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The Canadian Lodging Industry: Slowing Growth with a Stable Outlook

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The Canadian lodging industry has reached peak performance levels—RevPAR and profitability are at all-time highs. However, growth has slowed since the summer, and operating performance appears to be shifting into a lower gear.

Economic growth has shifted into a lower gear in Canada

The slowing pace of growth in the lodging sector is consistent with the economic performance of Canada in 2019. According to the Conference Board of Canada, the national GDP is projected to grow 1.4% in 2019, down from 1.9% in 2018. Challenges facing the energy sector, trade, and housing market have slowed the growth of the Canadian economy in 2019.

The Canadian energy sector, which is based largely in the province of Alberta, has been subject to a persistent downturn. Alberta crude was trading at a substantial discount on the world market, driven by oversupply and transportation bottlenecks resulting from limited pipeline capacity. To narrow this pricing gap, the Province of Alberta implemented mandatory oil-production restrictions, which successfully reduced the pricing gap but also scaled back exports, negatively affecting the economy. These factors have shaken the confidence of investors and limited capital spending in the energy sector; investment declined for the fifth consecutive year in 2019.

Trade uncertainty also remains a concern for the Canadian economy. Increased protectionism, both from the U.S. and China, as well as Brexit issues in the UK and European Union, has created uncertainty for Canadian exports. Improvement is expected in 2020 as Canada seeks to have the Canada–United States–Mexico Agreement (CUSMA) ratified.

Prior to 2019, the Canadian housing sector had been experiencing strong growth, especially in the major metropolitan areas of Greater Vancouver and Toronto. Faced with concerns over affordability and debt levels, provincial and federal governments implemented policies to cool over-hot housing markets. These initiatives have worked to slow the housing market, but the resulting 4.2% decline in residential housing investment has created headwinds for GDP growth.

Despite these challenges, employment was one of the bright lights for the national economy in 2019—a record 389,000 new jobs were created. The national unemployment rate should end the year at a remarkably low 5.6%, and further declines are expected in 2020 and 2021. Canada is projected to maintain moderate economic growth through 2020 with a 1.8% increase in GDP.

Liquidity abounds in the Canadian debt market

Given the uncertainty in the global economy and the slower growth of the Canadian economy, the Bank of Canada held its overnight interest rate at 1.75% throughout 2019. In the lodging sector, investors are finding liquidity that has not been available in Canada since the 1980s. Today, multiple debt options are available with competition among the options, resulting in compression of lender credit spreads. Market norms for spreads range between 175 and 275 basis points over 5-year Government of Canada bonds, resulting in interest rates ranging from 3.25% to 4.25%. Typical loan-to-value ratios on quality assets are 60% to 70%, with mezzanine options available for higher leverage. Amortization periods range from 15 to 25 years; 25 years is common for newer, quality assets.

Significant new hotel supply is on the horizon

Historically, the conservative nature of the Canadian banking sector has held hotel supply growth in check in Canada. With the recent increase in liquidity, however, many markets in Canada, especially those in Eastern Canada containing older hotel products, have a growing amount of supply in the development pipeline. Year-to-date through October 2019, the national room supply increased by 1.5% relative to the comparable period in 2018, and supply growth is projected at 1.9% in 2020 and 2.3% in 2021. Supply growth has shifted away from the resource markets of Alberta, Saskatchewan, and Newfoundland to the provinces of Ontario and Quebec, which now account for more than 60% of the hotels under development. British Columbia has experienced some of the strongest RevPAR growth in the country, but it is difficult to find available sites at a feasible cost in Greater Vancouver and Victoria, which is hindering supply growth in these key regions.

The outlook for RevPAR growth in Canada is modest

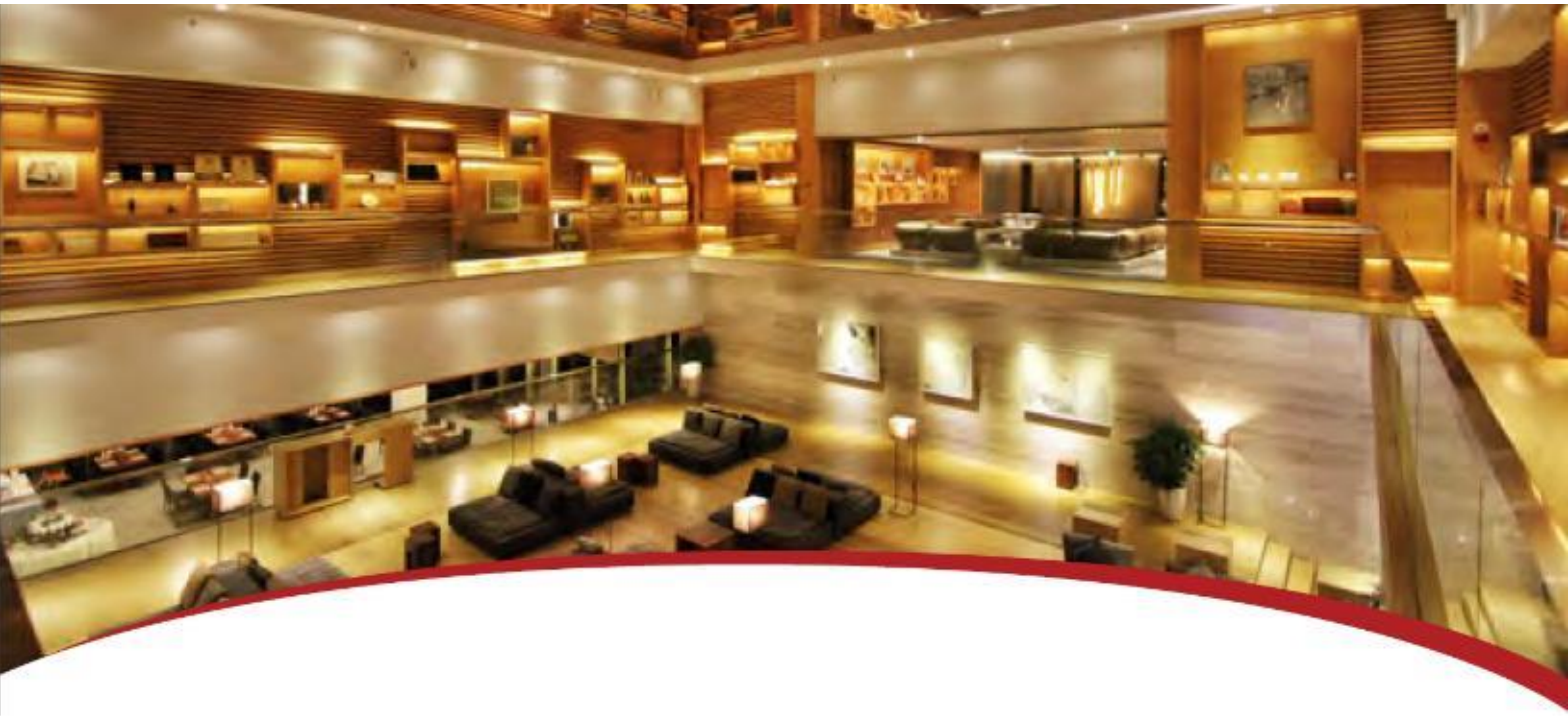
The slowdown in demand growth that started in the summer of 2019 represents a notable shift in the performance of the Canadian lodging market. Year-to-date through October 2019, demand increased by just 0.2%. At the same time, the country registered a 1.4% increase in supply, resulting in a decline in occupancy. With more properties competing for market share across the country, ADR growth has also slowed; the national ADR increased by only 1.4% through October. The notable areas for ADR growth in the country are Montreal and Vancouver, which registered increases of 4.5% and 3.6%, respectively, in the year-to-date period. Oil-reliant Calgary and Edmonton have faced the most severe rate losses, both having posted a decline of 4.6%. Year-to-date through October 2019, the national RevPAR was even with the level attained in the comparable period in 2018, which represents a substantial slowdown from the growth of 5.5% posted for the first ten months of 2018. With the uptick in GDP growth that is expected for 2020, demand growth is expected keep pace with the increase in supply that year. On this basis, we project the Canadian lodging market to realize a 2.1% increase in RevPAR in 2020 following the flat growth in 2019.

Strong operating performance is fueling transaction activity in Canada

Transaction activity in Canada was steady through the first three quarters of 2019. In this period, the national transaction volume was $1.25 billion, up 13% relative to the first three quarters of 2018. More than 60% of the transaction activity was in Eastern Canada. Capitalization rates have been stable, ranging from lows of 4.0% to 4.5% in the major urban core markets of Vancouver and Toronto to highs of 9.5% to 10.0% in the suburban/tertiary regions of the country. With the stable interest-rate environment, capitalization rates are expected to remain unchanged in 2020.

Canada continues to be a sound market for investment in the lodging sector

Growth in the Canadian lodging sector is slowing, but the country remains a sound market for investment. The fundamentals of the industry are healthy, and demand growth is expected to keep pace with supply increases next year, resulting in moderate RevPAR growth on a national basis. Owners have a variety of debt options at competitive rates, which is fueling an increase in construction and transaction volume. Growth is anticipated for the lodging sector, albeit at a more modest pace than in recent years.



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