview, Jones Land Lasalle KK Hotel and Hospitality Group, December 2014.

money. The company maintained an average occupancy rate of 91.9% throughout last year and their average daily rate stood at 7,719 JPY, the equivalent of 63.60 USD at current exchange rates[9]. In our view, for centrally located rooms that were sparkling clean and well organized, rates appeared quite reasonable, especially considering that luxury hotels in Tokyo or Osaka typically sell for more than 250 USD a night [10]. Also, putting things into perspective, the 14.9% average daily rate increase announced by the company in 2014 looks a lot less dramatic if one considers that it represents only 8.25 USD per night. The point is that, if well managed, growth from such a low base could be long-lasting given limited new supply and the current composition of the growing demand.

The pulse of the market suggests that while luxury hotels will continue to do well, the strongest growth opportunity most probably lies within the midscale segment. Abenomics appear to have made Japan affordable again. It has not only expanded the overall pool of foreign visitors, but also propelled a new market where more budget conscious travelers can participate.

Takeaway #4

Retail is hot – in spots

In our research around the globe, we often see examples of foreign visitors having significant impacts on local shopping. Driven by favorable exchange rates or taxes, or access to goods they cannot find at home, shoppers can be a mobile bunch. For instance, we have seen the effect of this phenomenon on the Hong Kong retail market. Millions of tourists per year flock to Hong Kong from Mainland China, not only to buy luxury watches, jewelry and hand bags, but also to stack up on daily necessities. A good part of Hong Kong's buoyant retail growth from 2009 to today has been driven by the Chinese shopping tourists.

Shortly after touching down on a Sunday afternoon, we went for a stroll down Chuo Dori in the heart of Ginza. Relative to our last few trips, we saw many more visitors from China and the rest of Asia. The experience felt a bit like Causeway Bay or Kowloon in Hong Kong. It definitely left an impression and sparked more conversations and questions.

The data support our impressions of higher retail activity. Tourist spending reached more than 2 trillion Yen in 2014, roughly double the amount of 2012. It is estimated that shopping accounts for 33.5% of the total spending, making it the largest component before accommodation and meals[11]. More precisely, clothing and accessories as well as cosmetics and pharmaceutical products take the lion's share, all together accounting for 50% of the money spent.

Our visits and meetings with retail focused J-REITs and shopping malls general managers enable us to add some color to the headline numbers. Our first impression in Ginza proved to be accurate. Retail landlords do see the positive impact of more foreign tourists, particularly those from Asia, visiting their stores and spending money. Like Hong Kong, Chinese visitors seem to be by far the main spenders. They typically buy large quantities of similar items — they "buy by the box" as they say locally. These items range from cosmetics, medication and clothing to home appliances and electronics goods. We have read reports of many shops seeing inventory shortages for such products.

A new expression even emerged across Japan to specifically describe the phenomenon: "Baku-gai" which largely stands for "explosive buying." Given the tax exemptions on many of these products and the

Chuo Dori street sees brisk shopper activity on a weekend afternoon. Source: japan-guide.com

[9] As at March 16, 2015.
[10] Japan Hotel Market Overview, Jones Land Lasalle KK Hotel and Hospitality Group, December 2014.
[11] Daiwa estimates from our meetings in January 2015.

prestige factor of them being bought in Japan, we suspect that Chinese shoppers are either buying many gifts for friends and relatives or reselling part of the merchandise in the Mainland.

From a retail landlord's perspective, while depicting a strong growth picture for the overall foreign spending figures, such a buying behavior largely concentrates the wealth in the hands of a few shopping locations. During our meetings, we learned that retail sales in the core Tokyo districts of Ginza or Omotesando, the center of Osaka as well as tourist hubs such as Kyoto are doing very well. For these centers, positive rental growth is likely. On the other hand, fringe or sub-regional locations are seeing very little impact, still mostly catering to a local clientele and hurting from the consumption tax hike of last April. At this point, there is little evidence that this divergence between core and non-core will recede. Speaking from an earnings growth perspective, we think investors and J-REITs should continue to expect very little from more remote shopping districts despite the surging headline growth in tourist spending. Here, investors should follow the crowds.

Conclusion

We have always seen Japan as a spectacular tourist destination. It has natural assets such as a rich culture, good food, clean air, and low crime. Now with economic and structural reforms, the stars have aligned for Japan's tourist industry.

In part thanks to Abenomics, it is no longer the expensive destination it once was and offers good value for money. Over the last two years, this allowed the country to broaden the range of its visitors, with important emerging middle classes joining the party. Sitting on strong foundations, we believe the rally has legs and that it is still early days.

That said, as high-conviction real estate investors, we remain selective. We are focused on a few targeted opportunities that are meaningfully benefitting from the strong headline trend. Examples include midscale hotels, offices that cater to tourism-related tenants, and gateway retail hot spots such as Ginza, Omotesando, Osaka center, and Kyoto.

"Buying by the box" in Tokyo's Ginza shopping district. Source: japantimes.co.jp/life

Initial research trip dates were from December 1 to December 10, 2014. Follow-up research and in-country visits conducted in January, March and May of 2015.