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CANADIAN LODGING INDUSTRY OVERVIEW

HOSPITALITY & GAMING

A Cushman & Wakefield Valuation & Advisory Publication

CUSHMAN & WAKEFIELD

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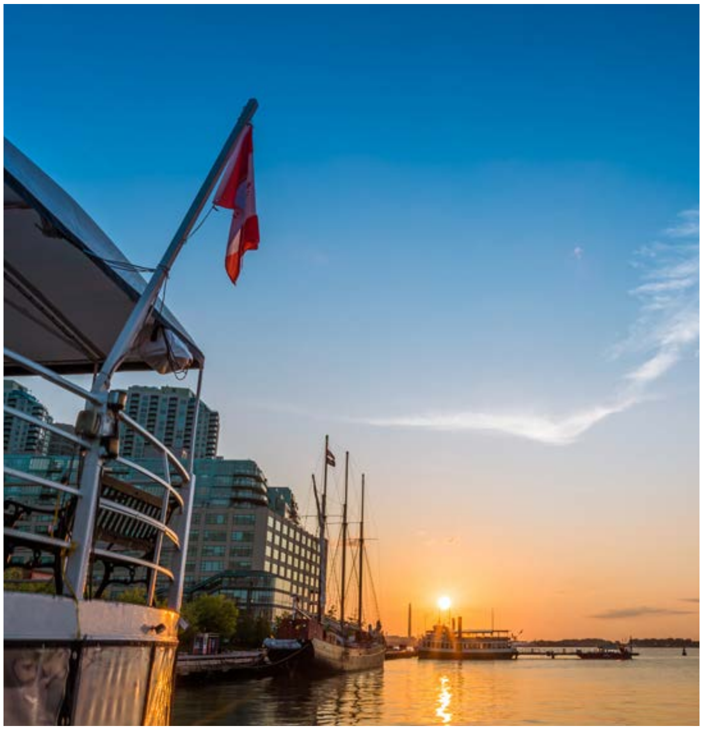
INTRODUCTION

Approaching year end, it appears 2018 will be another successful year for the Canadian hospitality industry. Hotels and resorts in most parts of Canada are performing at all-time highs with record occupancy, Average Daily Rates (ADR), and revenue. At the same time, the demand for hotel investments combined with record profits has driven asset values to all-time highs.

For the first time in almost a decade, there is reason to be cautious about the future with growing hints of political and economic uncertainty. In fact, when asking owners about their 2019 outlook, the words we hear the most are "cautious optimism."

Headwinds for owners include rising interest rates and increasing wages and operating costs. At the same time, hotels are a good inflation defense since they have the ability to adjust pricing to hedge against these costs, provided market conditions remain healthy.



The hotel sector has seen growing interest from investors, many of whom are new to the industry. The challenge for new entrants or those looking to expand their ownership interest, is the lack of assets to acquire. This, combined with record revenues, has led to a sharp increase in new room supply in several markets across the country. As we discuss in more detail, supply increases will have a major impact on the overall performance of the area hotels in the next two to three years.

Our review of key economic indicators shows continued growth can be expected in 2019. We anticipate above-average growth in ADR, particularly in key high barrier to entry urban markets. Western markets had seen improvement until third quarter 2018, as resource prices rose and other sectors of the economy saw gains. As 2018 closes, oil and gas prices have retreated, potentially impacting results entering into 2019. In the longer term, we expect development of new pipeline and infrastructure projects will stimulate demand growth.

Canadian Historical Operating Statistics: 2008-2017 and Year-to-Date Quarterly Comparisons

Year	Supply % Change	Demand % Change	Occupancy	% Change	ADR	% Change	RevPAR	% Change
2008			60.6%		$121.81		$73.82	
2009	1.4%	(6.1)%	56.1	(7.4)%	117.51	(3.5)%	65.92	(10.7)%
2010	4.2	13.1	60.8	8.4	128.71	9.5	78.31	18.8
2011	1.2	2.9	61.8	1.6	127.85	(0.7)	78.98	0.9
2012	0.5	1.6	62.3	0.8	130.12	1.8	81.08	2.7
2013	0.5	2.1	63.3	1.6	133.08	2.3	84.21	3.9
2014	0.5	3.0	64.8	2.4	137.36	3.2	89.06	5.8
2015	1.0	0.2	64.1	(1.1)	142.98	4.1	91.71	3.0
2016	0.9	1.5	64.4	0.5	149.02	4.2	95.95	4.6
2017	0.8	3.2	65.9	2.3	156.73	5.2	103.31	7.7
Average Annual % Change	1.2%	2.3%		0.9%		2.8%		3.8%
YTD Q1 2017			56.0		$140.15		$78.50	
YTD Q1 2018	0.9%	3.1%	57.3	2.2%	147.14	5.0%	84.25	7.3%
YTD Q2 2017			61.9		$148.80		$92.07	
YTD Q2 2018	1.0%	2.9%	63.0	1.9%	156.15	4.9%	98.41	6.9%
YTD Q3 2017			67.5		$159.01		$107.37	
YTD Q3 2018	1.0%	1.9%	68.1	0.9%	166.37	4.6%	113.33	5.6%

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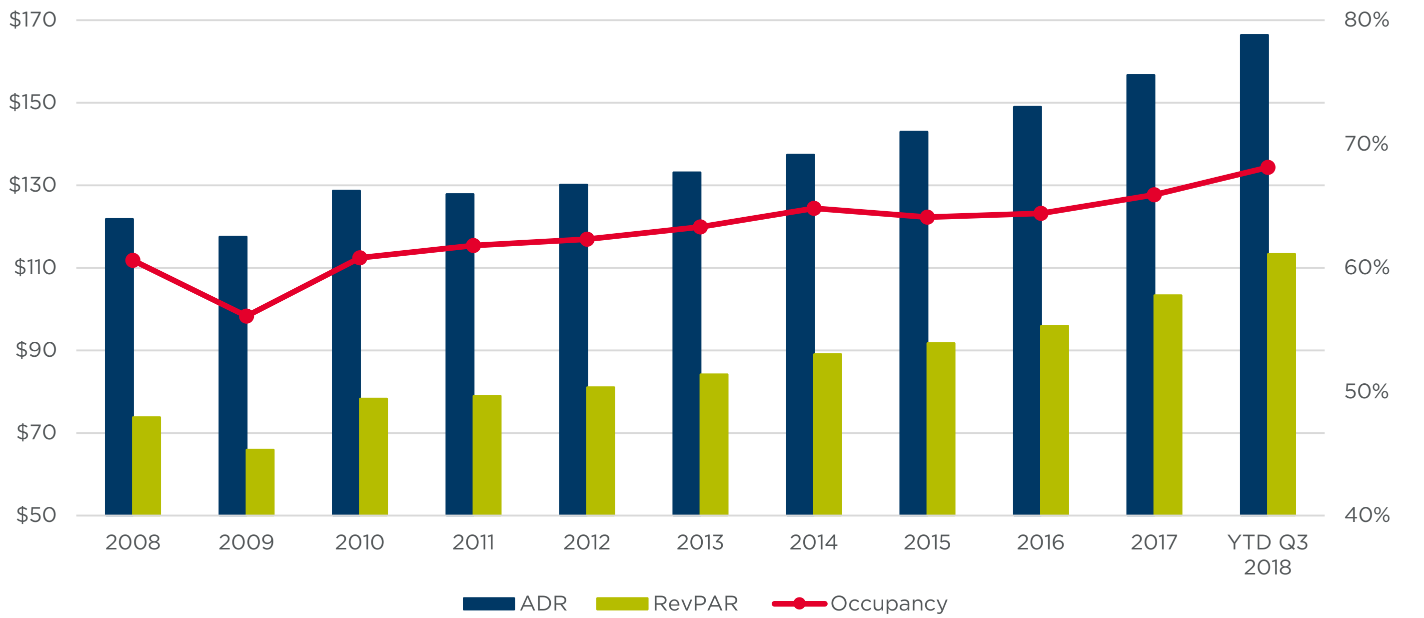
The Canadian hotel market had an exceptional year in 2017, driven by the national 150th and Montreal's 375th celebrations. Year-to-date third quarter 2018 data indicates that 2018 is on pace to be another record year. Occupancy increased by 0.9% with ADR growing at 4.6%, resulting in a RevPAR gain of 5.6%. On a national level, RevPAR has increased from $107.37 in Q3 2017 to $113.33 in Q3 2018. Through the first nine months of this year, demand growth across the country was 1.9%, exceeding the national supply growth of 1.0%. As many markets are now operating at capacity much of the year, the majority of revenue growth is occurring in average daily rates.

Although year-to-date results continue to be robust, there is a trend of slowing month-over-month growth through the first three quarters of 2018.

NATIONAL HISTORICAL ANALYSIS

Since 2008, ADR has increased by 29% and occupancy has increased by 5.3 points. The following graph illustrates trends in occupancy, ADR and RevPAR from 2008 through 2017, as well as through third quarter 2018. This graph shows the overall magnitude of the improvements, particularly in ADR and RevPAR growth, through September 2018.

Canada Occupancy, ADR, RevPAR: 2008-2017 and Year-to-Date Q3 2018



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REVPAR IN TOP TEN MAJOR MARKETS

TOP 10 MAJOR MARKETS

Vancouver and Toronto continue to lead the 10 major Canadian markets in terms of overall RevPAR. In the first nine months of 2018, the markets with the strongest RevPAR growth have been Victoria, Vancouver, and Toronto, all of which have been driven by strong growth in average daily rates. Calgary, Quebec City, and Edmonton have also shown good RevPAR growth thus far into 2018. In the first three quarters of 2018, many markets in resource-based economies saw the benefit of increased oil prices and expansion into exploration and extraction; however, as we head towards the end of the year, the drop in oil prices may put in jeopardy some of the earlier gains.

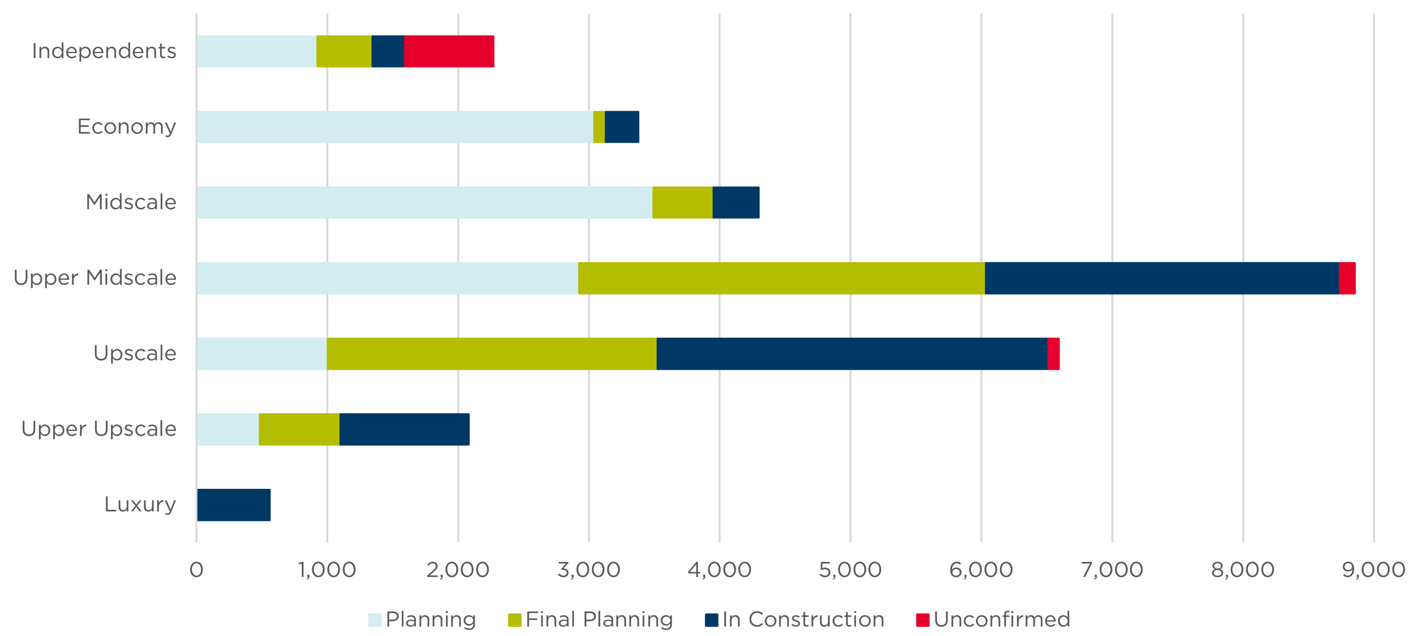
Halifax (+1.6%), Montreal (-2.5%), and Ottawa (-1.8%) are cities which particularly benefited from the 150th and 375th birthday celebrations in 2017, but have seen a return to more normal demand levels in 2018. In addition, Winnipeg saw strong performance in 2017 as the host of the Canada Games, but has seen RevPAR decline by 1.2% year-to-date September 2018 in the absence of this major event.

NEW SUPPLY

As of September 2018, STR reported that average supply growth across Canada was 1.0%. The latest STR report on new hotel development shows above average growth for eight of the top ten markets. Calgary is expected to see the strongest supply growth in 2018, followed by Halifax and Edmonton. Strong markets, such as Toronto and Vancouver, continue to present opportunity for supply growth, but are limited by the availability and affordability of land.

The majority of new supply is expected within the midscale, upper midscale, and upscale categories, particularly within the focused-service segment. However, there is a large proportion of projects within the planning stage amongst the economy, midscale, and upper midscale categories, indicating that a shift in the type of properties developed may be underway. This will be an interesting trend to watch for over the next few years as some of these projects come to fruition.

Canadian Hotel Development, Rooms in Pipeline by Scale and Phase



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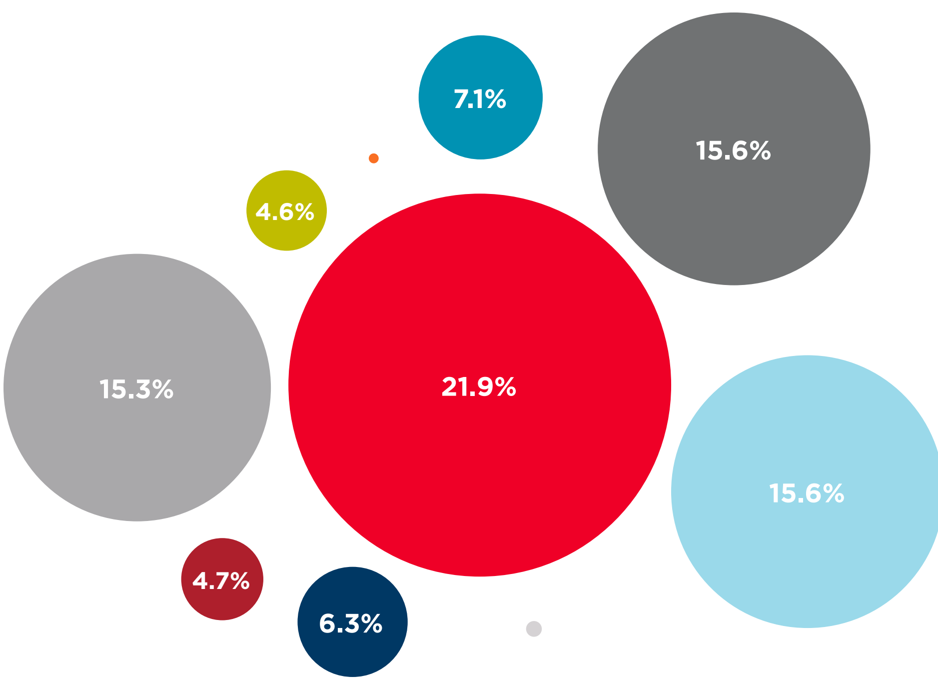
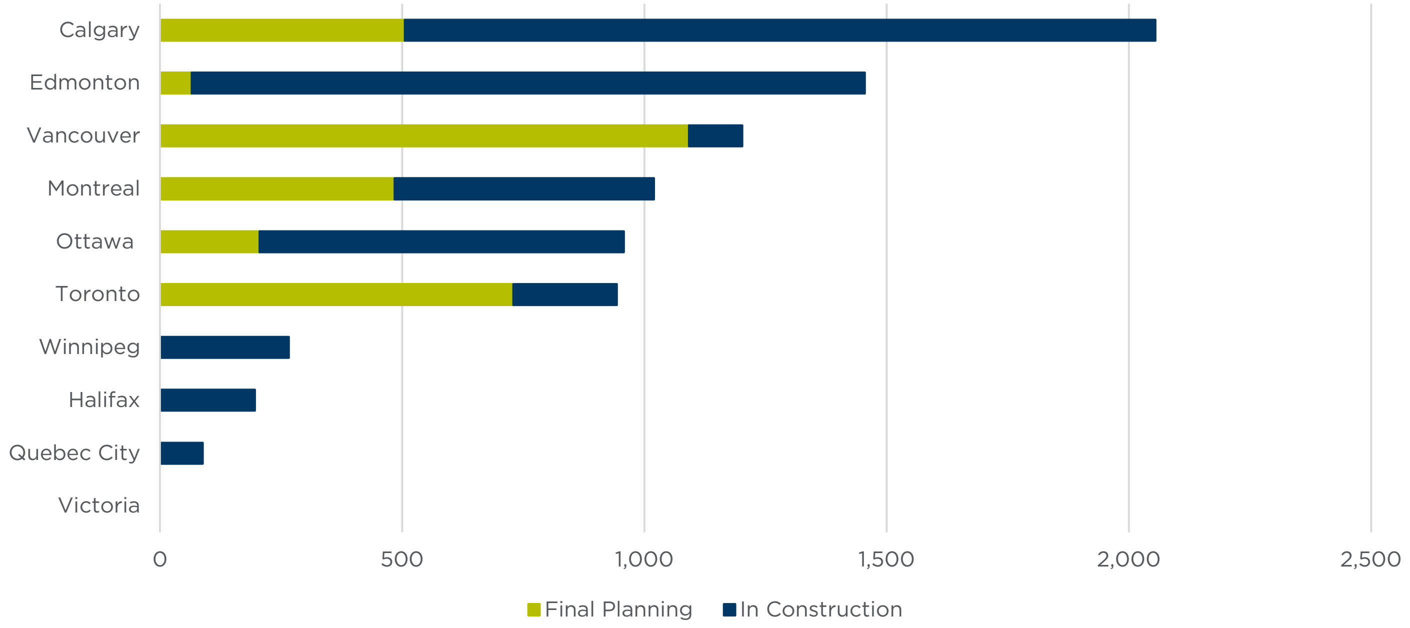
Canadian Hotel Development, Supply % Growth of Major Market by 2021



Market (as defined by STR)	Proposed # of Rooms	Supply Growth
Calgary	3,207	21.9%
Halifax	870	15.6%
Edmonton	2,751	15.6%
Ottawa	1,558	15.3%
Winnipeg	537	7.1%
Toronto	2,321	6.3%
Montreal	1,298	4.7%
Vancouver	1,202	4.6%
Quebec City	88	0.9%
Victoria	0	0.0%

Source: STR | Republication or other re-use of this data without the express written permission of STR is strictly prohibited.

Canadian Hotel Development, Rooms in Final Planning or in Construction



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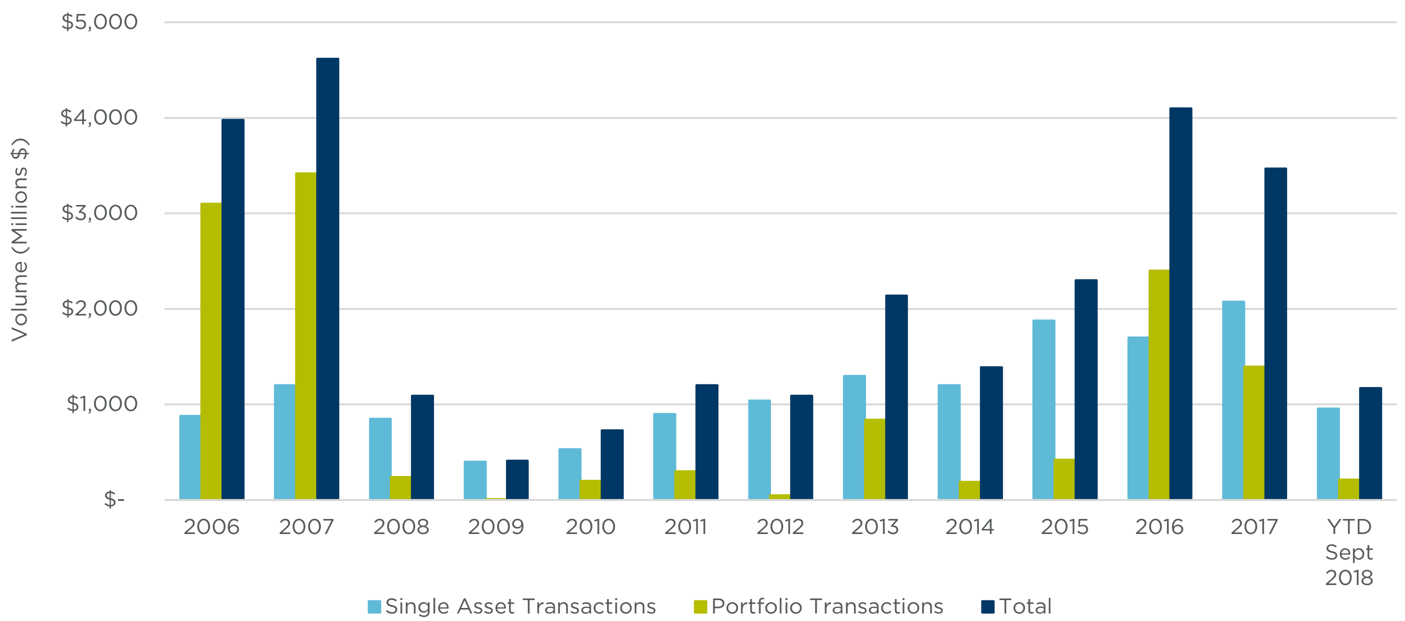
Surprisingly, Edmonton and Calgary still lead the country in new hotel development, notwithstanding the soft market numbers over the last three years. The majority of this development is occurring in the Calgary Airport and the Edmonton West and Edmonton South markets. Given the lead time required for development, many of these developments were committed to prior to the downturn. Their impact will likely cause some downward pressure on these markets which were showing evidence of recovery until the recent decline in oil prices.

Vancouver and Toronto, and to a lesser extent Montreal and Ottawa, are seeing more hotels in the planning stages as results in these markets now justify new construction, despite high land costs and construction costs. Areas where there is significant growth include the Ottawa West area and the suburban areas around Toronto.

TRANSACTIONS MARKET

The following chart summarizes Canadian hotel transaction volumes for the last twelve years. In 2017, total transaction volume approached $3.5 billion (including traditional single transactions, portfolios, and redevelopment sales), making 2017 the second-highest volume year over the last decade.

Canadian Hotel Transaction Volume: 2006 to Year-to-Date September 2018



Source: Cushman & Wakefield, CBRE, and Colliers

As of third quarter 2018, demand for hotel investment continues although, after three years of high sales volumes, the pace over 2017 has slowed dramatically. By the end of third quarter 2018, hotel sales volumes fell to 89 traditional transactions with a volume of $925 million, compared to 104 traditional transactions with a total volume of $1.6 billion by the end of third quarter 2017. The reduction in sales volumes is largely a result of the limited amount of product available in the Canadian market, driven in part by increased vendor pricing expectations.

Ontario continued to lead transaction activity, representing 35% of hotel sales across the country. British Columbia, Quebec, and Manitoba saw an uptick in transaction volume over the prior year, increasing by approximately 6%, 64%, and 200%, respectively.

FEATURED TRANSACTIONS

Notable transactions as of year-to-date September 2018 include:

Notable Transactions

Property	Price	# of Properties	# of Rooms
InnVest 12-property portfolio	Confidential	12	1,752
Marriott Chateau Champlain	$86,750,000		611
Le Sharaton	$92,000,000		825

Transaction Volume by Region Year-to-Date Traditional Sales

Province	Properties	%
Ontario	31	35%
British Columbia	19	21%
Quebec	18	20%
Alberta	7	8%
New Brunswick	2	2%
Manitoba	6	7%
Prince Edward Island	1	1%
Saskatchewan	3	3%
Newfoundland	2	2%
Year-to-Date Total Traditional Sales	**89**	**100%**
Year-to-Date Total Rooms	**8,731**	

Year-to-Date Total Traditional Sales Volume

Total $ Volume	Price per Room	# of Rooms
$925,171,225	$105,964	8,731

OUTLOOK

The current market is notable for its lack of quality investment product available for purchase. Currently, the majority of offerings are assets in tertiary markets, with limited product available in key markets such as Toronto, Vancouver, Montreal, and Ottawa. The climate of investment in hotels is strong, with ample equity and debt capital available; the challenge for investors is finding quality assets to acquire.

HOT TOPICS

THE TREND OF OUTSOURCING IN HOTEL FOOD & BEVERAGE

There has been a growing trend in recent years to outsource a hotel's food and beverage operations to those who are experts in the business. Hoteliers seem to have recognized that having a unique, intriguing food and beverage concept can be a differentiating feature of a property and can attract both hotel and non-hotel guests to food and beverage outlets. Many hotel food and beverage operations have historically generated marginal profits but have the potential to provide much greater contribution. To look more closely at this trend, we consulted with Eric Malcolmson of Icon Legacy Hospitality. The following summarize his take on this emerging trend:

Food and beverage-driven hotel concepts are driving demand for boutique and lifestyle hotels globally, and this trend is likely to continue for the foreseeable future.

Major hotel brands and owners are renovating their tired hotel restaurants and introducing inspired food and beverage (F&B) concepts to animate public spaces, increase hotel guest dining, draw local business, and increase room bookings. Until recently, hotel F&B was considered a necessary evil, but with the rise of social media, digital marketing, and a growing demand for socially-engaging spaces, a restaurant with great food, unique design, and artisan cocktails can be highly rewarding for hotel owners.

Creating successful hotel F&B venues often requires an upgrade to both the physical design and operational expertise. To achieve this, hotel owners are either (a) working with the hotel management team and F&B consultants to develop custom-designed F&B concepts and investing in experienced restaurant leadership at the hotel, or (b) outsourcing F&B operations to professional restaurant management companies and leased restaurant brands. There are many benefits and challenges to outsourcing F&B in hotels.

BENEFITS

- A third-party restaurant operator provides an opportunity for the hotel owner to match the expertise of each party in their respective hotel and restaurant sectors.

- Leasing F&B hotel venues provides a stable income stream and lower operational risk.
- Professional F&B operators bring expertise, operating standards, restaurant brand approval, and implement best practices to improve operating margins and overall profitability.
- Established restaurant brands (franchise/managed) have significantly lower interior design costs (versus custom F&B concept).

CHALLENGES

- The operation/concept must be a good match for the hotel guests and operation.
- All elements of the hotel and restaurant operations (receiving, security, storage, hotel guest payment, marketing, and use of the F&B venue space) needs to be determined and integrated.
- There are a limited number of large, national, or regional independent restaurant operators seeking to operate hotel F&B venues. They must rely on smaller entrepreneurs that may know the local market but may not have the depth or commitment to a long-term agreement.
- The requirement for a long-term lease or management contract means there is limited ability to make a change if needed.
- Less control over quality, operation, hotel guest interaction, and customer satisfaction. A bad experience at the restaurant can result in negative comments about the hotel.

Irrespective of whether the F&B operations are outsourced or operated by the hotel, the hotel owner should review the overall F&B operation and ensure that any significant barriers to success are remedied as these challenges will be the same for third party operators. Introducing F&B operators and brands can offer significant upside but these decisions should be made on a return-on-investment basis.

CANNABIS TOURISM?

On October 17, 2018, recreational cannabis became legal in Canada. Canada is only the second country in the world to have legalized the use of recreational cannabis, and the first of any industrialized nation. While there has been much debate over the social implications, tax benefits, and costs of regulation for cannabis, the discussion of the impact of legal cannabis on Canada's tourism industry is only just beginning.

Amsterdam is a well-known destination for cannabis users, with an expected 18 million tourists expected in 2018 with an estimated 25% to 30% of those visiting the city's 'coffee shops' to partake in tolerated marijuana use. Could Canada's major cities expect to capture a portion of these travelers?

Closer to home, recreational marijuana was legalized in the state of Colorado in January 2014. As illustrated in the following table, tourist visitation in Colorado showed increased growth in the year marijuana was legalized and the year immediately following. But, despite strong increases in marijuana tax revenue in 2016 and 2017, tourist visitation growth has slowed to pre-legalization levels. This data indicates an initial uptick in tourist visitation when marijuana is first legalized, followed by a softening interest. Indeed, the Colorado Tourism Office indicated that in 2017 the interest in legal marijuana had appeared to stabilize, with only 15% of visitors participating in marijuana-related activity and only 5% indicating legal marijuana as a motivation for their trip.

Colorado Tourism & Marijuana-Related Revenue

Year	Visitation	% Change	Revenue*	% Change
2009	51,700,000	-	-	-
2010	55,100,000	7%	-	-
2011	57,900,000	5%	-	-
2012	60,200,000	4%	-	-
2013	64,600,000	7%	-	-
2014**	71,300,000	10%	$67,594,323	-
2015	77,700,000	9%	$130,411,173	93%
2016	82,400,000	6%	$193,604,810	48%
2017	84,700,000	3%	$247,368,476	28%

Source: Colorado Tourism Office, Colorado Department of Revenue
* Revenue from Marijuana Taxes, Licenses, and Fees, in USD
** Legalization on January 1, 2014

In addition, further information released by the Colorado Tourism Office in 2015 indicated that those between the ages of 25 to 34 were most likely to indicate that marijuana legalization positively impacted their intention to travel to Colorado (33%), while 22% of those 55 and older indicated it negatively impacted their decision to travel to Colorado.

There are many questions that remain to be seen about the impact of cannabis legalization on the tourism and accommodation industries in Canada. Will legalization result in a sustainable increase in tourism? Will legalization draw some travelers to the country, but result in others choosing to travel elsewhere? How will changing perceptions impact traveler behaviour in the long term? With legalization still in its infancy, the emerging trends and travel implications will be an important consideration for operators, developers, and consultants in the coming years.

FINANCING AND THE HOTEL INVESTMENT MARKET

The Bank of Canada has raised its benchmark interest rate by a quarter point for the fifth time since summer 2017, pushing up the cost of borrowing for acquisitions and financing. The interest rate is now set at 1.75%, the highest it's been since December 2008. The Government of Canada (GOC) has increased its bond yield rate by 1.0% since 2016 reaching 2.3% for 10-year bonds, and the spread between average commercial real estate mortgage rates has remained relatively unchanged throughout 2018, hovering around 1.4%-2.0% over GOC bonds for 5- and 10-year mortgages. The spread is forecast to remain the same throughout 2019, so borrowers need only monitor bond yields to get an estimate of interest rates.

Hospitality financing can be slightly trickier than other asset classes; although there is ample competitive funding looking to be placed by lenders in commercial real estate, the hotel market is still seen as a special asset class. Knowing the appetite of the lenders in the marketplace is most important. CMBS conduit loans, non-traditional hospitality lenders, and private equity funds are stepping into the market.

LONGER-TERM LOANS

In terms of investor strategies, longer-term loans are becoming more attractive for borrowers who are uncertain about the future. Locking in rates as the cost of capital inevitably rises is a good way to hedge in an unpredictable market, especially as expenses (such as minimum wage and hydro) increase. Not only does a longer-term loan mitigate interest risk, but it also saves the borrower from paying fees associated with renewing financing. Some hospitality lenders have been offering 7- and 10-year terms.

If interest rates continue to rise and other factors remain constant, there is likely going to be a decrease in pricing for hotels in certain markets. When monthly payments rise, acquisition underwriting tightens and refinancing becomes stressed. Investors may underwrite an opportunity favourably in the short run, but decline the opportunity entirely due to pessimism regarding future interest rate hikes. Similarly, despite paying down equity throughout the term of the loan, owners refinancing might face even larger monthly payments on a smaller principal. Quality deals with increasing future cash flows will be paramount to ensure that refinancing risk is lessened.

IMPACT OF INFLATION

While rising interest rates can reduce the value of future cash flows, inflation can increase the value of the physical property. Also, rising inflation leads to higher room rates which can increase profitability and hotel valuations. Ultimately, if the increase in property value from inflation outweighs the decrease caused by rising rates, the net result can be positive. With the possibility of further rate increases, most experts agree real estate is a particularly attractive investment in today's market.

OPPORTUNITIES

There are prospects for hospitality investors all over the country; however, opportunities may not be as visible as they once were. Some western markets should give more potential for upside having bottomed out in their slumps; however, convincing mortgage providers of the upside and demonstrating market normalcy in these deals might be the biggest hurdle. Lenders will be tighter, perhaps offering lower LTVs, shorter terms, and higher interest rates in these deals. Meanwhile, other provinces have reached all time high performance levels, creating potentially unrealistic value expectations from owners in the eyes of buyers and lenders. In expensive markets, strategic partnerships have proven to be an effective method to reduce financing burdens, assembling higher equity, and producing more value for an asset.

CONCLUSION AND OUTLOOK

The hotel industry surprised many of us again in 2018, with RevPAR by year-end likely delivering more than a 5% improvement over 2017. Major markets continue to perform well and many resource markets are began to see improvement in results.

Hotel financing continues to be readily available as long as the project makes sense, and both domestic and foreign lenders continue to actively pursue deals. We continue to see first-time buyers entering the market, while seasoned hotel investors sift through opportunities in search of the best way to deploy capital and optimize future returns. A number of active investors have turned their attention south of the border due to the lack of buying opportunities in Canada. Pricing in some markets has reached or is near replacement cost, particularly for suburban limited- and focused-service product, reaching a breaking point for some buyers.

Strong performance indicators and an active investor market are proof that the Canadian hotel industry has positive momentum. The horizon shows a few clouds in the distance, but generally speaking it looks like clear skies.

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