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MARKET PULSE: COLOMBO, KATUNAYAKE, NEGOMBO SRI LANKA

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On the eve of the 2nd edition of Tourism, Hotel Investment & Networking Conference (THINC) Sri Lanka, hosted by HVS, this article explores the historical performance and outlook for three key hotel markets, namely Colombo, Katunayake, and Negombo, which are preceded by a snapshot of key macroeconomic and tourism statistics in the country. We also delve into prevalent travel trends and the challenges presented by the hospitality industry in these areas.

MACROECONOMIC SNAPSHOT

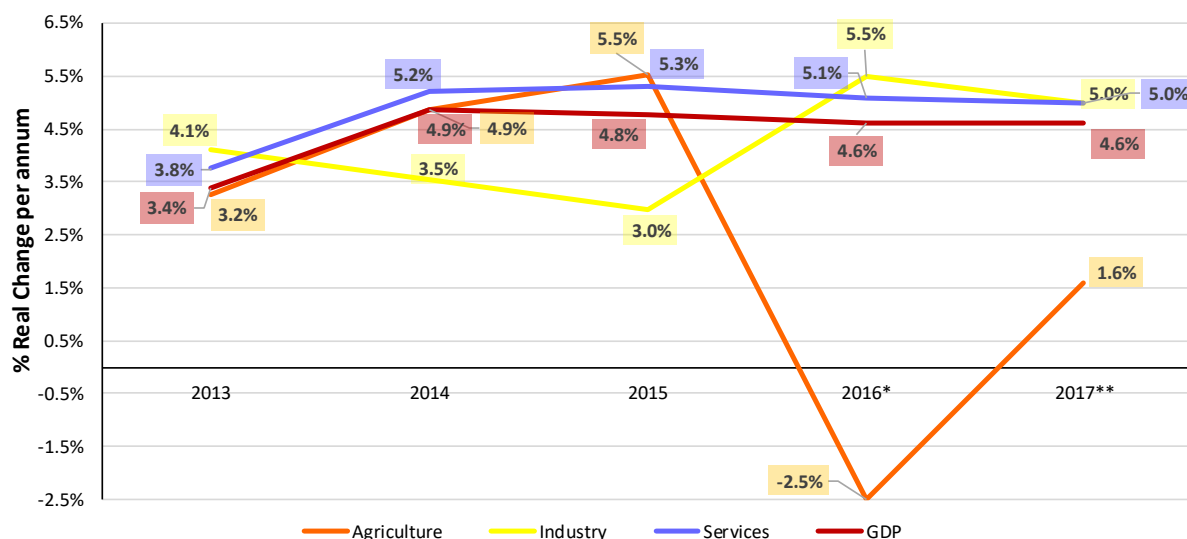
The Sri Lankan economy continues to inspire a fair degree of confidence, fortified by the gradual improvement in the external sector, with growing exports and remittances, and tourist arrivals reaching a record high in 2016. The 2017 budget points towards the persistence of the government's efforts to establish the country as a regional logistics and trading hub with better synergy with global markets as well as further openness towards foreign investments, particularly in tourism, apparel and information technology.

Sri Lanka's annual GDP growth is estimated at 4.6% in 2016, as seen in Figure 1, and is anticipated to increase at an average annual rate of 5.2% between 2017-21, per the Economist Intelligence Unit (EIU), primarily led by private consumption and the inflow of



remittances, as well as public investment in infrastructure. Historically, the Services sector has continued to contribute over 60% to the GDP (Figure 2), driven by the strength of the apparel, tourism and information technology industries.

FIGURE 1: SECTORAL GROWTH RATES (2013-2017)



*EIU Estimates ** EIU Forecasts

Source: The Economist Intelligence Unit

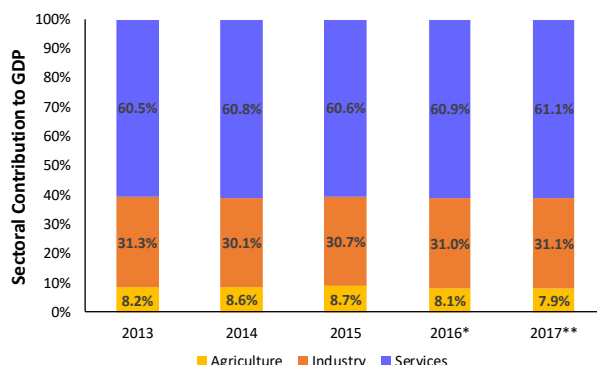
The Sri Lankan rupee continues to experience downward volatility vis-à-vis the US dollar, averaging at LKR149/US\$ in 2016 and this trend is expected to continue over the next five years, given the substantial trade deficit and inflation differential with the United States. Inflation, as measured by the Colombo consumer price index (CCPI), has averaged 4.5% in the past five years.

To sustain the Services driven economy and develop the nation as an integral trading hub, the Sri Lankan government has undertaken ambitious programmes to modernise the island's roads, railways, ports and air transportation. Coupled with improvements in the power and telecom sectors, the infrastructure developments in the Northern and Eastern provinces as well as around Colombo will ensure long term economic growth.

While the Colombo South Port Expansion project and the Hambantota Port development are already underway, the government is also focusing on creating a sustainable road network with projects such as the Outer Circular Highway, Colombo-Kandy Highway and the Southern Expressway. Additionally, the Terminal 1 at Bandaranaike International Airport is likely to be expanded by 2019 to accommodate 15 million passengers annually from the existing capacity of six million, further to which construction of the second terminal with the same capacity will commence.



FIGURE 2: SECTORAL CONTRIBUTION TO GDP (2013-2017)



*EIU Estimates ** EIU Forecasts

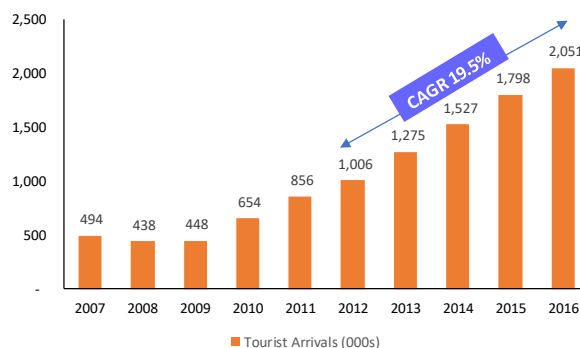
Source: The Economist Intelligence Unit

TOURISM & VISITATION

Tourism is the third largest source of foreign exchange earnings in Sri Lanka, accounting for 10.2% of the total in 2015. Total contribution of the Travel & Tourism industry to the country's GDP was 10.6% in 2015, and is forecasted to increase by 4.5% in 2016, per the World Travel & Tourism Council's Economic Impact 2016 report. Furthermore, Sri Lanka crossed the two million mark in tourist arrivals, recording a compounded annual growth rate (CAGR) of almost 20% over the past five years. Figure 3 presents the figures for tourist arrivals in Sri Lanka for the past ten years.

Not only have the tourist arrivals to the country witnessed exponential growth, earnings from tourism have also witnessed a CAGR of 31% over the past five years, totalling US\$3,026.5 million between January and November 2016, according to the Central Bank of Sri Lanka.

FIGURE 3: SRI LANKA TOURIST ARRIVALS (2007-2016)



Source: Sri Lanka Tourism Development Authority

Further to presenting the overall economic and tourism overview, we proceed to evaluate the operating performance over the past three financial years and provide an outlook for the branded hotel sector in Colombo, Katunayake and Negombo. We have considered the major international and domestic supply as the basis for the following analysis of these hotel markets, and excluded the smaller boutique or unbranded properties and one to two-star rated hotels. Moreover, the figures provided for the financial year 2016/17 are estimated based on interactions with the hotels' management and actual operating performance reported till December 2016. We have not accounted for hotels that have been operational for less than six months in 2016/17.

COLOMBO



The commercial capital of the island, Colombo is connected by the Colombo-Katunayake Expressway (E03) to the Bandaranaike International airport to the north. The city is well connected to other integral destinations such as Negombo, the Southwest Coast, Kandy, Nuwara Eliya, Dambulla, and Anuradhapura by a network of highways.

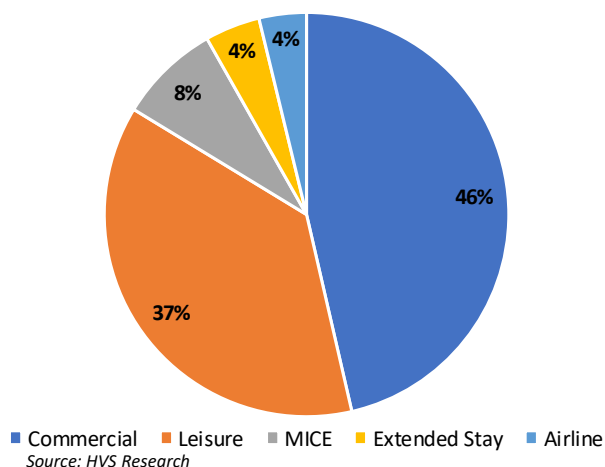
The data set presented for the Colombo hotel market comprises approximately 3,200 rooms.

Demand Segmentation

Hotels in Colombo cater to demand arising from varied market segments, such as Commercial, Leisure, Meeting and Conference, Extended Stay, and Airline. The room nights accommodated by the Commercial segment

continue to form the largest slice of the pie, as the city acts as a hub for corporates and investors. The next largest is the Leisure segment, as Colombo also serves as a gateway city for the rest of the island, and tourists travelling for a holiday tend to stop over in the city. Figure 4 presents the market segmentation for the Colombo hotels, as of 2016/17.

FIGURE 4: MAJOR DEMAND SEGMENTS FOR COLOMBO HOTELS (2016/17)

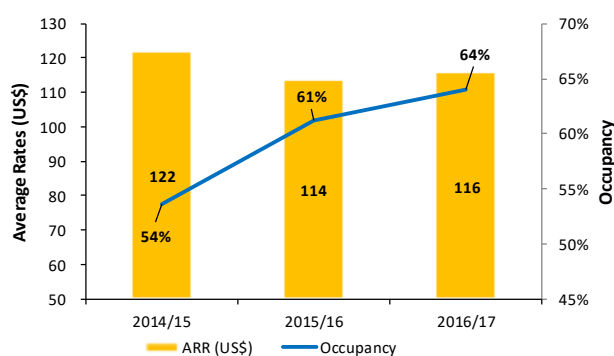


Going forth, we expect Commercial demand to drive business for the branded hotels, given the increased interest in modernisation of the city, the construction of the Port City project, expansion of existing corporates and development of new projects in the country. Future supply with large meeting spaces, such as the Shangri-La opening in 2017, bodes well for the Meeting and Conference segment. Additionally, the international brands, backed by their global sales offices and expected to enter the market over the next two to three years will most likely drive more business, especially from the Leisure segment. The Extended Stay business is anticipated to witness moderate growth over the medium term, due to the project related business generated by the Port City. However, the Airline segment (which includes crew business) may depict a slight erosion, as the existing hotels near the airport can absorb the existing demand, as well as due to the Colombo hotels consciously moving away from the low paying segment.

Hotel Operating Performance

Hotels in Colombo recorded an average occupancy of 64% in 2016/17, a growth of 5.0% over that recorded in the previous fiscal. The market has consistently recorded a steady increase in occupancy over the last three years. Average rates, on the other hand, tell a different story. The city has witnessed room night supply growth over the past three years in the budget and midmarket positioning, a welcome addition to a market previously dominated by five star and five star deluxe hotels. These hotels have been quickly absorbed in the market given their popularity with the price conscious Chinese and Indian travellers; however, they have added pressure on the existing five star hotels, thereby restricting the latter's ability to increase rates. Additionally, an important point to note is the depreciating Sri Lankan rupee, due to which marketwide average rates depict a decline or only marginal increases in US dollars. Various hotels, in fact, have managed to either hold on to their rates or even increase them when considered in the local currency. Also, due to the inflexible minimum rate regime prevalent in the city, limited business is generated from the Leisure tour operators and Meeting and Conference segments, as they have chosen to directly move to other markets within the country. Figure 5 presents the marketwide occupancy and average rate for the past for three years.

FIGURE 5: COLOMBO - HISTORICAL OPERATING PERFORMANCE (2014/15-2016/17)



Source: HVS Research

Outlook

HVS is tracking approximately 4,200 rooms announced as proposed supply for Colombo, with both domestic players increasing their footprint, as well as international brands entering the fray. Several of these projects are actively under construction or near completion and we anticipate 60% of the proposed supply to be developed over the next five years. Therefore, downward pressure on hotel occupancies is to be expected in the short to medium term.

On the other hand, when taking the long-term view, the new branded hotels can play a part in the Sri Lanka growth story, and induce demand for the entire market especially in the Meeting and Conferences and Leisure segments. Additionally, we anticipate that marketwide average rates will display a moderate but steady increase, as majority of the proposed supply comprises luxury and upscale hotels. On the flip side, we do believe that the city is flirting with the danger of being oversupplied in the five star space. Given the commercial orientation of the city, we believe that the development of three to four star hotels will support the growth of a more balanced hotel market.

Colombo is unmatched in terms of availability of commercial and residential developments, and quality infrastructure when compared to other hotel markets in Sri Lanka. Therefore, though supply pressure may affect market performance in the short term, we believe that the city will continue to remain a vital destination for tourism in the country, and gradually absorb new supply to establish itself as a sturdy hotel market.

KATUNAYAKE



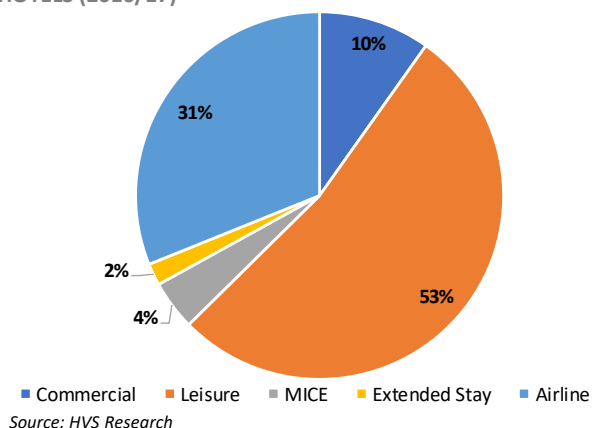
Katunayake is a suburb of Negombo in the Western Province, and the location for the Bandaranaike International Airport, the main entry and exit point for a clear majority of travellers visiting the island. It is connected to Colombo and Negombo by the Colombo-Katunayake Expressway, and is served by the Puttalam Railway Line. In order to further the government's export oriented strategy for attracting foreign investments, Katunayake is one of the three export processing zones (EPZ) in the country, administered by the Board of Investment of Sri Lanka (BOI). The EPZ is located opposite the airport, and houses over 80 garment and rubber related industries.

Demand Segmentation

Hotels in Katunayake primarily accommodate demand from the Leisure and Airline segments. A larger part of the Leisure demand stems from tour and travel agent business, as Katunayake fits in as the first or last stop in the entire travel itinerary, due to its proximity to the airport. Therefore, the hotels in the area are patronised predominantly by transient guests or airlines given its convenient location. In addition to the few room nights generated by the export processing zone, the Commercial demand lodged by the Katunayake hotels is provided by mainly short haul business travellers, who prefer staying close to the airport. The average length of stay, therefore, is not more than one night for these hotels. Figure 6 illustrates the market segments catered to by the Katunayake hotels in 2016/17.

The branded hotel market in Katunayake analysed in this article takes into consideration approximately 550 rooms.

FIGURE 6: MAJOR DEMAND SEGMENTS FOR KATUNAYAKE HOTELS (2016/17)

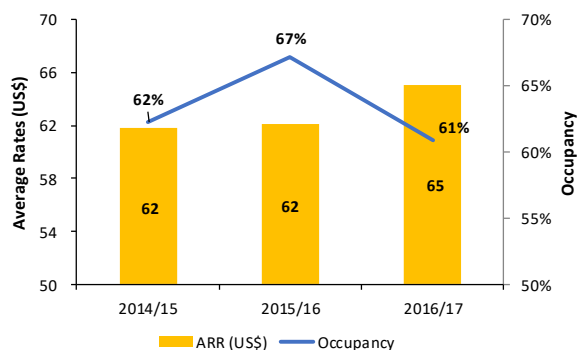


The proposed expansion of the Bandaranaike International Airport will supplement the transient Leisure and Airline segments in the area. The burgeoning online travel agent business in the country also points towards the increase in transient Leisure business for these hotels. We do not anticipate robust growth in the Commercial and Extended Stay demand, as much of the growth is likely to take place in Colombo driven by the city's ongoing and planned development as the country's commercial hub.

Hotel Operating Performance

Hotel occupancies as well as average rates have remained range bound over the last three fiscal years, as displayed in Figure 7.

FIGURE 7: KATUNAYAKE - HISTORICAL OPERATING PERFORMANCE (2014/15-2016/17)



Since both Airline and travel and tour operated Leisure rates are highly negotiated and contracted, the Katunayake hotels have struggled to increase their average rates over the past three years. Additionally, the branded market is facing increasing competition from the mushrooming guesthouses and homestays in the area, as well as hotels located in the proximate city of Negombo. Thus, the branded players have adopted an occupancy driven strategy for revenue growth.

Outlook

HVS is presently not tracking any branded proposed supply in Katunayake; however, the anticipated influx of rooms in the cities of Negombo and Colombo is expected to maintain the pressure on Katunayake hotels' operating performances in the short to medium term. Until the expansion of the international airport is completed, hotels in the area must cater to a more varied clientele in order to sustain occupancies and increase average rates. Quality banquets and meeting spaces are the need of the hour, such that the Katunayake hotels can leverage their proximity to the airport and target the growing MICE segment.

NEGOMBO



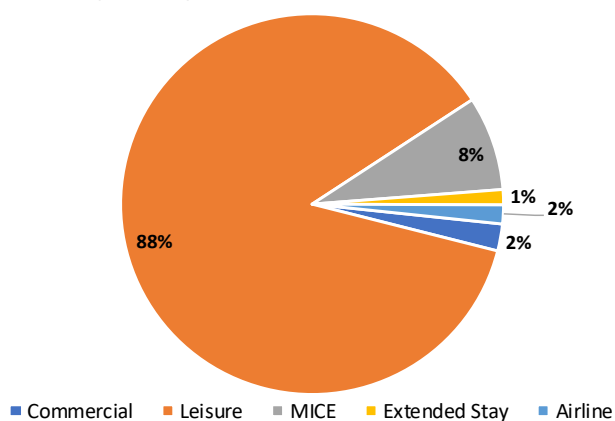
Well connected to the international airport and Colombo city by the Colombo-Katunayake Expressway, Negombo, located in the Gampaha district, has transformed from a modest fishing village into one of Sri Lanka's popular beach destinations over the past few years, especially attractive for price-sensitive travellers. Its economy is largely dependent on tourism and fishing.

We have considered approximately 1,400 rooms in Negombo for the following analysis.

Demand Segmentation

The largest contributor to room night demand for the Negombo hotels is the Leisure segment, and 80% of the business is generated by Foreign Leisure travellers from major source markets such as Germany, France, Britain and the Nordic nations. However, resorts in the area are now witnessing gradual increase in travel from India and China in line with the trend seen at the country-level. European guests have a longer length of stay when compared to those from Asia and the Middle East. While travel agents and tour operators generate 45% of the Leisure demand, online booking channels have evolved as the preferred choice for individual travellers. The Meeting and Conference demand is primarily domestic and social in nature. Figure 8 displays the customer segments catered to by the Negombo hotels in 2016/17.

FIGURE 8: MAJOR DEMAND SEGMENTS FOR NEGOMBO HOTELS (2016/17)

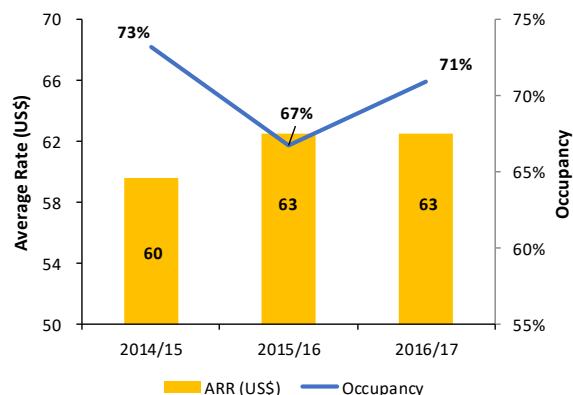


Hotel Operating Performance

The Negombo hotel market witnessed the addition of over 200 rooms over the last three fiscal years, with the majority entering in 2015/16. Due to the supply pressures, marketwide occupancy declined by approximately 9.0% in the same year, only to gradually regain momentum in 2016/17. Given that the new entrant is positioned in the upscale space, marketwide average rates recorded growth of 5.0% in 2015/16 over the

previous fiscal. However, 2016/17 saw the hotels weaken rates and take the occupancy route. Figure 9 illustrates the historical operating performance of the Negombo hotel market for the last three fiscal years.

FIGURE 9: NEGOMBO - HISTORICAL OPERATING PERFORMANCE (2014/15-2016/17)



Source: HVS Research

Outlook

The Negombo hotels' operating performance is anticipated to experience similar troughs and crests in the short term, as HVS is tracking approximately 800 rooms as proposed supply, with roughly 70% actively under construction. Hotels may drop their average rates further to tackle new supply pressures, in a market that is already price sensitive in nature. Moreover, the organised hotels continue to face competition from the steadily enlarging unorganised sector (guest houses and homestays). There is cause to be optimistic, however, as a portion of the demand currently accommodated by the unbranded hotels can be shifted to quality hotel rooms, as and when they enter the market.



TRENDS AND CHALLENGES

In closing, we highlight a few significant hospitality and tourism trends, keeping the focus on the three hotel markets covered in this article. Further, we briefly touch upon the key challenges faced by hospitality industry in these areas.

Asia continues to be the top source market for hotel room night demand.

Sri Lanka's proximity to its top source markets, namely India and China, has resulted in a sustained growth of arrivals, year-on-year. Additionally, improving connectivity, increasing available disposable incomes and the expanding middle class in these source markets has augmented the sustained growth in demand.

Western Europe remains a key driver for demand.

Western Europeans, chiefly British and German nationals, contribute a bulk of the demand between November and February. With the intent to escape the cold and harsh winters, visitation by the Western Europeans during this period is primarily to the western coast known for its golden beaches and calm seas. Attracted to the sun and sand, these nationals clock the longest length of stay on the island (approximately 14 nights).

Increased volume of sales via Online Booking Channels.

Traditionally, hotels in Sri Lanka were sold as a part of the destinations marketed by travel agents and tour operators. However, a shift in booking patterns is steadily gaining traction, with Online Travel agents (third party websites such as booking.com, expedia.com and agoda.com) becoming a significant source for hotel bookings, especially for free individual travellers. With the island gaining popularity, hotels have also reported an increase in the number of bookings made on other online mediums, such as booking engines and brand websites.

Emergence of new itineraries.

The popular destinations for travellers to Sri Lanka have been Colombo, the Southwest Coast, the cultural triangle and the hill country. Traditionally, travel itineraries for the island have been centred upon these key destinations. In addition to selling the popular circuits, tour operators have now begun customising itineraries with a special focus on experiential travel. Although still nascent, these holidays include cruise tourism, dive tourism and Ramayana trails.

Proliferation of the unorganised segment.

In addition to a rapidly transforming organised hospitality landscape, the country is witnessing a spurt in the development of the unorganised segment, which offers a fair quantum of competition, especially to the budget hotels. Small home-stays and guest houses, typically ranging anywhere between two and thirty rooms, have burgeoned in these cities. Providing an affordable option for accommodation, these home-stays mainly attract the “backpacker traveller”.

Dearth of Skilled Human Capital is a growing cause for concern.

The swiftly expanding hotel and resort supply is adding tremendous pressure on the industry from a manpower perspective. There is a serious paucity of trained and skilled staff. Furthermore, retention of trained employees has become a grave concern for hotel operators on the island. With the significant increase in supply expected over the next few years, largely concentrated in Colombo, this gap is likely to only broaden.

CONCLUSION

The hospitality industry in Colombo, Katunayake and Negombo is on the cusp of a major change. The ongoing development of the Port City, expansion of the Bandaranaike International Airport and entry of iconic hotels such as the Movenpick, Sheraton and Shangri-La are likely to have a significant impact on the hotel markets in the coming years. While the cities are expected to mature with these developments, we end this article on a note of cautious optimism. Going forth, new hospitality projects need to be carefully planned and executed to ensure sustained returns for the various stakeholders.





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