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City Lodge Hotels Ltd

Diminishing business travel limits growth but huge capex expected to pay off

Background

City Lodge operates more than 50 hotels, targeted at both business and leisure travel, under five brands: Fairview, The Courtyard, City Lodge, Town Lodge and Road Lodge. The bulk of its operations are in SA, but it has a growing presence in East and Southern Africa.

Our Thoughts

This counter has always been priced at a premium over other travel and leisure stocks, although it operates somewhat in a niche in that it specialises in accommodation. We believe the recent dip in its share price – due to disappointing annual results to end-June – does open an opportunity for medium- to long-term investors to accumulate the stock, but it is unlikely to recover much in the next year. City Lodge has been investing heavily in new builds and any upswing in economic activity should boost performance on the back of its increased capacity. On average, it is only filling up two-thirds of its hotel rooms.

Data published by StatsSA show that South African revenue from tourism accommodation increased 4.9% (hotels: 4.6%) year on year in May. However, it is worrying that the growth came from price increases of 6.7%, which offset a decrease in volumes of 1.7%. These industry figures are mirrored in City Lodge's annual results: between 2007 and 2016, tourism accommodation grew revenue by a compounded annual growth rate of 12% (hotels: 11%). The stagnant economy is hurting City Lodge.

In the Kenyan operations, occupancies declined in the build up to the recent elections. Management expects a recovery but the current post-election violence is a concern.

We expect a number of events to boost City Lodge's income statement, balance sheet and free cash flows. First, the finance costs associated with its 2008 BEE transaction will fall away at the end of 1H18 as the financing facilities become due. Management says the liabilities are well covered by the value of underlying shares. This will improve both its bottom line and its gearing profile.

Second, we expect the group to start reducing its capital expenditure, which should improve its free cash flows. If the new capacity created is coupled with an upswing in demand, it will see significant growth on the top and bottom lines.

Our call

The share is likely to trade sideways in the interim and pick up as its new hotels become entrenched and the economy recovers. City Lodge has been increasing its presence in Africa, diversifying revenue streams and gaining exposure to potentially higher-growth markets. Its target is to generate at least 35% of business from other African countries from just below 10%. Now that the Ebola scare has largely dissipated, business is picking up again in East Africa.

We maintain a hold recommendation mainly because it is priced for superior growth, yet growth is set to be muted in the short-term. We believe that this company will outperform over the longer term.

Equity Research

HOLD

12-month target price	R146.08
Spot share price	R134.64
12-month implied total return	8.5%

City Lodge share price

Source: I-Net BFA

Key statistics

Market cap: R5.9bn

Net debt-to-equity: 21.9%

Price:earnings ratio: 16.6

Forward PE ratio:13.6

Dividend yield: 3.7%

Forward dividend yield: 4.4%

Risk: medium

12-month high: R175.99

12-month low: R127.00

Ave monthly volume: 0.88-million

Financial year-end: 30 June

Latest event

Final results

Date announced: 16 August

Share details

Company: City Lodge Hotels Ltd

JSE Code: CLH

Sector: Travel & Leisure

Sensitivity analysis				
	Terminal growth	2.0%	4.0%	6.0%
Wacc	10.0%	16 735	20 139	26 947
	11.0%	14 582	16 972	21 276
	12.0%	12 872	**14 608**	17 503
	14.0%	10 336	11 323	12 804
	15.0%	9 372	10 138	11 244

This reflects the sensitivity of our forecasts to assumptions of the terminal growth rate and the weighted average cost of capital (Wacc). The highlighted cell shows our target price in cents.

Expanded capacity likely to see scale benefits accruing when economy picks up

Performance Review

RESULTS IN BRIEF	FY17	Change	FY16
Revenue (Rm)	1 520.4	1.8%	1 493.2
Operating profit (Rm)	496.4	-5.3%	524.4
Operating margin (%)	32.6%	-7.0%	35.1%
Attributable earnings (Rm)	295.1	-6.4%	315.3
HEPS (cents)	810.2	-6.6%	867.9

Low business and consumer confidence in SA dented business travel, which saw average occupancies being knocked down to 63% from 66%. Coastal hotels fared better than inland hotels due to inbound tourism, but weekend occupancies were soft.

Botswana turned in a poor performance, influenced by its high correlation to SA's business activity. In Kenya, occupancies waned in the second half of the year in the build up to the presidential elections. However, business is expected to normalise in Kenya, assuming the post-election violence is not sustained.

Margins shrank because operating costs accelerated by 5%, and they now eat up more than 1.8% of revenue. The group maintained its 60% payout ratio and its total dividend of R5/share is 3.3% lower than last year.

Prospects

City Lodge generates more than 90% of its business within SA and about two-thirds come from corporate travel. The South African economy has been muted but any upswing in demand will serve the group well. There are a number of construction projects under way locally.

In order to diversify concentration risk and increase the contribution from other African countries to 35%, management is working on a number of projects outside SA. Two hotels in Kenya and Tanzania are under construction. They will have a combined capacity of 319 rooms and are expected to open between 2Q17 and 3Q18. In Namibia, development of a 147-room Town Lodge is under way and it is expected to open in September. And in Mozambique, construction of a 148-room City Lodge hotel has just begun and is expected to open in the second quarter of 2018.

Valuation

Using conservative estimates, we expect average revenue growth of 10% a year in the short to medium term, which should gradually fall to a sustainable growth rate of 4% in the long run. We estimate that City Lodge's adjusted pre-tax operating margin should stabilise at around 34% in the medium to long term. Using a discount rate of 12%, we obtain a target price of R146.08/share. That translates to upside potential of 8.5%.

Bull Factors

- Signs of economic recovery supported by improving commodity prices
- BEE financing costs fall away at end-FY17
- Lifting of travel advisories on Kenya
- Growth set to improve after Kenyan presidential elections
- Different brands to meet range of market needs and incomes
- Significant market share with well-established brands
- Capital expenditure sets platform for medium-term growth
- African expansion will enhance earnings diversification and position the company to participate in Africa's growth

Bear Factors

- Depressed corporate travel in SA due to stagnant economy
- High degree of revenue concentration in domestic market, though this is being addressed through African expansion
- Political uncertainty over the policies of presidents Zuma and Trump

Extract of the DCF model	2017A	2018E	2019E	2020E
Operating profit (R'm)	496.4	531.1	616.1	683.8
Net operating profit after tax (R'm)	295.1	360.5	418.2	464.2
Working capital changes (R'm)	(17.5)	18.6	(22.7)	24.9
Capital expenditures	(202.4)	(214.5)	(203.8)	(193.6)
Unlevered free cashflows (R'm)	227.3	282.8	327.8	445.2
Headline earnings per share (cents)	810.2	989.0	1 147.3	1 273.5
PER (times)	16.6	13.6	11.7	10.6

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A buy recommendation is made where the target price is 10% above the current price, a sell when it is 10% below the current price, and a hold recommendation when it is within 10% of the current price. The risk measure is a subjective determination guided by the beta of the share price. We also examine the financial and operating leverage of the business.

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