

# Canada's Tourism Industry: Industrial Outlook

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By:

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Insights You Can Count On



## What's Inside:

*Canada's Tourism Industry: Industrial Outlook* provides a 360 degree view of Canada's tourism industry. The report focuses on the latest travel trends and how they affect the demand for travel to and within Canada. In addition, the report analyzes the factors that contribute to changes in key input and output prices and their effects on the future growth of revenues and costs within the Canadian tourism industry. In turn, the report paints a comprehensive picture of the profitability of the industry going forward.

*Canada's Tourism Industry: Industrial Outlook* provides an overview of Canada's tourism industry and focuses on the key industries of transportation, accommodation, food and beverage services, and other tourism industries. The report is published twice per year.

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# Canada's Tourism Industry

## Key Issues



### Domestic Demand

Domestic tourism spending remains strong, bolstered by solid growth in disposable income and strong labour markets.



### Travel Deficit

Fuelled by the high value of the Canadian dollar, the gap between foreign travel spending in Canada and Canadian travel spending abroad is steadily growing. Canadian travel spending in foreign countries is also increasing at a faster pace than domestic spending.

## Overview

The key drivers of growth for Canadian tourism demand are weakening, but they remain in positive territory. The Canadian economy is expected to stay healthy in 2008 thanks to the strength of domestic demand and an improving trade balance. Tax cuts continue to boost disposable income among Canadians and bolster corporate profits, helping to fuel growth in both leisure and business travel.

However, the high value of the Canadian dollar is making international travel more affordable, while making Canada a more expensive place to visit, encouraging foreigners and Canadians to travel elsewhere. Also, by encouraging conference planners to relocate events to destinations with weaker currencies, the high dollar may also have an adverse effect on business travel. Although the rapid rise of the dollar has come to an end for now, the dollar is expected to remain above US\$0.95 over the long term.

As a result, the high dollar is significantly widening Canada's travel deficit. The gap between spending in Canada by foreign residents and spending in foreign countries by Canadians is steadily growing at Canada's expense. In 2002, Canada's travel deficit stood only at \$1.7 billion. Since then, the rapid rise of the Canadian dollar has contributed to the rise in Canada's travel deficit to \$10.2 billion. What's more, with the Canadian dollar expected to remain at close to current levels over the entire forecast horizon, the travel deficit is expected to continue to widen.

While Canadian outbound travel is booming, the domestic travel sector also continues to grow strongly. Helped by tax cuts and solid employment growth, Canadian consumers have remained the stalwart of the economy and of the tourism sector. Worries about the state of the U.S. economy have hurt confidence in Central and Eastern Canada; however, confidence remains strong in Western Canada. Overall, tourism expenditures increased 3.8 per cent in 2007, bolstered by a 5.9 per cent increase in spending by domestic travellers.

Going forward, solid employment growth along with continued tightness in the country's labour market should ensure strong income growth, even in the absence of additional tax cuts. In turn, growth in travel demand is expected to continue at a solid pace. However, given the strength of the Canadian dollar, it has become clear that not all of the increase in Canadian's travel budgets will be spent here, but instead will be used for trips going to the United States or other international destinations.

Tight labour markets also affecting the tourism sector. The unemployment rate among many tourism industries has approached or dropped below record lows in nearly every province. The effects of this tightness are apparent in a number of ways; the share of self-employed or involuntary part-time workers has fallen, and workers are increasingly dictating the terms of their employment. Labour market tightness is also exerting upward pressure on wages in the sector and is hurting the sector's profitability.

Meanwhile, demographic changes have become a fundamental driver of growth in tourism demand over the past several years. Canadian baby boomers started to turn 55 years of age in 2001—a significant milestone, because people aged 55 to 70 are considered to be in their prime travel years. They tend to be empty nesters, and are more likely to have the financial means to travel. They also have the time to travel, are healthy, and are looking to experience Canada and the world. What's more, Canada's key international travel markets in the U.K., France, and Germany all feature a similar baby-boom cohort that is fuelling international air travel demand.

In Canada, the number of people aged 55 to 70 as a share of total population is not expected to peak until sometime in the mid-2020s. However, the strongest growth of this segment is happening between 2001 and 2011 and is generating a healthy boost to travel, both domestically and internationally. Beyond 2011, this boost will slowly disappear, and the industry will have to look for other drivers of growth. Until then, however, the baby boomers are a main reason for the continued strength in travel demand—what could be called the Silver Age of the travel industry.

In contrast to the healthy growth in domestic demand, foreign tourism spending in Canada has been decreasing since the beginning of the decade. Real foreign tourism spending dropped by 3 per cent in 2007, mainly because of a decline in U.S. overnight visitors. In fact, U.S. overnight travel in Canada has declined by an annual average of 3.7 per cent over the last three years. Visits from countries other than the United States have been more resilient, averaging annual increases of 1.5 per cent over the same period. Stellar gains from countries like China—from which travel to Canada surged by almost 40 per cent between 2005 and 2007—are offsetting declines from some European countries and Japan.

Growth in foreign spending is expected to remain weak over the near term. A contributing factor will be the latest identification requirements under the Western Hemisphere Travel Initiative (WHTI) for travellers entering or re-entering the United States. Air travellers have had to show passports since early 2007; since early this year, travellers at land and sea borders have had to show government-issued photo identification plus proof of citizenship. This latest requirement is expected to result in a further drop in visitors from the United States this year, although the transition so far has been relatively smooth. Full implementation of the final phase of the WHTI is expected to be on June 1, 2009 and carry with it another impediment to U.S. visitation.

The decline in U.S. visitors has had a substantial impact on the profitability of the tourism sector in Canada. In 2007, pre-tax profits dropped 7.1 per cent to \$1.1 billion compared with the previous year. The appreciation in labour and material costs helped increase overall operational costs in the sector by 4.5 per cent, outstripping revenue gains by a solid margin. In 2008, tourism profits are expected to fall another 8.1 per cent, despite a projected growth in revenues. Tightening labour markets will continue to push up wages, and expanding levels of investments will result in substantially higher capital costs. Tourism profits are expected to begin improving in 2009, bolstered by continued growth in demand for travel by Canadians as well as the resumption of growth in the number of foreigners travelling to Canada. Tourism profits will also receive a boost in 2010 from the Vancouver Olympics.

# Transportation

## Key Issues



### Foreign Markets

Foreign markets are no longer an overall drag on the air transportation industry, as increases in international visits will offset the declining number of air visitors from the United States. Clearer border identification requirements are also helping to soften the decline in U.S. visitors in the face of weakening economic factors.



### Domestic Market

Strong growth in incomes and corporate profits is boosting spending on pleasure and business travel, including spending on transportation. The airline industry is also benefiting from increases in travel to international destinations.

## Short-Term Forecast Trends

Production:	<b>Strong</b>
Prices:	<b>Moderate</b>
Profits:	<b>Recovering</b>

## Overview

After several years of strong demand growth, record load factors for the airlines, and a largely modern fleet of aircraft, it should be boom times for Canadian air and ground transportation industries. However, rising costs continue to drag down their financial performance and intense competition is keeping a tight rein on airfare increases. With airlines struggling to pass on all of the higher operational costs to passengers, the air industry's bottom line is suffering.

Yet, transportation demand continues to expand. Real demand for air and ground transportation rose by 7 per cent in 2007. Canadian airlines continue to benefit from strong growth in domestic travel and from growth in Canadian outbound travel. Despite a significant decline in U.S. air travellers to Canada and a somewhat lacklustre performance from overseas markets, total traffic at Canada's largest airports rose by 5.5 per cent in 2007. In addition, strong growth in both leisure and business travel volumes boosted demand for rental vehicles by 6.2 per cent last year.

Transportation revenues continue to climb thanks to strong gains in real sales and modest price increases. Although competitive pressures will continue to hinder airfare increases over the medium term, overall revenues over the next two years will increase by 5.2 per cent and 6.6 per cent, respectively. Healthy growth in income and corporate profits will continue to support demand from leisure and business travellers, boosting growth in real sales.

Solid gains in industry productivity are helping airlines stay profitable despite rising costs and minimal price increases. Productivity in the air transportation industry is expected to keep improving over the coming years, averaging roughly 2 per cent growth per year. Two of the factors contributing to strong productivity growth are higher load factors and increased fuel efficiency: airlines have been flying fuller planes and taking advantage of the higher Canadian dollar to invest in more fuel-efficient engines and aircraft.

Despite solid gains in productivity, transportation costs increased 4.9 per cent in 2007, driven largely by rising oil prices and labour costs. Looking forward, costs are expected to grow by 4.7 per cent in 2008 and 5.1 per cent in 2009. Although oil prices will remain high compared with their historical norms, the pressure they exert on material costs should ease over the forecast, as their growth eases. Labour and capital costs will continue to see sizable increases as a result of tight labour markets and continued investment in new aircraft.

With cost appreciation outstripping revenue growth in 2007, transportation profits fell despite the solid gains in demand. Airline profits spiked in the first quarter of the year when oil prices briefly fell below US\$60 per barrel, but weakened in the second half of the year as oil prices soared. Competitive pressures are expected to limit airfare increases, but ongoing sales growth and productivity gains will allow profits to improve significantly this year. In 2008, pre-tax profits for the industry are expected to reach \$150 million and by 2009, pre-tax profits are forecast to surpass \$380 million.

# Accommodation

## Key Issues



### Occupancy Rates

Strong national occupancy rates for hotels have allowed average daily room rates to increase slightly and have pushed up investment in the accommodation services industry.



### Dollar

Because the Canadian dollar is still flirting with parity with the U.S. dollar, Canada remains a relatively expensive destination for travellers. This is limiting demand for accommodation as foreigners and Canadians choose to travel in other countries.

## Short-Term Forecast Trends

Production:	<b>Moderate</b>
Prices:	<b>Modest</b>
Profits:	<b>Weak</b>

## Overview

Robust growth in domestic travel spending has been the major driver of the remarkable profit growth in Canada's accommodation industry over the past few years. However, this trend seems to be weakening, as growth in both real sales and prices has recently decelerated. Still, thanks to the spillover from previous years, industry profits reached \$738 million in 2007.

In contrast to the healthy growth in domestic demand, foreign visits to Canada continue to decline, mainly because of the decrease in U.S. visitors. In addition, the high value of the Canadian dollar continues to hurt Canada's price competitiveness for domestic and foreign visitors, while fuelling demand for Canadian outbound travel. The rate of Canadians travelling outside of the country is increasing at a steadier pace than that of Canadians travelling domestically.

The national occupancy rate for hotels was 65 per cent at the end of 2007, unchanged from the previous year, according to PKF Consulting. Despite the flat occupancy rate, the market was tight enough to allow the average daily room rate to rise by 3.2 per cent. Given the healthy occupancy rate, non-residential investment in the

accommodation services industry grew strongly and is now very high relative to revenues. Investment is expected to stay high, thanks to the positive industry outlook.

Following two years of robust growth, accommodation revenues expanded by a more modest 4.1 per cent in 2007 as a result of weaker gains in both prices and real sales. Price appreciation reached a modest 2.2 per cent in 2007, but stable year-to-year occupancy rates allowed the industry to exert some pricing power, boosting average daily rates. In 2008, revenue growth maybe held back by the slowing economy, limiting revenue growth to 3.8 per cent. In 2009 revenue growth is expected to accelerate to 4.6 per cent, fuelled by increases in prices and sales.

Meanwhile, hoteliers were able to limit cost increases to 3 per cent in 2007, thanks to the modest appreciation of labour and capital costs. However, because of the tight labour market—something the accommodation industry is especially sensitive to because it is so labour intensive—labour costs are expected to begin rising quickly this year. Employment still has room to expand; however the shortage of labour continues to drive up wages, which are forecast to rise precipitously over the medium to long term.

Accommodation industry costs are expected to rise 6.8 per cent this year, as tight labour markets continue to fuel strong increases in wages. Capital and material costs are also expected to contribute more strongly to expenses, as hotel investment continues to expand.

Cost increases were more than offset by revenue growth last year, allowing profits in the accommodation industry to soar. But lower price appreciation and heightened cost pressures will result in a 27 per cent drop in pre-tax profits this year to 541.6 million. A slowdown in cost appreciation will help reverse this drop in 2009. Also, the improvement in foreign spending will help profits in the industry rise to \$560 million in 2009.

# Food and Beverage Services

## Key Issues



### Prices

Food services companies have been able to consistently raise prices above the rate of inflation thanks to their ability to compete on service as well as price. This allows them to pass their rising costs on to consumers and leads to improved profitability.



### Tight Labour Markets

Tight labour markets, particularly in Western Canada, have led to rising wage rates and limited sales growth in the food services industry. With labour markets expected to stay tight, labour costs will remain an issue for the industry over the entire forecast period.

## Short-Term Forecast Trends

Production:	<b>Moderate</b>
Prices:	<b>Healthy</b>
Profits:	<b>Improving</b>

## Overview

Despite healthy growth in the overall economy, Canada's food services industry struggled last year. Industry revenues actually fell in the first half of the year, as price increases were insufficient to offset declines in real sales. Sales improved modestly in the second half of the year, but industry profitability remains under pressure, primarily because of rising food and labour costs. As a result, the industry barely made a profit in 2007, their weakest showing since 2001.

The weakness in industry profitability is somewhat surprising given healthy economic growth. Varying economic conditions across Canada's regions are one factor, but tight labour markets are another. Not only are labour shortages driving up wage rates, they are limiting the industry's ability to expand in some markets.

Price appreciation for the industry decelerated last year, but was still healthy at 2 per cent. Although the food services industry is highly competitive, restaurants are generally able to raise their prices faster than the rate of inflation. Because the industry is highly fragmented, with menus and the level of service varying widely, companies are able to compete on quality as well as price. Looking forward, the majority of the industry's revenue growth will continue to come from rising prices rather than production growth. Price appreciation will keep outpacing the rate of inflation, and real sales growth will accelerate to a healthy pace.

Cost appreciation outpaced revenue growth in 2007, rising by 5.4 per cent. Although businesses responded to slower sales growth by reducing some costs and trimming debt, this was insufficient to offset the slowdown in revenues. A key factor has been the continued rise in labour costs. Labour shortages, particularly in Western Canada, are pushing up wages and contributed to growth in labour costs of nearly 5 per cent in 2007. Meanwhile, high oil prices continue to push up the cost for food in Canada. In turn, material costs for food and beverage services are rising. In 2007, material costs rose by 6.1 per cent, the fastest rate among the different cost categories. Over the next two years, cost appreciation is expected to slow, allowing industry revenues to catch up. Labour, material and capital costs will all play a role in rising costs over this period, but two key factors will be the tight labour market, and rising food costs.

Looking forward, the industry's financial performance should improve. With personal income growth expected to remain healthy, growth in real sales will continue to increase modestly. The industry will continue to pass its higher costs on to consumers, as industry price appreciation continues to outpace increases in broad inflation. Total spending on food and beverage services is expected to increase 2.2 per cent in 2008. Improving foreign demand is expected to help accelerate growth in spending to 2.8 per cent in 2009. Although margins will remain quite low, staying below 1 per cent over the medium term, industry profits will steadily improve.

# Other Tourism

## Key Issues



### Canadian Travel Demand

Strong growth in Canadian travel demand continues to bolster the outlook for tour operators and travel agencies.



### Tight Labour Markets

The high dollar and continued weakness in the U.S. market are also hurting foreign spending on recreation and entertainment and other tourism industries.

## Short-Term Forecast Trends

Production:	<b>Strong</b>
Prices:	<b>Improving</b>
Profits:	<b>Healthy</b>

## Overview

Demand for “other” tourism goods and services, namely recreation and entertainment, travel services, pre-trip expenditures and convention fees, continues to grow at a healthy pace. Buoyed by strong Canadian travel demand, real spending on “other” tourism is expected to increase by 4.1 per cent in 2008 and by 2.5 per cent in 2009. In fact, were it not for the ongoing weakness in the United States market, growth in the sector would be even stronger. As it is, the weakness in the United States is negatively affecting overall foreign demand and is therefore dragging down demand for the industry as a whole. Foreign demand is expected to decline by another 2 per cent in 2008, but is expected to recover slightly in 2009 and grow by 2.3 per cent.

Strong domestic demand for travel is having a very positive impact on “other” tourism. The strength in demand is fuelled by Canadians travelling at home as well as abroad. For instance, Canadian domestic travel has boosted real spending on domestic recreation and entertainment to the tune of 7.1 per cent in 2007. Showing only mild signs of slowing down and with rising demand from baby boomers for this industry, domestic spending on recreation and entertainment is expected to post another strong performance in 2008 and 2009.

Meanwhile, strong Canadian outbound travel is benefitting travel services. Canadian travel to countries other than the United States grew by 9.9 per cent in 2007 and is

expected to continue to grow at a rapid pace over the next two years. Canadian providers of travel services are benefitting from this trend as the likelihood to engage the help of a travel agent rises as people travel to new and farther destinations. In addition, travel services are one of the few Canadian industries benefitting from the high value of the Canadian dollar. The strong dollar is allowing Canadian tour operators to purchase rooms and foreign vacation properties at a much lower rate. In turn, they can offer vacation packages at significantly lower prices, thereby stimulating demand for their services.

Revenues in the industry are expected to benefit from the ongoing strength in demand, as well as higher prices. Prices actually fell in 2007, partly as a result of the high value of the Canadian dollar. Yet, with the dollar having peaked, labour shortages pushing up wages and demand pushing capacity, prices are expected to increase by 1.1 per cent in 2008. Thus, revenues are forecast to grow by 5.1 per cent and 4.4 per cent in 2008 and 2009 respectively.

Despite the strong growth in demand and revenues, profits in the industry will remain modest. Strong competition and rising costs are keeping a lid on profitability. In fact, growth in overall costs is expected to outstrip growth in revenues as labour, material and capital costs are all expected to increase significantly over the next two years. As a result, profit margins in the industry will decline, however total profits will still improve slightly to \$272.2 million in 2008 and \$286.1 million in 2009.