CANADIAN MONTHLY LODGING OUTLOOK – FEBRUARY 2013

IF YOU BUILD IT, WILL THEY COME?

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If You Build It, Will They Come?

The relationship between demand and new supply

The economics behind the supply and demand relationship have long been a bone of contention among hoteliers. Will the creation of new supply automatically generate new demand? Will the influx of new demand stimulate an increase in supply? Although certain instances can make it appear that supply increases inevitably lead to increased demand, this only happens when specific market dynamics are present. The presence of latent demand is the primary reason that demand levels often mirror increases in supply within a market. Although many other variables directly affect supply and demand trends in the hotel industry, the analysis of latent demand is critical when forecasting future market-wide demand and occupancy levels for markets anticipating the entrance of new supply. The possibility of oversupplying a market is a significant risk that developers must be wary of when approaching new markets. An overbuilt market fosters a sluggish operating environment that lowers profitability for not only the developers of the new project but also those already present in the market.

How Supply Can Generate Demand

New hotels are able to bring new demand into a market through latent demand, which can be categorized as either unaccommodated demand or induced demand.

Unaccommodated demand is the potential room night demand that the existing market supply has not realized (e.g., a traveller who is unable to stay in a market because all the hotels are sold out). As unaccommodated demand does not yield any occupied room nights, it is not included in the accommodated room night demand levels. These guests would be able to secure hotel rooms if new supply entered the market. As this demand would not be realized without the addition of new rooms, the entrance of new supply is said to generate this demand, turning what existed as potential demand into actual accommodated room nights for the market.

Induced demand refers to the additional room nights that the entrance of a new demand generator is expected to bring to a market. A new hotel acts as a demand generator for the market, bringing in new business through its brand affiliation, reservation system, sales team, and unique facilities and amenities. Moreover, new hotels potentially increase the exposure and awareness of a market and open up new sources of potential demand. This is particularly the case with resort destinations, where the entrance of a fresh new product can renew interest in a market among tour operators.

Properly analyzing latent demand is critical to determining the potential effect of new supply on the market-wide occupancy. Although quantifying existing levels of unaccommodated demand and the potential of a new project to induce room nights can be difficult, as a general rule unaccommodated demand exists in markets with occupancies in excess of 70%. It is also important to ascertain from local hoteliers when the market generally sells out and how many room nights are being turned away. A highly seasonal market might contain significant unaccommodated demand during the summer months but insufficient year-round levels to support a new hotel project. Markets with year-round unaccommodated demand offer the best potential for hotel developers. The amount of induced demand that a new hotel will bring to the market depends on many factors, including brand affiliation, location, amenities and services offered, existing products in the market, and the size of the proposed project. The best way to forecast induced demand is to analyze the effects of comparable hotel projects on the same or similar markets.

Canadian Market Examples

In the Canadian context, there are two lodging markets that have shown a tremendous ability to quickly absorb a significant amount of new supply: the Calgary Airport market and the Edmonton South market (Figures 1 and 2).

Figure-1 Calgary Airport

Year	Average Daily Room Count	Supply	Change	Demand	Change	Market Occupancy
2007	1,239	452,235	—	350,840	—	77.6 %
2008	1,331	485,635	7.4 %	364,469	3.9 %	75.0
2009	1,339	488,735	0.6	349,988	(4.0)	71.6
2010	1,446	527,690	8.0	371,032	6.0	70.3
2011	1,587	579,168	9.8	419,222	13.0	72.4
2012	1,895	691,575	19.4	509,337	21.5	73.6
Average Annual Compounded Change			7.7 %		7.1 %	

Source: HVS

Figure-2 Edmonton South

Year	Average Daily Room Count	Supply	Change	Demand	Change	Market Occupancy
2007	1,166	425,590	—	353,357	—	83.0 %
2008	1,166	425,590	0.0 %	334,221	(5.4) %	78.5
2009	1,208	440,897	3.6	294,093	(12.0)	66.7
2010	1,476	538,630	22.2	349,738	18.9	64.9
2011	1,562	570,130	5.8	389,125	11.3	68.3
2012	1,562	570,130	0.0	402,459	3.4	70.6
Average Annual Compounded Change			6.0 %		2.6 %	

Source: HVS

As shown in the above tables, both the Calgary Airport market and the Edmonton South market absorbed a large amount of new supply without having the market-wide occupancy level drop to an unsustainable level. In both instances, significant supply growth went hand in hand with increases in demand. Both markets recorded strong occupancy levels in 2007 and 2008, which was a signal to developers that the market contained sufficient levels of unaccommodated demand to support new hotels. In addition to new supply, these markets had to deal with the slowdown in oil activity combined with the impacts of the global recession. The ability of these markets to absorb new supply is highlighted by the years in which the rate of demand growth exceeded the significant supply growth, resulting in increases in the market-wide occupancy.

It is important to note that most markets would not be able to absorb that much new supply with such ease. These particular markets are located in the economic hotbed of Alberta, where booming economic conditions have resulted in extremely favourable hotel operating environments. In addition, both the Calgary Airport and Edmonton South markets are in areas that have land available and that are being rapidly built out. Nevertheless, these markets exemplify how increases in supply can bring about growth in demand if the right market conditions are present. The new hotel projects were able to both capitalize on the high levels of unaccommodated demand and induce a significant number of new room nights into the market.

Risks

Overbuilding is a risk for any developer looking to enter a market, especially when the primary sources of demand are erratic and not well diversified. The levels of base demand and latent demand must be sufficient to sustain the increases in supply for hotel development to be lucrative. Otherwise, the market-wide occupancy will plummet, creating a hostile operating environment where hoteliers must undercut room rates to compete for guests. This can lower profitability and render a developer unable to recover the cost of the investment. Oversupplying a market also negatively affects those who are already invested in the market.

Developers need to approach single-demand-source markets with caution, including the booming tertiary markets that cater to the oil and gas industry in Western Canada. Although there may be considerable unaccommodated demand present while the industry thrives, developers should consider what demand levels will be like when fortunes reverse for the industry. Hotels in these markets are extremely vulnerable to downturns in the single industry on which they depend. The risk of oversupply rises dramatically with the overdependence on a cyclical single demand generator. A diversified demand base allows hoteliers to pursue other sources of demand when one sector flags, helping to maintain the occupancy level necessary to remain profitable.

Conclusion

In short: if you build it they will come, but only if the correct market conditions are in place. New supply will generally attract new demand into a market. The ability of new supply to generate its own future demand and allow for a sustainable market-wide occupancy level largely depends on the existing levels of latent demand present within a market. A high amount of unaccommodated demand will result in an opportunity for new supply to enter the market and capture this demand that would otherwise remain unaccommodated. The performance record of the Calgary Airport and South Edmonton markets proves that markets can successfully absorb new supply even when the supply growth is in excess of 50%. The risk of overbuilding is nevertheless a factor that must be weighed whenever a new hotel is being considered for development. Developers can minimize this risk by looking for markets that have high levels of latent demand, a well-diversified demand base, and a historical record of being able to absorb new supply.

About the Author

Eric Wright is a hotel Consulting and Valuation Associate with the HVS Vancouver office in Canada. Eric received his bachelor's degree from the Hotel Institute de Montreux, Switzerland, and has spent several years in various hospitality roles in Switzerland, Thailand, the United Kingdom, and Canada

Canadian Lodging Outlook February 2013

STR and HVS are pleased to provide you with the month's issue of the Canadian Lodging Outlook. Each report includes occupancy (Occ), average daily rate (ADR), and revenue per available room (RevPAR) for three major markets and the Provinces.

If you would like a detailed hotel performance data for all of Canada, STR offers their Canadian Hotel Review. The Canadian Hotel Review is available by annual subscription which includes both monthly and weekly issues. Each monthly issue of the Canadian Hotel Review also includes an analysis provided by HVS. For further information, please contact: info@str.com or +1 (615) 824-8664 ext. 3504.

February 2013	Occupancy Rate (%)		Average Room Rates ($CAD)		REVPAR ($CAD)		Room Supply	Room Demand	Number of Rooms	
	2013	2012	2013	2012	2013	2012	% chg	% chg	Sample	Census
Montreal	58.7%	58.3%	$128.07	$126.47	$75.17	$73.77	0.5%	1.1%	16,884	27,867
Toronto	63.5%	61.0%	$132.79	$129.97	$84.33	$79.33	0.5%	4.6%	31,501	36,709
Vancouver	56.0%	56.6%	$123.58	$123.39	$69.18	$69.89	0.2%	-0.9%	19,868	26,330
Provinces										
Alberta	63.8%	61.1%	$137.25	$132.60	$87.60	$81.06	-0.1%	4.3%	39,312	68,250
British Columbia	52.8%	53.9%	$131.58	$128.78	$69.50	$69.47	0.7%	-1.4%	38,185	82,727
Manitoba	63.1%	63.1%	$115.03	$116.16	$72.56	$73.30	2.9%	2.8%	5,659	13,847
New Brunswick	47.2%	47.7%	$108.22	$108.92	$51.09	$51.99	-2.2%	-3.3%	5,186	10,385
Newfoundland	66.2%	59.3%	$128.73	$125.00	$85.15	$74.14	1.6%	13.3%	1,877	5,634
Nova Scotia	52.0%	52.4%	$111.09	$109.02	$57.71	$57.14	1.2%	0.3%	6,289	10,699
Northwest Territories	INS	INS	INS	INS	INS	INS	INS	INS	204	1,373
Ontario	56.4%	55.7%	$121.44	$120.65	$68.55	$67.25	0.9%	2.2%	85,591	133,518
Prince Edward Island	37.8%	44.5%	$95.07	$91.45	$35.94	$40.68	0.0%	-15.0%	889	3,727
Quebec	58.5%	59.5%	$130.98	$129.31	$76.66	$76.93	0.2%	-1.4%	27,727	75,035
Saskatchewan	65.7%	64.9%	$129.98	$122.76	$85.38	$79.62	4.6%	5.9%	8,359	17,177
Yukon Territory	INS	INS	INS	INS	INS	INS	INS	INS	460	1,660
Canada	**57.6%**	**57.1%**	**$127.07**	**$124.82**	**$73.21**	**$71.27**	**0.7%**	**1.6%**	**219,738**	**424,446**

February 2013	Occupancy Rate (%)		Average Room Rates ($CAD)		REVPAR ($CAD)		Room Supply	Room Demand	Number of Rooms	
Year-To-Date	2013	2012	2013	2012	2013	2012	% chg	% chg	Sample	Census
Montreal	51.7%	52.7%	$126.63	$124.93	$65.49	$65.83	0.5%	-1.4%	16,884	27,867
Toronto	60.1%	58.1%	$131.75	$128.51	$79.16	$74.72	0.5%	3.9%	31,501	36,709
Vancouver	52.2%	52.7%	$122.84	$121.91	$64.11	$64.27	0.4%	-0.6%	19,868	26,330
Provinces										
Alberta	58.7%	56.0%	$136.13	$130.71	$79.84	$73.21	0.1%	4.9%	39,312	68,250
British Columbia	48.7%	50.0%	$130.98	$128.22	$63.84	$64.05	0.8%	-1.7%	38,185	82,727
Manitoba	57.0%	57.0%	$114.77	$114.71	$65.41	$65.43	3.0%	2.9%	5,659	13,847
New Brunswick	42.8%	44.1%	$106.74	$107.90	$45.68	$47.62	-2.7%	-5.7%	5,186	10,385
Newfoundland	60.6%	54.9%	$127.96	$124.04	$77.50	$68.14	1.6%	12.0%	1,877	5,634
Nova Scotia	46.7%	47.2%	$110.06	$107.74	$51.44	$50.84	1.2%	0.2%	6,289	10,699
Northwest Territories	INS	INS	INS	INS	INS	INS	INS	INS	204	1,373
Ontario	52.4%	52.0%	$119.90	$118.98	$62.85	$61.84	0.9%	1.8%	85,591	133,518
Prince Edward Island	34.7%	40.2%	$91.95	$89.18	$31.90	$35.82	0.0%	-13.6%	889	3,727
Quebec	51.4%	53.0%	$128.51	$126.98	$66.09	$67.30	0.2%	-2.8%	27,727	75,035
Saskatchewan	61.6%	61.6%	$129.25	$122.98	$79.57	$75.81	4.3%	4.2%	8,359	17,177
Yukon Territory	INS	INS	INS	INS	INS	INS	INS	INS	460	1,660
Canada	**52.9%**	**52.6%**	**$125.72**	**$123.28**	**$66.45**	**$64.86**	**0.7%**	**1.2%**	**219,738**	**424,446**

*INS = Insufficient Data

About STR

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