

Japan's Hotel Market After The Quake

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Glossary

ADR	Average Daily Rate
BCP	Business Continuity Plan
GDP	Gross Domestic Product
RevPAR	Revenue Per Average Room

Executive Summary

The total damages due to the earthquake on March 11th in Japan are estimated at JPY16 to 25 trillion (USD190 to 300 billion) and that will result in almost zero GDP growth in Fiscal Year 2011 starting from April 2011. However, the economy in Fiscal Year 2012 will be boosted by massive recovery works.

Because of the earthquake and the subsequent radiation concerns in Fukushima, Japan saw 73% drop in inbound visitation during March 12th to 30th as compared to the previous year. Together with suspension of domestic travelling, Tokyo Full-service Hotel market saw 38% drop in Revenue Per Available Room (“RevPAR”) in March 2011.

In case of the 9-11 Incident, it took three years for New York City to recover RevPAR to the level of 2000, a year before the incident. If Japan can quickly address the radiation concerns, there is a good chance on a quicker recovery of inbound volume.

The valuation of a hotel asset will be affected mainly by a change in income projections, not by discount/capitalization rate movement. Balance-sheet lenders would take a wait-and-see attitude, therefore, there won't be many forced hotel assets for sale in the next six months.

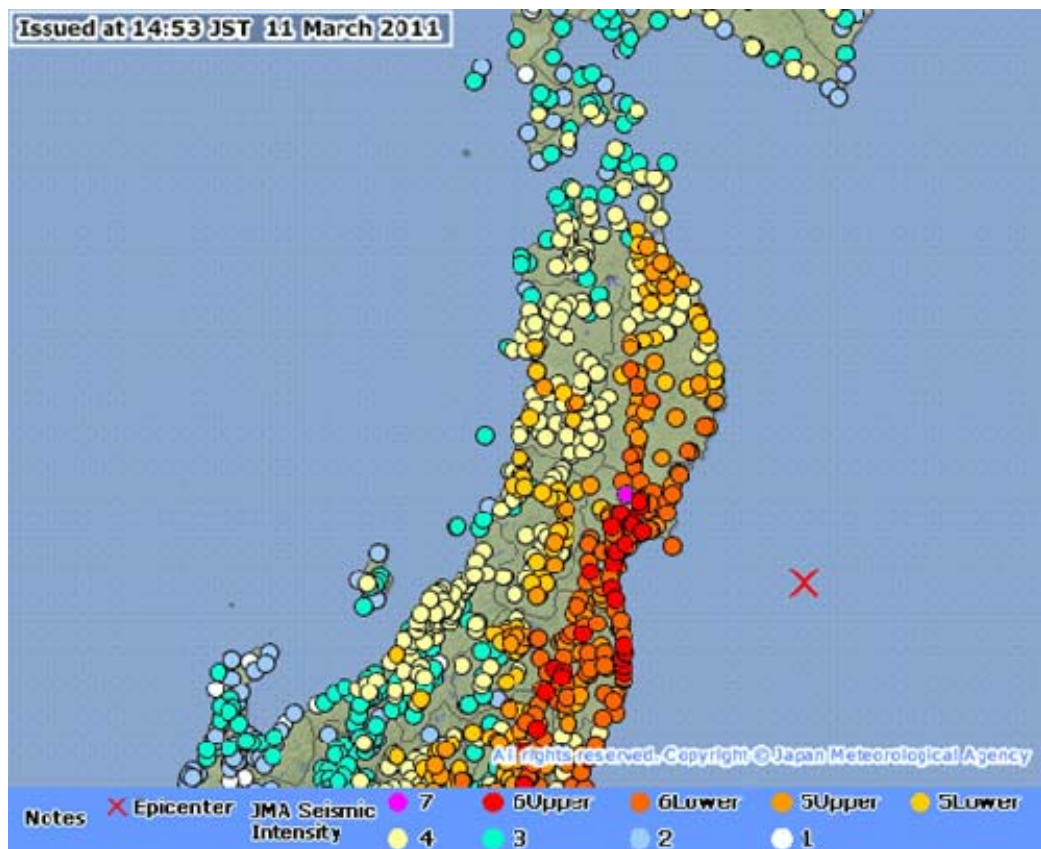
Preface

The 3-11 Earthquake in Japan

On March 11th, 2011, a Magnitude 9.0 earthquake, which is one of the greatest in recent history, hit the eastern part of Japan, and more than 28,000 people have since been reported deceased or missing, mainly due to the tsunami immediately after the first quake. There have since been numerous aftershocks, causing further disruption to the 140,000 displaced residents living in 2,300 shelters in 18 prefectures as of April 13th.

The tsunami hit the six nuclear power generators in the coastal line of Fukushima Prefecture, and in four the cooling function failed, which resulted in a radiation leak due to overheating of the nuclear fuel rods. Tokyo Electric Power Corporation (“TEPCO”) and the Japan Government continue to try and regain the control over the reactors.

Map : Seismic Intensity Map of the 3-11 Earthquake in Japan



Source: Japan Meteorological Agency

Objectives

In this report, we would like to address the following issues.

- i. Identification of the influential factors on tourism and hotel business in Japan
- ii. Hotel trading performance to date and outlook
- iii. Implication to hotel investment activities in Japan

This report has been prepared based on the information available to us as of April 25th 2011. Since the situation surrounding the earthquake issue changes everyday, we plan to issue follow-up reports as and when an update is required.

Influential Factors on Tourism and Hotel Business

Factors under consideration

1. Structural Strength of Buildings

It is reported that more than 90% of the deceased and missing were drowned due to the tsunami. This contrasts with the Magnitude 7.3 earthquake in Kobe, Japan on January 17th, 1995, where approximately 80% of the 6,400 victims were killed by collapsing buildings. Most of the crashed buildings were either wooden-structure houses or old buildings built before the new anti-earthquake building code was enacted in 1981. In this sense, the new building code is proven to be effective, even against a 9.0 earthquake.

Hotel investors have been and will be cautious regarding building code compliance. The calculation of Probable Maximum Loss is based on the destruction of economic value in the event of a once in 475 years earthquake. Clearly the recent quake was the case of such a great one.

2. Soil Liquefaction (“ekijoka” in Japanese)

Some of reclaimed areas experienced soil liquefaction - a phenomenon where soil loses its strength after violent shaking. For example, the city of Urayasu, Chiba, where Tokyo Disney Resort (“TDR”) is located, experienced this phenomenon across about 75% of its surface land. As a result, the gas, water, and sewage infrastructure underground was severely damaged. Reportedly TDR itself had a reinforced soil system so it was spared this problem and was able to reopen on April 15th.

While the majority of reclaimed land did not have this problem, hotel investors should check the liquefaction risk in this kind of reclaimed area upon acquisition.

3. Aftershocks (Subsequent Quakes)

As of April 21st, there have been 503 earthquakes of magnitude 5.0 or greater observed in the region since March 11th. The greatest to date was a magnitude 7.4 earthquake observed on April 7th. The Japan Meteorological Agency cautions that there could be relatively strong subsequent quakes for the next 6-12 months. This risk alone may cause a slow-down of inbound business, especially in the leisure segment, setting aside the radiation leak issue (see below).

Also, a great aftershock would jeopardize ongoing reconstruction of infrastructure, and, in particular, further threaten the troubled nuclear reactors.

4. Radiation Leak

As of April 25th, people within a 30km radius of the troubled nuclear reactors in Fukushima Prefecture have been ordered or recommended, dependent to the area, to evacuate.

Insignificant level of radioactive materials have been detected on some vegetables and dairy products from the surrounding area and their sale has been banned. Radioactive materials were also detected in the water in the Greater Tokyo area early April, but this only lasted a few days and no further detection was reported. In general, while the situation is still challenging in the coastal area of Fukushima, Tokyo is more than 200km away and life has broadly returned to normal.

On April 12th, the radiation leak was upgraded to a Level 7 emergency from Level 5, putting it at the risk level on par with the events in Chernobyl, Ukraine in 1986. This re-categorization gave the rest of the world the inaccurate impression that the situation was getting worse. In contrast, it was understood in Japan that the government had been slow to recognize the severity of the incident. The International Atomic

Energy Agency stressed on the same day that Fukushima was not a risk of a reactor explosion and that to date, there had been no fatalities caused by the radiation leak. Therefore, the situation is very different from Chernobyl.

Having said that, the fight to regain control over the reactors continues. On April 17th, TEPCO announced a roadmap to stabilize the nuclear power plants. The first three months until mid-July will be used for continuous cooling to diminish the radiation leak, and the next three to six months will be used to achieve normalized temperatures in the reactor pods. Thereafter, the government will make a judgment whether it is appropriate to allow people to re-enter the 30km exclusion zone around the reactors. This roadmap indicates that TEPCO believes it can manage the radiation issue within 30km radius in the next six to nine months, and, more importantly, the radiation exposure risk outside of the circle is considered low.

5. Shortage of Electric Power

The four troubled nuclear reactors at Fukushima are off-line. At the same time, other power generators in the affected area ceased operation. Thermal power generators are coming back on line, but they are not enough to cover the expected demand in summer. TEPCO initially estimated that their maximum power generation capacity would be 46.5 million KW as of the end March, but it recently revised the estimation to 52 million KW on April 15th. Regardless, it is still short of the estimated maximum demand at peak time during summer, which is 60 million KW.

Kansai Electric Power Company based in Osaka can share some electricity with TEPCO, but their electric frequency is different from TEPCO. Therefore, the bottleneck is the capacity of the frequency converters and it is unlikely that Kansai Electric can make up the supply gap.

The Japanese Government has encouraged both large corporations and individual households to save electric power during the upcoming summer season when power-consuming air-conditioning systems will be heavily used. This energy saving effort may dilute productivity and in turn delay economic recovery. But, at the same time, it seems a good opportunity for both corporate and household sector to introduce LED or some other energy saving products. Such changes could have long-term benefits for the economy.

This energy saving effort is already underway. For instance, railway companies have reduced the frequency of subway/train services; office buildings have turned off half the lights in their common areas; and convenience stores have turned off their lighted signage. Yahoo! Japan updates an electric power consumption measure within TEPCO's service area every hour on its top page.

6. Voluntary Restraint on Leisure Spending

Japan has entered a period of mourning for the deceased. As a result, high-end restaurants and bars, especially those catering to corporate entertainment, have had a tough time. Over time, this kind of consumer spending will gradually normalize.

The Japan Tourism Agency reported that domestic traveler numbers declined 25%-40% in the fourth week of March from the first week of the month, although late March is a spring break for students. Reportedly, travel reservations in April and May declined 20% to 45% from a year earlier as of April 7th.

Prime Minister Naoto Kan stated on April 8th that extreme voluntary restraint on leisure and celebrations would negatively affect the pace of economic recovery and encouraged people to behave normally while showing respect and sympathy for the bereaved families and refugees.

7. Demands from Refugees and Recovery Workers

As hotels within or close to the disaster zone accommodate aid workers and refugees, they tend to have a high occupancy. For instance, hotels in the city of Sendai, the capital of Miyagi Prefecture, one of the three severely affected prefectures, are running at almost 100% occupancy rate. This situation is expected to continue throughout the reconstruction.

Some of hotels in the Greater Tokyo area are also accepting refugees. For instance, Grand Prince Akasaka had ceased operations on 31st March for redevelopment. However, it decided to accommodate up to 700 families mainly from Fukushima Prefecture until the end of June when demolition work starts. This is only a temporary source of demand.

8. Expatriate Evacuation

Due to the poor handling of information on the radiation leak, many countries such as France and Germany recommended the departure of their citizens in the wake of the earthquake. For example, the German Embassy in Tokyo shut down and

relocated to Osaka until it partially reopened on April 11th. Meanwhile, a more measured approach was adopted by the United States and British governments. The US dispatched a military team of more than 10,000 to rescue isolated people in the affected area. By April 20th, all embassies except for Angora, Kosovo, the Dominican Republic and Burkina Faso had resumed their operation in Tokyo.

Irrespective of their home country's recommendation, many expatriates evacuated from Japan. Many have since returned to Japan, but there is likely to be a small but permanent relocation of some expatriates and foreign students as a result of these events.

9. Drop of Inbound Volume

Most inbound travels to Japan were cancelled regardless of the distance from the troubled nuclear reactors in Fukushima. Many multinational corporations including Jones Lang LaSalle issued a travel warning, banning unnecessary/non-urgent travel to Japan in the immediate aftermath of the quake.

As many inbound leisure travelers cancelled their trips, hotels reliant on inbound business have had a difficult time. For instance, Huis Ten Bosch, a Dutch Themed Park in Nagasaki, Kyushu, which is 1,000km away from Fukushima (almost the same distance to Busan, Korea), suffered a 90% cancellation rate after March 11th.

Many foreign airlines have cut back services to Tokyo (Narita/Haneda) and airline crew did not stay at Narita, which was considered unsafe. For instance, Lufthansa's flight from Frankfurt/Munich to Narita was diverted to Kansai/Nagoya from March 14th to 24th, and returned to Narita but via Seoul where crew stayed from March 25th to April 15th. As of April 25th, the majority of foreign airlines are back to normal in terms of routing but with smaller fleets and less frequency in some cases. These changes have invariably had an impact on facilities in Narita and Greater Tokyo.

On April 14th, the Japan National Tourism Organization announced that the number of inbound visitors to Japan in March 2011 was 352,800, 50.3% down as compared to March 2010. The number was up 4% until March 11th, and the rest of the month recorded a 73% drop as compared to the previous year.

It was reported on April 20th that a travel agent in Hong Kong had started group package tour arrangements to Hokkaido, Osaka and Okinawa, which are far from Fukushima, with a refund guarantee in case an earthquake greater than JMA Seismic Intensity (Richter Scale) 5.0 hits during the tour.

For inbound volumes to return to normal, it is critical for Japan to explain the safety of the radiation leak to the rest of the world.

10. Office Demand Shift from Tokyo to Osaka/Fukuoka

Many multinational corporations headquartering in Tokyo responded to the earthquake/radiation issue quickly. They put their Business Continuity Plan ("BCP") in motion and some financial institutions tried to secure high-quality offices and residences in Osaka/Fukuoka to shift some headquarter functions from Tokyo. Due to the license from Financial Services Agency, their core team cannot be stationed outside of Japan.

In conjunction with the office demand shift from Tokyo to Osaka/Fukuoka, they blocked many hotel guestrooms within/near to the two cities. While the hotels in the western part of Japan suffered a cancellation of inbound business as well, this corporate office demand shift related business made up for the drop to some extent. However, this demand was temporary and seems to have diminished 4-6 weeks from the disaster.

11. Damages and Recovery Works

The Japanese Government announced on March 23rd that the total damages due to the earthquake are estimated at JPY16 to 25 trillion (USD190 to 300 billion), which is much larger than the Kobe earthquake in 1995, which was JPY10 trillion (USD120 billion) and for the 9-11 Incident in the state, which was USD60 billion. As a result, the Nissay Life Insurance Research Institute revised its forecast for Japan's GDP growth in Fiscal Year 2011 (starting from April 2011) and FY2012 to +0.1% from +1.7% and +2.7% from +1.7%, respectively. The economy in FY2012 will be boosted by massive recovery works required in infrastructure, housing and other areas.

Comparison with the 9-11 Incident

There have been several cases in the world where one incident changed the whole picture for the local hotels industry, such as the terrorist attack in Luxor in 1997; 9-11 in New York City in 2001; the bombings in Bali in 2002 and 2005; the SARS epidemic in Asian cities in 2003; the tsunami in Phuket in 2004; and the bombings in London in 2005.

While the details of the event and the subsequent recovery vary by incident, in the cases above it took between six months and three years to see a full recovery in tourism.

Amongst these incidents, 9-11 seems to have many similarities with the 3-11 earthquake, so it might be a good reference point to predict the recovery pace for this time event.

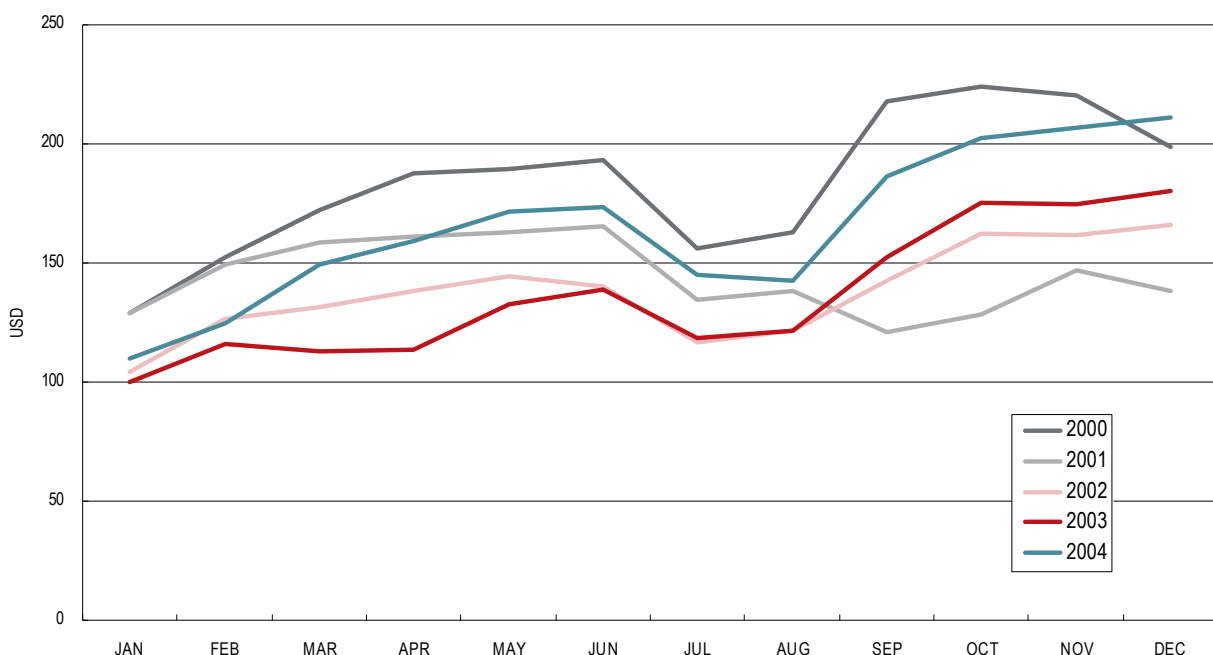
Here are the similarities between the two events:

- One of the largest financial centers in the world was hit by a disaster. Tokyo was not heavily hit by the disaster itself, but foreign perception of the radiation leak as well as actual electricity shortages will have a direct impact to Tokyo's, and to some extent, Japan's tourism industry.

- The psychologically affected area is large. Right after 9-11, people thought any air travel to major cities in the states would be risky. Likewise, foreigners are nervous about potential exposure to radiation anywhere in Japan.
- It is a fight against an "invisible" enemy, and we are not sure when this fight would end. If a cause of problems is a natural disaster itself, it is regarded one-off event. But its by-product, people's fear, can continuously cause problems.
- The incident has wide-reaching impacts for other countries. Air safety standards were reconsidered world-wide after 9-11, while the safety of nuclear plants will now be an issue in many countries. Also the 3-11 earthquake reminded people of the fragility of global supply chains. A missing part which is produced by a factory in Tohoku causes a delay of the entire car manufacturing process, for example.

In case of 9-11, New York City's RevPAR (Revenue Per Available Room) in September 2001 marked 45% drop from the same month of 2000, and it took three years to recover RevPAR to the level of 2000, a year before the incident.

Chart1 : RevPAR of Full-Service Hotels in Manhattan (USD)



Source: Smith Travel Research, Jones Lang LaSalle Hotels

It should be noted that the decline of RevPAR had started in February 2001, seven months before the incident. Even so, it was April 2004 when RevPAR recovered to 2001's level.

The main reason for the delayed recovery could be the wars in Afghanistan and subsequently in Iraq, which started right after the 9-11 incident, as people felt that a risk of terrorist attacks would be high until these wars end. The catastrophic events would have had a lasting impact on the perceived safety of NYC – something only time can heal. This caused a gradual recovery, rather than a V-shaped recovery in RevPAR, as occurred after SARS. Therefore, 9-11 might be the worst case scenario for Tokyo's and Japan's tourism in terms of RevPAR recovery, if Japan fails to manage the radiation leak issue from the viewpoint of foreign visitors.

In short, if Japan can quickly address the radiation concerns, there is a good chance we will see a quicker recovery of inbound volume. In fact, in case of the Luxor incident in 1997 and the bombing in Bali in 2002, it took just one year to see a recovery of the number of visitors.

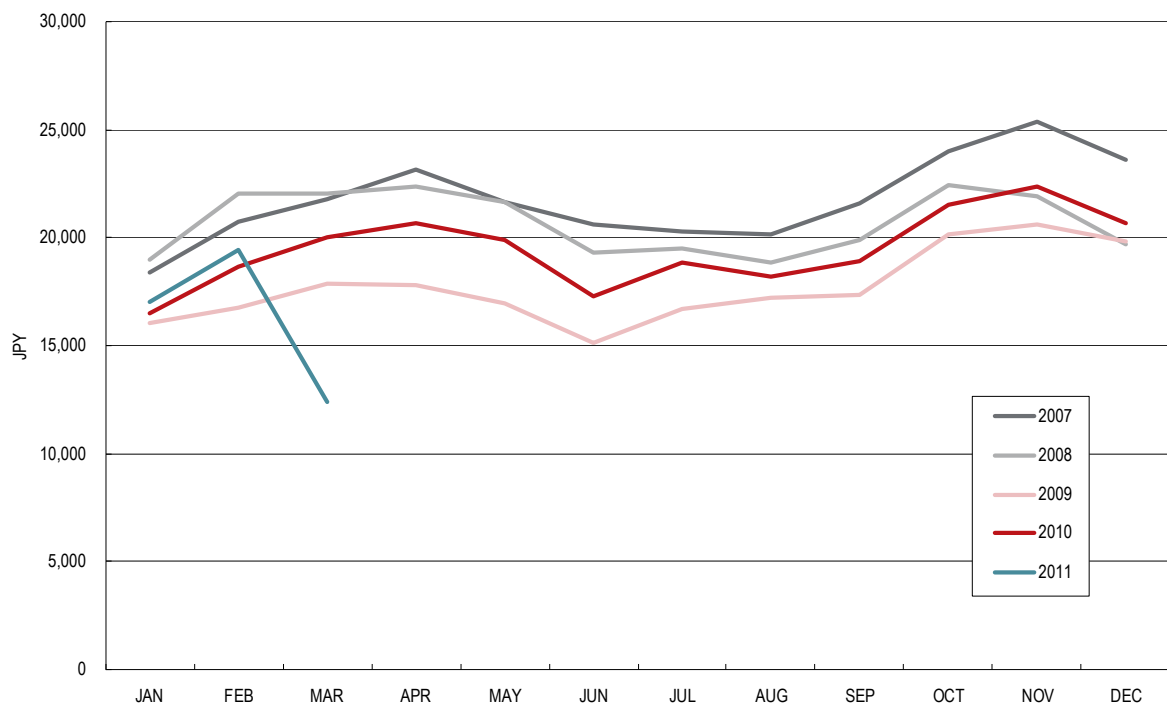
Hotel Trading Performance To Date and Outlook

In the first 30 days from March 11th, there have been a couple of common issues which significantly lowered hotel occupancy in Japan, regardless of location. First, the majority of bookings by inbound guests were cancelled. This caused a big impact on international luxury hotels in Tokyo. Second, many domestic business trips were also cancelled because transportation systems such as trains and express highways were not functioning properly. For example, the Odakyu Railway suspended its Romance Car express service from Shinjuku to Hakone-Yumoto until April 15th, and this affected Hakone as a popular destination not only for inbound leisure travelers but

also for people who live in Greater Tokyo. Reportedly there were 288,500 guest cancellations in Hakone in the March to June period. Third, people cancelled leisure activities as they were not in a mood to enjoy travelling.

As a result, the March result of Tokyo Full-Service Hotel trading performance showed a 38% drop in RevPAR as compared to the same month of last year.

Chart2 : RevPAR of Full-Service Hotels in Tokyo (JPY)



Source: Smith Travel Research, Jones Lang LaSalle Hotels

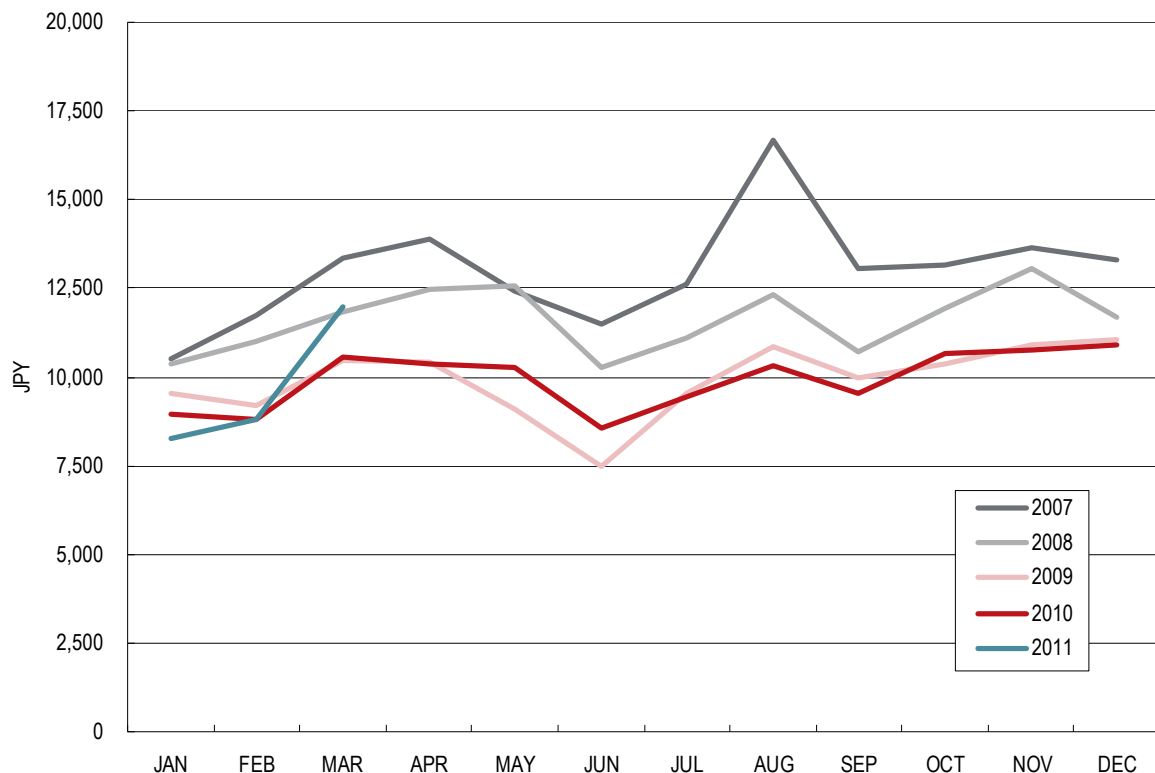
In contrast, Osaka’s Full-Service Hotel market showed 13% improvement. The Osaka market is historically less reliant on leisure and inbound travellers, which are the two most damaged segments due to the 3-11 earthquake. In addition, several multinational corporations secured guestrooms in Osaka as a part of BCP even at a rack rate, and some school excursions shifted their destination from Tokyo Disney Resort to Universal Studios Japan in Osaka. However, these special demands in Osaka will diminish as the situation surrounding the radiation leak in Fukushima calms down. Those who have to stay in Osaka to maintain their offices are settled in serviced apartments or permanent residences.

As of April 25th, the situation seems improving in the eastern part of Japan. Most foreign countries have lifted their travel warnings (excluding the area around the Fukushima Dai-ichi Nuclear Power Plants), public transportation systems such as Tohoku Shinkansen Bullet Trains and Tohoku Express Highways are back in operation, and the mood in Japan is shifting from rescue/mourning to recovery/encouragement.

Some 10,000 people queued at the entrance of Tokyo Disney Land at 8am on April 15th when it reopened.

Several hoteliers we have interviewed have started to see a recovery of domestic business volume both in the leisure and corporate sectors. It is the domestic corporate business segment which seems likely to be the first to recover in full. A recovery of inbound corporate business is also expected during the second half of this year, while a recovery of inbound leisure may drag on into 2012. In the meantime, the MICE (Meeting, Incentive, Convention, and Exhibition) and corporate banquet business will be challenging for a while as many Japanese corporations will recognize extraordinary losses due to the 3-11 incident in Fiscal Year 2011 ending March 2012 and these segments have a longer lead time to materialize bookings. The wedding party business was the least affected and bookings are on track. A recovery of the Average Daily Rate will follow a recovery in occupancy as it is difficult to increase a room rate when occupancy is low. Therefore, we expect a recovery of RevPAR, which is a product of Occupancy and ADR, to the level of 2010 by the first half of 2013, in general

Chart3 : RevPAR of Full-Service Hotels in Osaka (JPY)



Source: Smith Travel Research, Jones Lang LaSalle Hotels

Here are our views on individual markets based on the above:

Tokyo Full-Service Hotel Market

Because of a lack of inbound and leisure demands, the occupancy rate is around 10-40% as of 15th April. Meanwhile, expatriates are coming back to the city and corporate inbound business is recovering. Also there are new bookings coming for the upcoming Golden Week holiday season (29th April to 8th May) mainly as leisure demands from the Greater Tokyo area. The inbound leisure segment will be the last to improve, but a Luxury/Upscale Hotel sector captures more FIT (Free Independent Travelers) than Groups and the FIT booking pace may improve faster than Groups'. In the next 12 months, this sector will experience a 20-30% drop in RevPAR as compared to the previous year, mainly due to a delayed recovery in inbound leisure and MICE bookings.

Tokyo Limited Service Hotel Market

Similar to the Tokyo Full-Service Hotel sector, the March result showed a 27% dip in RevPAR as compared to March 2010. However, this sector focuses on domestic corporate which will be the first to recover. Therefore we expect a relatively quick recovery in occupancy, while there are lingering concerns about room rates due to competition with full-service hotels which lack leisure demands. In the next 12 months, RevPAR will be struggling at 10-15% less the previous year's mainly due to room rates.

Tokyo Disney Resort Market

TDR shut down for five weeks after the quake and did not re-open until April 15th. TDR official hotels such as Hilton Tokyo Bay, Sheraton Tokyo Bay, and Tokyo Bay Maihama Hotel served meals and public bathroom facilities for those affected by the destruction of infrastructure by soil liquefaction in city of Urayasu, but this was not for profit.

Oriental Land Corporation ("OLC") who runs TDR announced that the operating hours of TDR will go back to normal from April

23rd and Tokyo Disney Sea will reopen on April 28th. This is good news, but it is short notice to try and pick up accommodation demands during the Japan's Golden Week holiday season (April 29th to May 8th) for the hotels near to TDR.

The longer-lasting impact on visitors' mindset and the potential shortage of electric power during summer time cause lasting concerns. However, people appear keen to enjoy Disney's magic experience, and OLC will procure three 5,000KW gas-powered electric generators at a cost of JPY3 billion and implement an energy saving plan. Therefore, accommodation demands in this area will recover gradually.

Osaka Full Service Hotel Market

The BCP related business was temporary and April result's will be back to normal to the level of 2010. The market will also be affected by the gradual recovery of inbound leisure. RevPAR in the next 12 months will be 5-10% down from the previous year result.

Okinawa Resort Area Market

Apparently there were many cancellations for Japan's Golden Week holiday season in early May right after the quake in March, as a result of the uncertainty at that time. As the situation is going back to normal, some cancelled demands may be picked up at the last minute, but not with a full recovery. With regards to the peak season in July and August, hoteliers expect 80% of bookings as compared to the previous year. In the next 12 months, RevPAR will be 10-20% down from the previous year result mainly due to room rate pressure.

Implication for the Hotel Investment Market

Since the 3-11 Earthquake, there have been three hotel acquisitions:

- Setsugetsuka, Hakone at JPY3,550 million, acquired by Japan Hotel and Resort REIT
- Comfort Hotel Tokyo Higashi Nihonbashi at JPY3,746 million, acquired by Japan Hotel Fund REIT
- Dormy Inn Kumamoto at JPY2,334 million, acquired by Japan Hotel Fund REIT

These transactions are unique because of a fixed rent income from the hotel operator/lessee, and, in the case of the Japan Hotel Fund, they are related party transactions where the sellers are the sponsor to the buyer. Nonetheless, the fact that the transactions were concluded after the quake is good news for the market.

Since the Global Financial Crisis in 2008, the majority of hotel assets sold at above USD30 million in Japan were acquired by Asian corporations, Asian High Net Worth Individuals, or Japanese owner-operators. Despite the 3-11 earthquake, they are still keen to invest. Except for the above-mentioned cases, investment funds including J-REITs have been inactive due to a lack of non-recourse debt financing.

We have been communicating with Asian investors about their appetite for hotel assets in Japan. While Korean and mainland Chinese generally have a negative view on Japan's tourism industry, Singaporean and Hong Kong Chinese are still keen to invest in Japan, subject to a solution of the radiation leak issue and the availability of new forecasts of the 2011 operating budget.

While cash flow projections must be carefully reviewed, we do not think that investors would increase the applicable discount/cap rate just because of the 3-11 incident. Therefore,

we believe that the valuation of a hotel asset will be affected mainly by a change in income projections, not by discount/cap rate movement.

Except for a hotel under a fixed-rent lease with a credit-worthy lessee, any hotel with fluctuating cash flow needs to wait for reforecast cash flows to be produced by the local manager. In this sense, hotels located in the western part of Japan where the impact of the earthquake was relatively small and reforecasting cash flow is relatively easy could be transacted during the second half of this year. In contrast, hotels located in the eastern part of Japan where the impact of the earthquake was relatively large and reforecasted cash flows will take time will not see major transactions until the first half of 2012, given the several-month lead time required to conclude a deal.

Some of hotels under a long-term fixed-rent lease agreement with a local hotel operator who is not financially sound may technically fall into default as the majority of lease agreements in Japan do not have a force majeure clause. In reality, such a lessee would request of the lessor a temporary rent reduction and that would cause the lessor to request the lender for special treatment in the loan agreement. These will likely be resolved on a case by case basis.

We understand that a numbers of hotels have maturing CMBS loans in 2011. It is expected that lenders will be tolerant of the current hotel trading environment and will not take strong action such as a foreclosure or deed in lieu of foreclosure. They may consider replacement of the asset manager if it is related to the borrower. Balance-sheet lenders would be also cooperative with the borrowers to wait for recovery of the cash flow and the asset value by extending the term for several months or refinancing the loan for another few years. Therefore, we do not expect that there are many forced hotel assets for sale in the market in the next 6 months.

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