Investors' Chronicle | Alpha

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Alpha shares analysis

11 April 2022

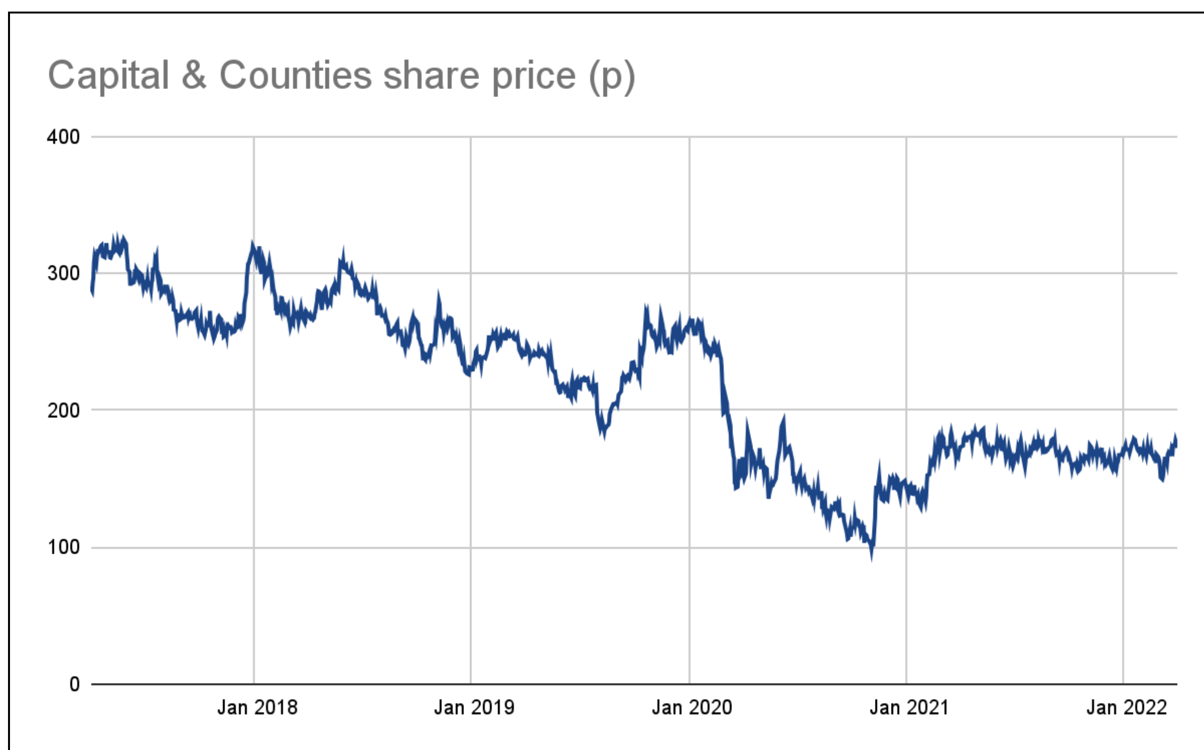
The only way is up?

This week we look at businesses that have screened well for upgrade momentum. This can be tricky to assess at the moment as many businesses are experiencing a strong rebound or catch-up post Covid and it is important to determine whether there is a positive underlying story that shows sustainable growth potential after trading has normalised. Very different businesses here again: London real estate, digital marketing and international hotels.

- **Capital & Counties (CAPC)** – CapCo owns large parts of the well-known London tourist and leisure destination Covent Garden. Central London real estate has been hit hard by Covid, Covent Garden arguably more so because it relies so heavily on tourist footfall. Rents fell by 24 per cent and yields rose from 2½ to 3¾ per cent pushing the net asset value (NAV) down from c.325p to 190p. Although the NAV has picked up to 212p, this largely came from the 25 per cent stake in fellow London investor **Shaftesbury (SHB)**, not its own estate. Rents are rising slowly and yields are unlikely to fall as benchmark interest rates rise so investors should not soon expect the NAV to show any material improvement. Shaftesbury might be a better option.
- **Next 15 (NFC)** – a global digital media agency with good growth credentials and organic growth above 25 per cent plus value to be extracted from a steady stream of acquisitions; especially the latest, Engine UK. Furthermore, a still largely federated group structure has made limited use of cross-selling and a drive to 'productise' its services should extend its reach. Upgrades are likely but not now as recent annual results already bumped up forecasts. On the downside, headline results are stated after heavy adjustments and the numbers could be more prudently struck, especially on the treatment of acquired goodwill. There is potential and value here, but the business is complex and opaque to all but industry experts, so any buyer is taking something of a leap of faith.
- **Intercontinental Hotels (IHG)** – IHG is a top five global hotel operator and, in common with other industry leaders, owns few hotels itself instead running a largely fee-based franchise model. Travel is rebounding, especially in IHG's key market of US domestic and Europe, Middle East, Asia and Africa remain barely profitable for now but should rebound. The war in Ukraine is likely to push recovery back, as is the latest surge in Covid so neither management nor analysts are likely to pencil in higher forecasts for a while. While the stock might look cheap against its main US-listed competitors, it has stuck around a PE ratio of 20x for much of the last 20 years and that suggests the share price is about right for now.

Analyst: **Robin Hardy**

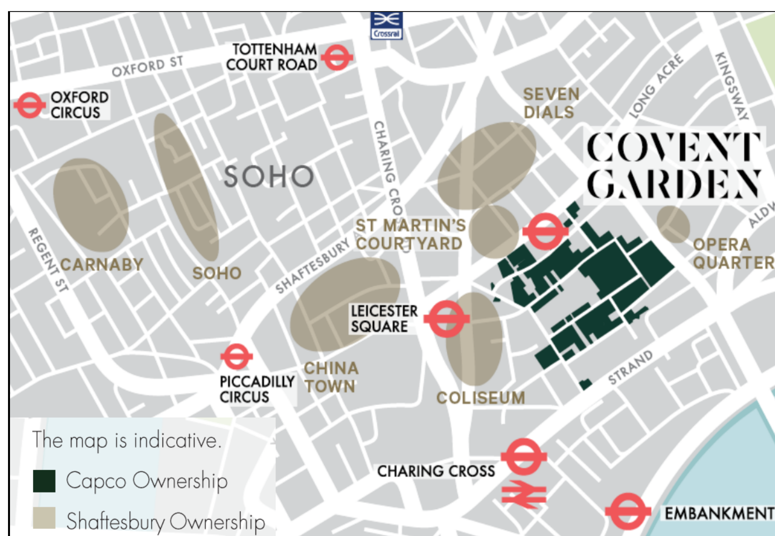
Capital & Counties – All that glisters…



Source: FactSet

Capital & Counties (CAPC usually referred to as CapCo) is a real-estate investment trust (Reit) that owns a substantial amount of the well-known London shopping and dining destination Covent Garden. The former fruit & veg market along with its environs in the capital's West End has long been a mecca for tourists but the shares have suffered a long-running de-valuation, even before Covid stopped the visitors coming (see above).

CapCo London retail-estate interests



Source: Capital & Counties

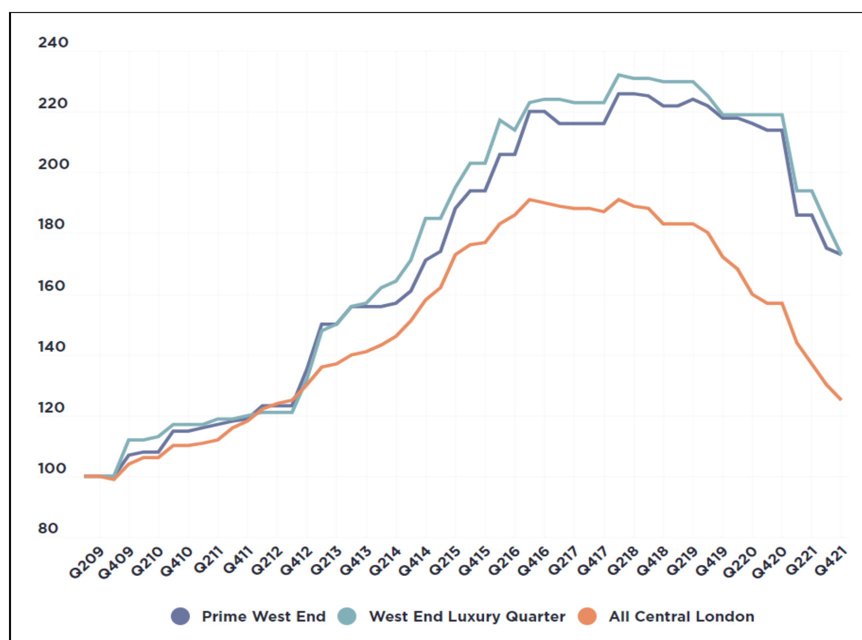
The wider London real-estate market

The property market in the UK capital has had a tough time through the pandemic, a position not helped by the view (with the benefit of hindsight) that the market had become somewhat overheated. Rents were high and yields were low (low yields are typically meant to indicate that high rental growth is to be expected, that asset quality is high and that the estate is hard to expand, replicate or replace). However, this was not entirely due to over-exuberance by London property investors. It was also a function of the ultra low levels of risk-free returns (RFR) as shown by long-dated sovereign bond yields. The yield on property (which equals the passing rent divided by the capital value) can also be expressed as a premium over the RFR and even before Covid, the RFR dropped to long-term lows, moving below 0.5 per cent in Q4 2019. This allowed prime London yields to fall as low as 2 per cent.

Since the start of Covid, London prime real estate has suffered on multiple fronts:

1. General lack of demand for retail space – the rise of online shopping – in 2021 West End vacancy rates were 15 per cent
2. Long closures and low footfall – in Q4 2020 footfall was down 66 per cent
3. Rising RFRs and rising capitalisation yields - inflation returning, lower confidence in rents, more rent-free periods, shorter leases, more break clauses
4. Pressure on consumer income especially impacting retail
5. Lower tourism impacting visitor-specific locations such as Covent Garden
6. Falling rents as a result of all of the above

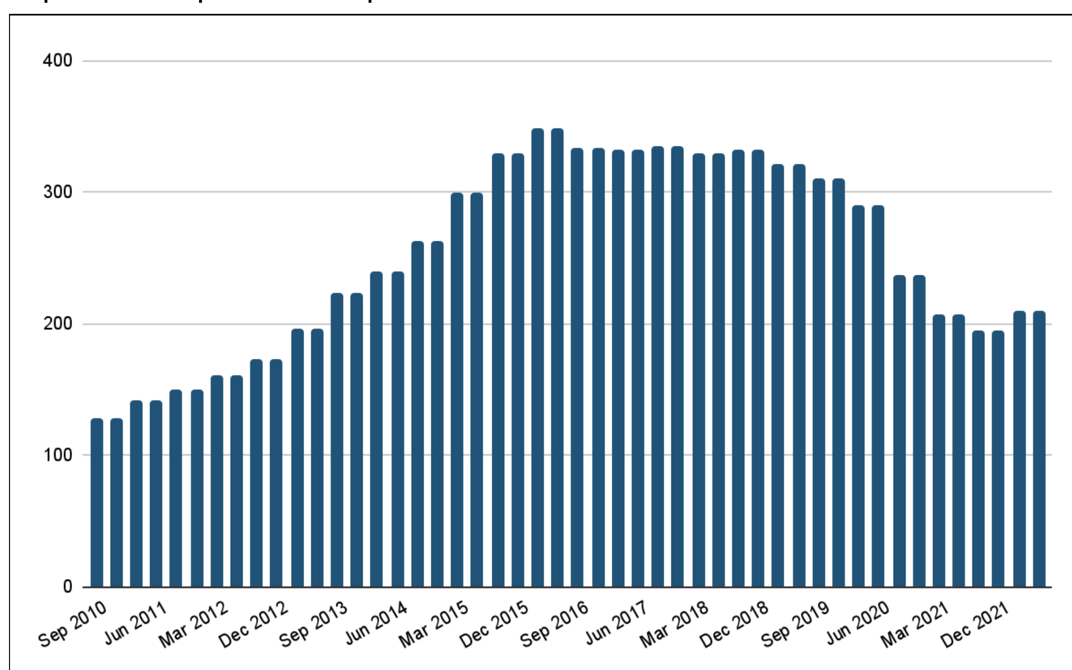
Prime Zone A* rental - Q2 2009 = Base 100



Source: Savills Research | Zone A = 20ft of retail space from the street back

This is reflected in a sharp drop in NAV for any central London portfolios, such as CapCo's, which is shown below. Rents had already stalled in many London markets as early as 2016 but to that point had almost doubled and were expensive: Oxford Street and Regent Street achieved rents of c.£900-1,200/sq.ft and Bond Street £2,400/sq.ft. While the very best locations have held up better, overall central London rents have fallen back to levels last seen 10 years ago.

CapCo's NAV per share in pence



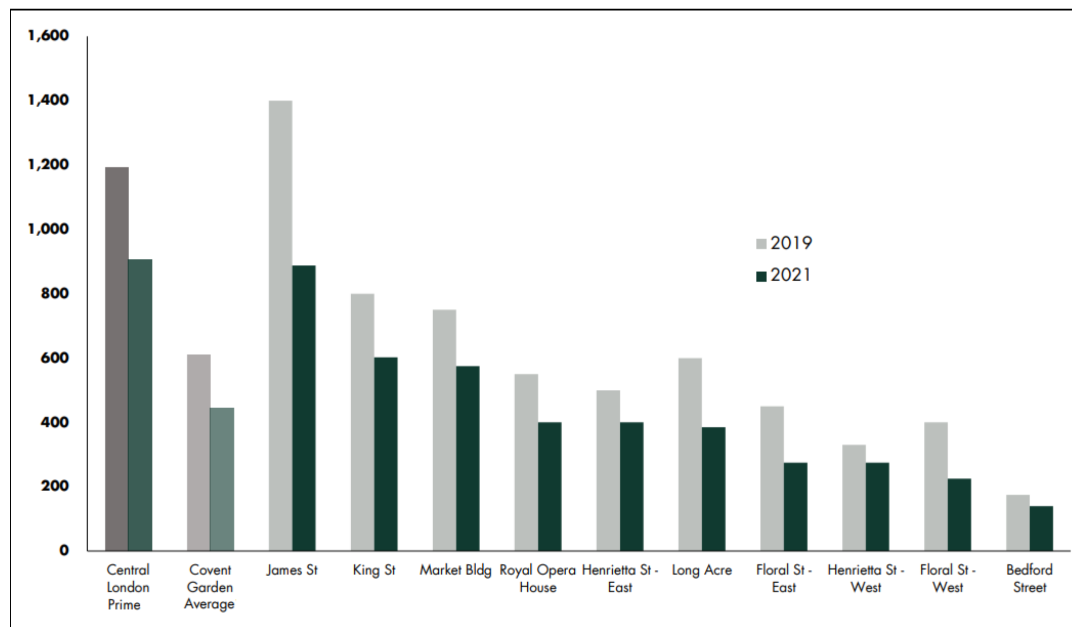
Source: FactSet

Covent Garden

Covent Garden is a popular shopping and leisure (eating out) destination, but it depends to a very large extent on tourism. It is not a location that attracts Londoners in any great numbers other than periodic visits to the various flagship stores of in-vogue retail brands. Most of the shops are small and offer inflexible space and this is reflected in the rents.

Running as low as £160/sq.ft and only £400/sq.ft on average, this location is clearly not seen as being amongst the most prime in London. It does, however, have the advantage of much lower voids (un-let space) with only around 3 per cent of its space empty against 12-15 per cent for central London overall and new leasing activity has been relatively high. However, this is a market with naturally higher 'churn' than other locations as fast fashion and current trend names come and go fairly rapidly and, unlike shopping centres or major high street destinations, there are no clear, large space anchor tenants.

Covent Garden rents etc in £/sq.ft Zone A



Source: Capital & Counties

Rents are edging up slowly, but the gap between passing rent (what can be collected now) and the estimated rental value (ERV – what might be possible to collect if all positive factors fall into place) remains wide at 25 per cent. While ERV can point to the potential growth in the NAV (assuming flat yields) it is rarely that simple in practice. That is why ERV is an indicator of potential rather than a figure used in valuations.

Another key factor when looking at real estate is the Weight Average Unexpired Lease Term (WAULT) – the average period of visible rent. CapCo's remaining average lease term remaining is almost 8 years (a pretty decent level) but 21 per cent of its space expires within two years. This means that CapCo will always be running hard to keep its space filled and also means that the current high rate of new letting could be viewed as more a necessity than a virtue.

This local real estate market may have turned the corner but it is unlikely to race away any time soon.

A trophy destination?

As interest slowly begins to return to the London real estate market, leading surveyor and estate manager Savills believes that the focus of interest today is in so-called 'trophy' assets: property that is exceptionally rare and in high demand by investors and occupiers. While Covent Garden is unique and, in some parts, is able to command rents towards the higher end for the city, it is not widely regarded as being in the 'trophy' bracket. There are

a lot of restrictions in the area with listed buildings, major adjacent areas that CapCo does not own (there is a lot of ownership by sovereign wealth funds and high net worth individuals locally), a risk of some space being over-rented (where the rent is well above what should be expected and/or sustainable for the location).

On this last point, a handful of Covent Garden locations command rents almost as high as the premier shopping locations, such as Bond Street. Here the customers are the super-rich so the high rents fit. In Covent Garden, the passing customers are generally tourists with far lower spending power. This means that rather than having naturally high rents, CapCo has to fight very hard to keep up the premium tenant profile. While many businesses choose to have their flagship stores here, they may be loss-leading for the brands but there have long been rumours that the enormous Apple store operates close to rent free, tolerated as the landlords' loss leader as it acts as a draw. That is not a sound model.

Earl's Court

In 2012, CapCo purchased (in JV with London Transport) a large tract of land in the Earl's Court area of west London encompassing the major exhibition halls and a number of decaying council housing estates. The plan was to create a new 'quarter' with more than 1,000 homes, a new high street with 42,000 sq ft of retail space, and 164,000 sq ft of office space. At its peak (in 2015) the scheme was seen as being worth £1.5bn, but it was never popular (the *Guardian* called it London's worst major regeneration scheme) and investors in Reits generally dislike development (too much risk, too long time frames, no rent, no dividends). It was sold two years ago for just £425mn, 16 per cent below even its then written-down book value with the last of the deferred payments only received in late 2021.

CapCo retained some of the residential element (known as Lillie Square), but progress exiting from this appears grindingly slow with Far Eastern investment interest drying up (and likely to get worse as Chinese residential markets drag on investors). There has been a long-running battle with City Hall over the provision of truly affordable housing on the site - if the Mayor gets his way on 35-50 per cent truly affordable housing, the scheme would have very little net value.

Overall, Earl's Court, which was meant to add diversity to what was seen by many as an overly concentrated portfolio, has cast a long and lasting shadow over CapCo and has played a leading role in creating a less than warm view of the company in the eyes of many investors. It has also been a key factor in keeping the share price lower relative to NAV relative to that of its peers.

Shaftesbury

In 2020, CapCo bought a 25 per cent stake in fellow West End landlord Shaftesbury (SBH), the owner of Carnaby Street, parts of Soho and much of Chinatown. This was largely funded by recycling the capital released from the sale of the Earls Court scheme plus the issuance of an innovative 'exchangeable' bond. The stake became available after Hong Kong property tycoon Sam Lee sold his stake in Shaftesbury following a long-running legal wrangle over pre-emption rights. This initial investment was c.£465mn, topped up by £65mn in October 2020's discounted equity issue by Shaftesbury: so, the initial book value in CapCo's accounts is £525mn.

While SHB is often seen as 'the neighbour across the fence' there are marked differences between the two businesses. CapCo generally has high rents across its portfolio (c£600/sq.ft average) against SHB's average of nearly £200/sq.ft partly to do with location but also because of CapCo pushing its rental values hard during more buoyant times. SHB has more rented residential space and almost double the amount of food and beverage (F&B) square footage: through Covid, F&B has seen less rent erosion than retail as it does not have the additional pressure from online transition and the boom in take away helped keep many F&B operators in better shape.

CapCo's investment should bring in close to £12.5mn per annum in dividends (£15mn in 2023) but makes a yield less direct investment in London real estate. Even after property yields in the capital have increased due to Covid, the initial return is still likely to be only around 3.0 to 3.5 per cent against the 2.5 per cent CapCo is earning now. In addition, it has no control over the portfolio.

So, in having a large stake does this mean SHB and CapCo will get together? There is reportedly no great warmth between the two management teams and the SHB board is understood not to be interested in a tie-up with CapCo, but SHB may not be able to prevent a combination. This is because Norges Bank holds 25.75 per cent of SHB, which it increased from 20.5 per cent in October 2021 - a move some observers believe could have been to allow it to force SHB's hand and allow CapCo to push past a 50 per cent stake and assume control of the business. A situation to watch.

Upgrade potential?

Although CapCo was highlighted by our Alpha screen targeting stocks with earnings upgrade potential, that does not really apply to a REIT. Property stocks are valued on their net asset value or NAV (property estate's market value less debt) and the premium or discount to the NAV that applies to the stock and/or sector. This depends on the wider economic climate, risk-free interest rates, rental growth and stock specifics such as

geography and property sub-sector exposure. None of these looks especially favourable at present.

Things are beginning to get a little better in terms of footfall and tourist volumes, but Covid is clearly not over, the geopolitical situation is pregnant with risk and there is a squeeze on consumers' net income both domestically and internationally. Central London, and Covent Garden in particular, serve markets that feel towards the sharper end of discretionary spending. Smarter shops (as distinct from truly premium retail such as Bond Street) risk losing custom and restaurants face pressure on occupancy, food prices, energy costs and wage bills which must begin to bear on what F&B establishments are willing and able to pay in rent.

CapCo's NAV did rise in the last six months but not on its own account – more than 100 per cent of the increase came from its investment in Shaftesbury. Covent Garden dropped fractionally (0.6 per cent) and Lillie Square fell 14 per cent: Shaftesbury rose 8 per cent although there was a little more momentum in the second half of the year. Nothing came from profits which are de minimis.

In order for the NAV here (and across the sector) to rise rents need to start showing stronger growth and while they are edging up, analysts feel that they may only be able to achieve 2-3 per cent per annum this year and next at best. Yields may have stopped rising but they may struggle to fall largely because of the rising RFRs. In December 2021, CapCo's 3¾ per cent portfolio capitalisation yield was 300bps above the 10 year Gilt yield but is now only 200bps above (reckoned to be equal to the long-run average) and could reduce more. All told, this is likely to keep CapCo's NAV on a tight leash.

Given that the bulk of what little increase we have seen in CapCo's NAV in the last 12 months came from its stake in Shaftesbury, perhaps investors should look at that stock rather than CapCo. Over the last 10 years, Shaftesbury has given investors a total shareholder return (TSR) of 41 per cent while CapCo shareholders have seen a 10 per cent loss, with a similar story over five years. CapCo may look cheaper on a 20 per cent discount to NAV against Shaftesbury's 3 per cent discount but the quality gap may be wider than this.

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Next Fifteen – not just your average media agency

Source: FactSet

Next15 is an interesting and rather complex business set in the media agency sector. Unlike many of its peers which aim to offer streamlined and integrated advertising and marketing solutions, this company has a very different approach, operating structure and end customer profile. Also unlike its peers, advertising is relatively low on the list of services that the group offers.

Rather than being one company or cohesive organisation, Next15 is more of a federation of businesses, even a marketing sector conglomerate. The businesses built organically or acquired are (typically) not integrated, do not share common brands and, in many cases, are not fully owned by the PLC with staff/directors or original founders, VC or PE owners retaining a stake. While this latter point is seen as a positive (investors like players to keep some 'skin in the game') it does mean that external investors potentially miss out on some of the growth, especially in the more dynamic businesses.

This federated structure is unusual and while it is likely to mean that overheads are higher than they might otherwise be, there is clear evidence that margins (21 per cent EBIT last year) and growth (revenue up 36 per cent) are strong. Also, a more cohesive structure in future could lead to lower costs and higher revenue without harming the fabric of the operations.

Look at it four ways

Next15 has struggled historically to lay out for investors how its businesses generate revenue and profits. Previously, it only reported on geographical lines but more recently has bowed to investor pressure (perhaps too strong a word) to present more along the lines of business disciplines. This gives us the current reporting structure of:

> **Insight** – this is the smallest segment and contains market research companies (similar to YouGov) that allow businesses to make more informed marketing decisions. The greater majority of the customer base operates in the technology space.
>
> **Engagement** – the largest part of the group (half of total revenue) but slower growth and margins at the low end for the group. Traditional PR and business communications but almost entirely in the digital channels (social media, adware, in-game, YouTube etc).
>
> **Delivery** – this is a lead generation business that helps companies to grow more quickly. This has the highest margins at almost 36 per cent on an adjusted basis (see discussion later). Its skills are in both digital and traditional marketing.
>
> **Transformation** – the fastest growing segment (99 per cent organic growth in 2021) which, as the name suggests helps businesses transition from start-up status through PE and VC investment and on towards equity markets. Digital transformation, more broadly, is a rapidly evolving business segment.

After the end of the last financial year, Next15 acquired Engine UK, a diverse but more traditionally structured transformation, communications and creative business with, we understand, the express aim of breaking it up, spreading it around the group and eliminating a rather expensive central overhead cost (£19.5mn, equal to 21 per cent of revenues: Next15's central costs are just £13mn or 3.5 per cent of revenues). While this more integrated operational model is 180 degrees different from that of Next15, this was more an opportunistic than strategic move, with the benefits to arise from cost elimination and marriage value with existing businesses.

Engine came in with low margins, returning only 13 per cent earnings before interest, tax, depreciation and amortisation (Ebitda) – so likely single digit EBIT (operating profit) margins. The Next15 group average EBIT margin was 22 per cent in FY 2022, but Engine's likely contribution is low enough to reverse group margins in the current year by 250-300bps to c.19 per cent. However, Engine was bought on the cheap: below 7x stated

Ebitda, more practically 3-4x Ebitda when the central costs are trimmed back so it will boost earnings per share (EPS).

Look at it in a different four ways

While the four way split of the business above works now, Next15 wants to transform its offering from services into products: a process imaginatively known as 'productisation'. This is an interesting new area across all industries where businesses with a well-established service offering (often in the consulting field) attempt to go through an evolution, rendering their core services down to plug-and-play software or an app. There are broadly six core models of productisation that Next15 could follow:

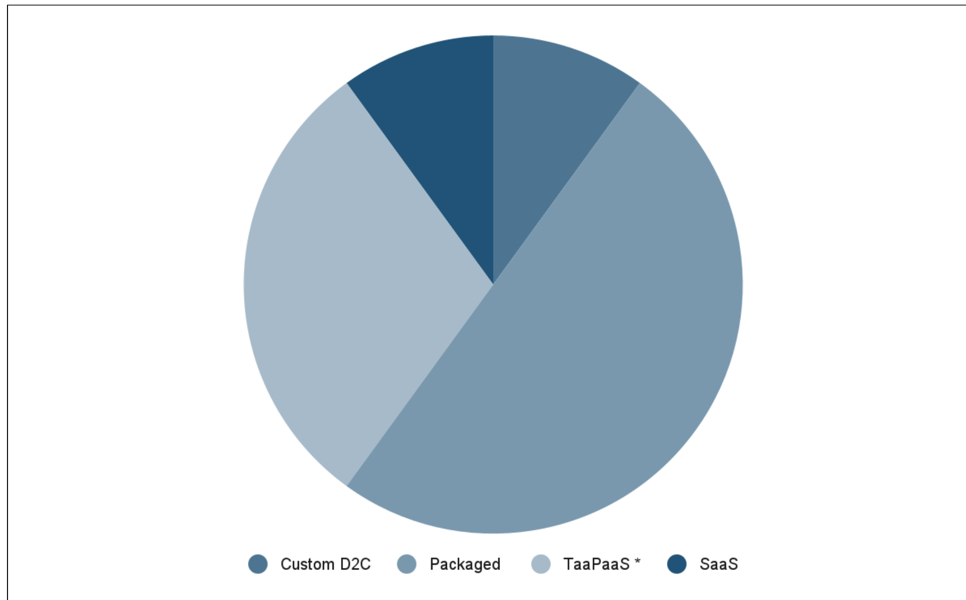
- One-time (repeatable) projects
- Recurring services
- "Unlimited" services
- Coaching or done-with-you services
- Software with a service or SaaS
- Productised consulting

If successful, these are powerful ways to extract more value from your skill sets, lower customer acquisition costs, potentially allow third parties to re-sell services in solution sets and provide improved revenue visibilities as many items can be bundled as Something as a Service (XaaS). The last point is likely also to help improve a stock's rating as such streams of earnings tend to be given high valuations by the market given that they have high visibility and tend to be 'sticky' (customers just keep renewing).

It is very early days on this front and the great majority of the group's revenues still come from direct-to-customer (D2C) execution but the plan is to radically reshape the revenue profile of the business, as shown in the pie chart (below). However, it is not clear externally into what new categories the old definitions will fit.

In practice, difficulties exist dealing with technology-oriented businesses as they have such diverse business and operating models. This process is easier with less advanced businesses that use well-established business practices. However, there are still a lot of common practices that can be packaged. The risk has to be commoditization and that could mean that the pricing of services falls, especially if all of the group's peers follow the same path - why would they not? However, the scope to reach to SMEs and even micro-entity businesses with such an offering could substantially widen the potential market size.

Next15's future revenue model



Source: Next15 PLC | TaapPaaS = Technology-enabled products and services

Order out of chaos

It might be a little disingenuous to say the structure of the business is chaotic but that is more naturally the state of any federated or conglomerate business. This does, however, offer scope for additional revenues and lowered costs for Next15.

> **Costs** – leaving businesses as largely independent means inevitable duplication of functions and higher than necessary costs. This could help add to the margin without impacting on businesses' dynamism.
>
> **Cross-selling** – there appears to be little drive within the group to sell the services of company X to company Y's customer base. Perhaps this feels like too much of an imposition from the centre but does feel like a missed opportunity. The drive to productise is a push towards resolving this but is likely to be a slow process. Also with organic revenues growing at over 25 per cent without cross-selling, there could be a risk of over-trading. However, the scope to boost revenues is certainly there.

Please do not adjust your set

It is always wise to take a much harder look at any company that is consistently presenting heavily 'adjusted' or 'normalised' results. Next15 has reported significantly adjusted results for the last few trading periods, notably the 2021 full results released on April 5th. In this case, an 'adjusted' pre-tax profit of £79mn compares with a statutory reported loss of £80mn. This is a very pronounced adjustment, and although there has

been a large gap in each of the two previous years, 2022 was an order of magnitude higher (2021: £49mn adjusted PBT vs £1.3mn loss statutory | 2020: £40mn PBT against £5.6mn).

In this case, the major swing factor is a non-cash, notional interest charge related to the deferred consideration payable on acquisitions – this was £110mn and as a pure, newer accounting standards requirement backing this out is understandable. However, while this is a non-cash item today, it will become a cash flow item later as deferred consideration. Indeed the amount of deferred and profit-related consideration for past acquisitions has risen steeply through the year. At the start of the 2022 financial year the board reckoned it would need to pay out £62mn by 2028; that figure is now £215mn. Although this might be expected to be funded by the performance of the acquired businesses, it could limit spending power on future acquisitions.

There are a lot of moving parts within Next15's profits and this can make it difficult to see how well the business is performing only by looking at the headlines or to know which sets of figures are the most helpful indicator. For example, the business is expanding as revenue grew 36 per cent (26 per cent organic) but digging down we see that staff costs grew by the same amount (so gross margins are flat) but other group costs fell slightly meaning that net margins have increased. Rapid expansion can push costs and ideally, when reaching the scale we now see (sales of over £360mn) one might expect cost expansion to be lower than sales.

A couple of other points that might raise eyebrows: 1) Goodwill write off – the statutory figure was £27.5mn but in the adjusted accounts just £11mn. The difference is "employment linked acquisition payments" which notes to the accounts point out are "are not exceptional or non-recurring". Prudence says these should be deducted from profits as they are a cost of doing business in expansive, asset-light businesses. 2) Share based payments (SBPs) – another £5.8mn in the form of share-based remuneration has been added back and typically this should be left in for prudence. This particular charge might, as the accounts state, be "not aligned with the timing of the anticipated benefit of the incentive" but they are a cost associated with delivering the trading performance.

As a statutory loss has been retained, the value of the balance sheet has fallen from £118mn to £61mn: of the £61mn of net assets £183mn is capitalised goodwill and £46mn is a deferred tax asset (an asset that usually arises when either the Company has overpaid taxes or paid advance tax) and looks largely to have arisen from historic statutory losses.

Overall, these are a tough set of figures for private investors to follow. While the largest item used in the adjustment is only an accounting movement today, it is connected to a large future cash flow meaning it should be pushed aside and the treatment of goodwill and SBPs could be more prudent.

Minorities

In accounting terms a 'minority' is the portion of post-tax profits that come from a subsidiary not 100 per cent owned by the PLC. Other, external shareholders (usually the vendor) retain a stake in the company and they 'own' a share of the profits in proportion to their shareholding. This does not impact pre-tax profits where 100 per cent of the profit is 'consolidated' but does impact EPS. In these latest results, PBT is reported (as adjusted) to be 61.5 per cent higher but EPS is only 48 per cent higher. There was a slightly higher tax rate and a small increase in the number of shares but the 'minority' charge has increased almost four-fold from £1mn (2.5 per cent of profit) to £3.6mn (5.8 per cent of profit).

This is all perfectly normal and above board but is an element to watch. If a company is a steady acquirer of businesses, it is important to know how much of the profit or growth will accrue to your stock's earnings and not exit to another group of shareholders.

A soaring share price

The Next15 share price has soared recently, rising 14 per cent in a week and 33 per cent in a month. Overall, the shares are more than double their pre-Covid levels and six times higher than their Covid-slump low of 246p. Does this performance align with how the business and its profits are evolving?

There have been upgrades to forecasts recently: FY2023 was upped by 11 per cent and 2024 by 14 per cent so this aligns with the shorter-term performance. Looking back over 12 months, estimates for these same trading periods are respectively 35 and 41 per cent higher: so again, the share price surge has been pushed by EPS forecasts rather than by a re-rating.

Where might we look for further revision in the consensus forecasts?

1. **Engine UK** – this looks to be a value accretive purchase and Next15 paid a pretty low price for it.
2. **Organic growth –** this looks to have been maintained into the current year which suggests that there is real momentum here rather than just a rebound or catch-up spending post-Covid. Marketing and advertising spend is often the first thing cut when the outlook darkens and that was certainly the case in 2020 and 2021.

3. **Fast growing customers** – while global advertising and marketing spend is likely to grow at least at a high single digit percentage, it is likely that Next15's customers and their spending will grow faster. Due to the technology bias, rather than seeing a rate of business expansion of 7-8 per cent (it appears that specific industry growth rates for media agencies are not recorded, so this is an estimate), tech businesses might be expected to achieve 20-50 per cent growth.
4. **Outsourcing** – digital marketing and other services that Next15 offers are becoming increasingly complex leading to more businesses having to outsource and close internal marketing departments.
5. **Cross-selling and productisation** – perhaps not in the very near future but towards the end of a two year forecast window these might begin to impact.

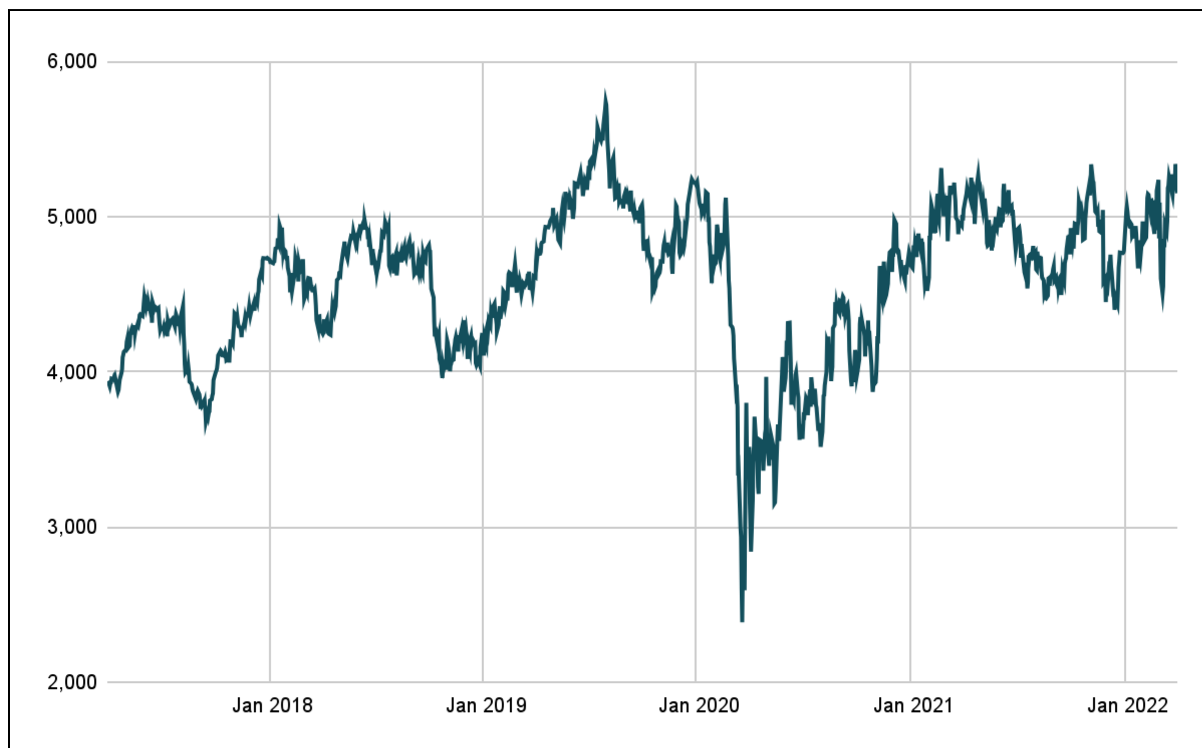
However, there are risks. First, key markets (especially the US) could go into recession and marketing spend is sacrificed. Second, that Engine cannot be as easily broken up or have its central costs eliminated as far or fast as expected. Third, that the move to productise its services proves to be more expensive and more harmful to pricing than hoped. Fourth, wage growth and staff retention issues begin to rise more steeply in an inflationary environment and those higher costs cannot be passed on. Overall, however, it appears that the positives here outweigh the negatives.

Too much of a leap of faith?

So, there is some scope for further upgrades but probably not for at least another quarter as we are only a couple of days after the latest trading update. In the round, the rating looks about right here for now with a forward PE of 15x adjusted EPS and 26x statutory EPS. As above, the danger is that this stock looks cheap versus its higher growth rate on the adjusted EPS but the adjustments that management and analysts are making may be too imprudent leaving the adjusted EPS too high.

Another concern here has to be the relative opacity of the business - even after a long hard look, it has been difficult to understand what exactly this business does and, in some cases, for whom. For example, a large subsidiary in the US (MACH49) recently won a >$400mn, five year contract but stated that the client was "currently operating in stealth mode" so investors have no idea what this new contract entails. Also in its results, there is largely only detail on growth rates of specific businesses without any specifics and only bland (albeit positive) statements on the outlook. This is a business with a strong record, operating with fast growing clients, showing good organic growth, appearing able to buy new businesses well but nonetheless this does feel a little too much like a blind investment or a leap of faith.

Intercontinental Hotels – safe to go back in the water?



Source: FactSet

Wot? Not hotels?

Intercontinental Hotels (IHG) is a major, branded hotel group (alongside the likes of Hilton, Marriott, Accor etc) but itself owns very few hotel assets. So what is it? Effectively, IHG is a brand franchisor for a long list of hotel brands (see brands chart below) from economy hotels (motels plus) through to boutique establishments.

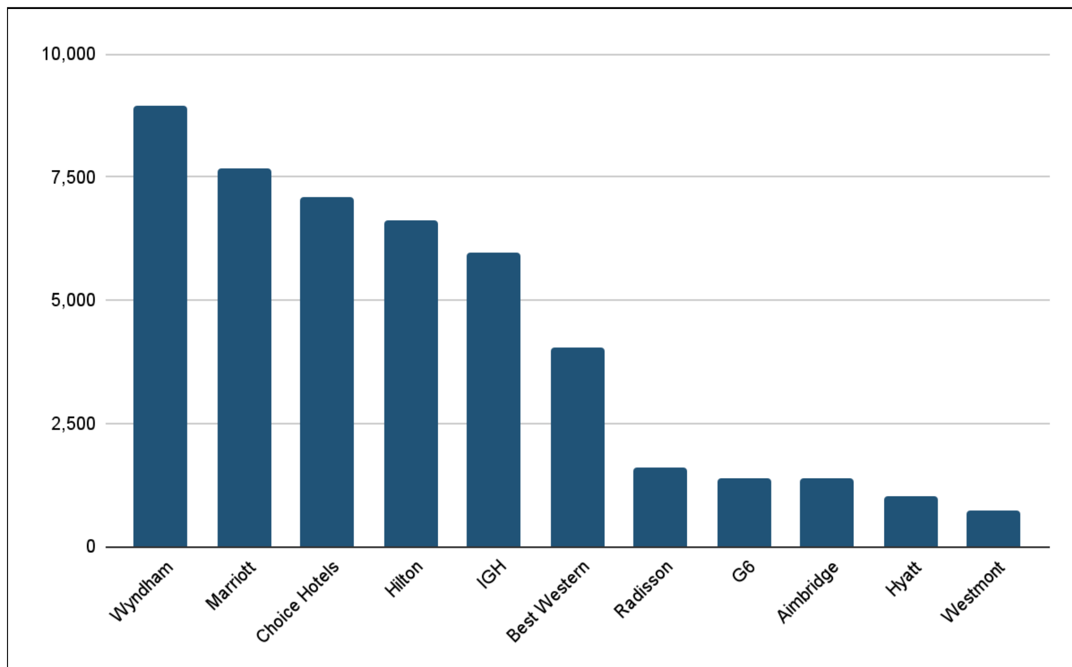
Asset owners or hotel operators can buy into the identity and operating requirements of a chosen brand and with that access to the marketing, booking & loyalty programme technology platform. This is in exchange for a fee (equal to around 2 per cent of revenues and 20 per cent of profit from each branded hotel) payable to IHG. Hotel operators also gain access to IHG's extensive database of market intelligence, procurement programmes, ESG tools and lifecycle management tools. Some 90 per cent of the group's revenues comes from this fee structure.

This 'asset light' franchise structure is also employed by the world's largest hotel chain (by room count) Marriott , Wyndham (the largest by hotel count) and Hilton. Hilton looks to have come later to the franchising model, selling previously owned assets into a REIT in the mid-2010s. Owned hotels tend to be in independent, smaller, local segments of the market, although Global No.12 (Extended Stay America) does own 90 per cent of its 650 hotels.

IHG's hotel brand portfolio

Source: IHG PLC

Leading hotel brands – by number of hotels globally



Source: Statista

Ravaged by Covid

The travel industry was hit particularly hard by the pandemic with longer periods of international travel restrictions and even limits on intra-country travel – the US is the group's largest market and even domestic booking suffered a major decline. Another pressure from Covid has been the transition to remote meetings which have taken out a large number of business bookings and, with what looks likely to be structural changes in working practices, a decent amount of this will not return.

This is where the franchising model has come into its own and while fee revenues have dropped, there is no unrecovered overhead as there is with fully owned hotels. Still, a major part of the fall in profits for the larger hotel groups has come from having to carry the full overhead on the relatively few hotels they do own.

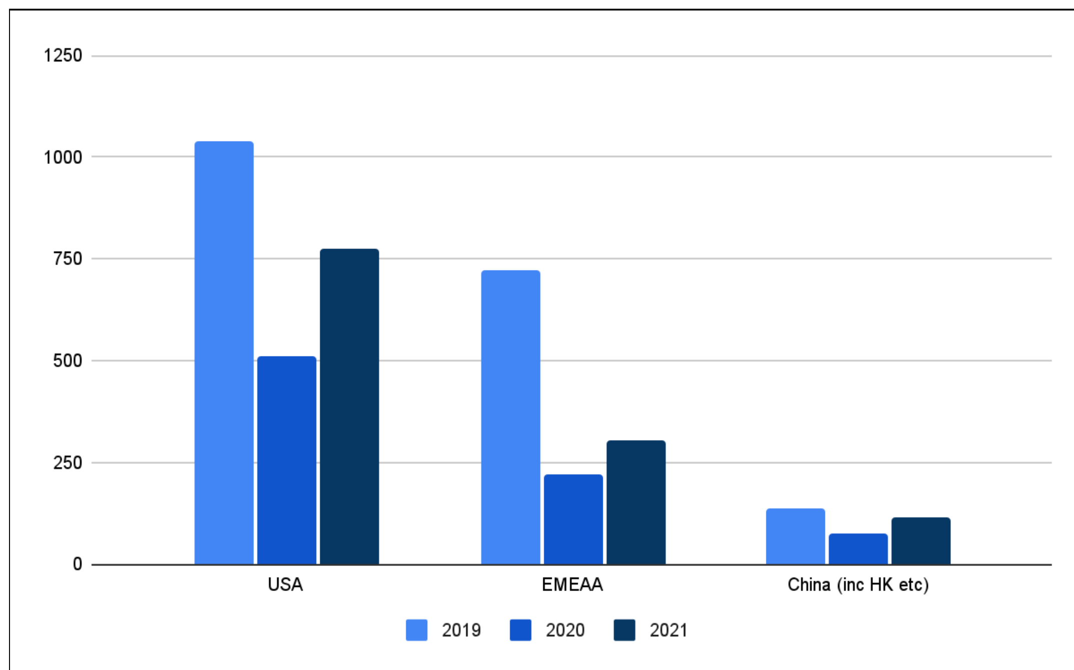
Another benefit for IHG has been its heavier bias towards 'blue collar' business hotels. This would encompass the likes of workers who cannot carry out their work over Zoom and must still visit customers' premises - this would be the likes of photocopier repair staff or those who carry out remote maintenance.

European weakness more acute

While IHG is primarily an American business operationally, it does have a sizable presence in Europe, Middle East, Asia and Africa (EMEAA) and Greater China (the Republic + Hong Kong, Taiwan and Macau). As Figure 3 shows, the EMEAA segment has suffered the greatest decline through Covid and the weakest rebound. This is partly because the travel restrictions here were much more severe than in the US but also because there are many more owned or directly managed hotels in this region. This means that IHG bears the full unrecovered costs and sees an operational gearing effect that is not present in a fee-centred structure. Europe is also more of a tourist-driven market for hotels, unlike the US (generally and especially for IHG) which derives around 95 per cent of its occupancy from domestic travel.

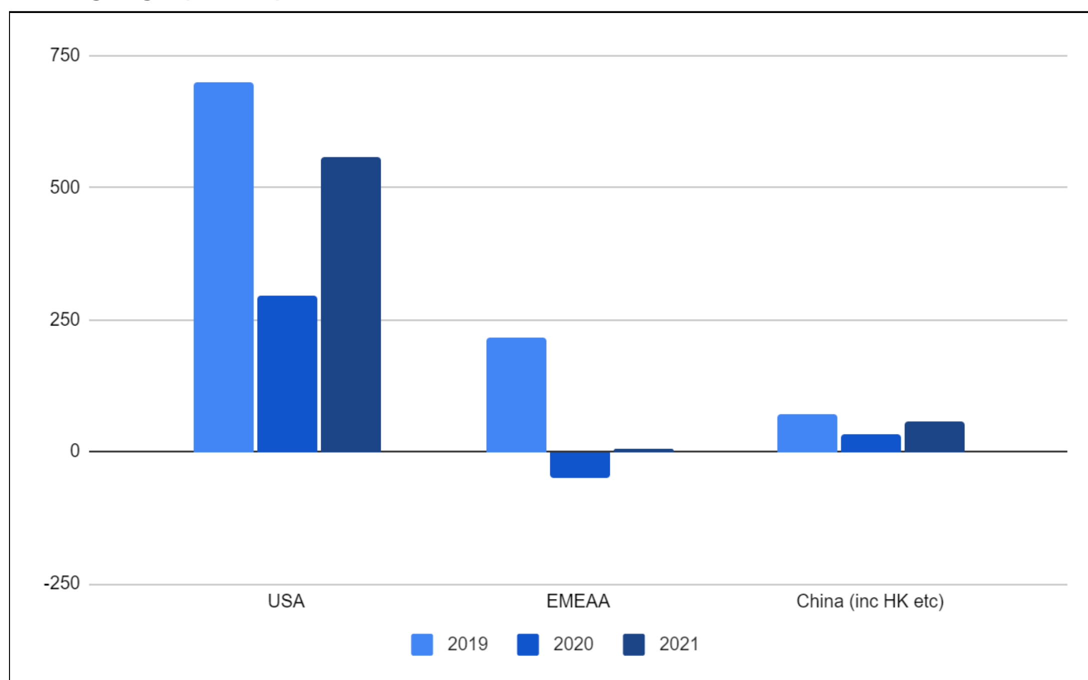
While this is a drag on the business now, it also carries the best recovery or rebound potential, more so after the sizable reduction in overheads and some rationalisation of the owned portfolio. This division is barely profitable at present but in 2019 (and before) was able to make returns margins of around 35 per cent. That suggests that, over time, EMEAA could pick-up >$200mn of operating profit, which is material when the whole business returned only a little more than $500mn of EBIT (before central overheads) in FY2021.

IHG's geographical revenue sources - $mn



Source: IHG

IHG's geographical profit sources - $mn before central overheads



Source: IHG PLC

Just when you thought....

One reason to remain a little on the cautious side (for the sector rather than this stock specifically) is that while the worst of Covid is seen as being behind us, it is not fully out of the picture. Only this week we saw several hundred flights cancelled from the UK

because of Covid shortages and two weeks ago the UK government reported 1 million new cases in a week. So, localised and short-term problems from Covid are likely to keep up a level of pressure on business and leisure travel for some time.

Then there is the uncertainty about how the Ukraine war will evolve and there is the nagging issue of China and Taiwan that could impact one of IHGs local markets and keep Chinese travellers at home if a sanctions regime needs to be introduced. China has also recently recommenced major local lockdowns.

Holding its nerve on pricing

The hotels industry is typically highly cyclical with chains tending to lead on price to sustain their occupancy when overall demand slips. Through Covid, however, the whole industry has managed to resist a price war, largely because of a belief that this was a short-term and fast recovering downturn rather than a longer recessionary decline. Also, there were often little potential guests over which to fight. The longer pressure on demand persists, however, the less likely it is that the line will continue to be held, more so if demand only dribbles back.

While in some industries this might suggest that some kind of price maintenance is taking place, this is an industry with a pretty clean record in that regard. The reason the pricing nerve has been held is the now extensive market intelligence that the leading hotel groups have acquired about customer behaviour when demand is subject to specific shocks rather than a broader economic slide.

Domino effect?

When looking at a business that relies on franchising, memories of what happened to Domino's Pizza in the UK might creep into mind. In that case, the franchisor (the PLC) had allowed a very small number of franchisees to take a large share of the total outlet network. This allowed them to push back on the level of fee that the PLC was charging, undermining its position financially. There appears to be no such problem here for IHG with no hotel owners, operators or investors controlling more than around 2 per cent of the total hotel/room count.

Underlying drivers

Up to 2019, global tourism and hotel stays were growing at a mid-to-high single digit percentage rate and most observers and forecasters believe this rate can resume. There is a lot of recovery to flow through from the estimated 70 per cent drop in 2020, which in 2021 had only recovered to be at 40 per cent below 2019 levels. Through 2021 there was a steady month-on-month recovery with the US (driven by internal travel) actually showing a positive level relative to 2019 for the first time by December; EMEAA still

remained at 30 per cent below 2019 but had started the year down by three-quarters. The outlook is still somewhat fragile but the momentum seen through 2021 does seem to support market expansion returning to 4-5 per cent at least after 2023. The squeeze on household incomes may still upset this as we have not seen this level of pressure in disposable income for, perhaps, 40 years and the industry as structured today has not yet been through such a cycle.

On top of market growth, as Figure 2 shows, there are still a large number of mid-sized chains that could merge with or be acquired by the likes of IHG. The Marriott/Starwood combination of 2016 (at $13.6bn) has shown that even the joining of large chains can create value. The only potential problem for IHG is its balance sheet which, while improving, still shows debt at around 3x Ebitda: its debt covenants are only set at 3.5x debt to Ebitda. There is strong cash flow and Ebitda is expanding, so the debt ratio is falling, but to make any more substantial moves, IHG would almost certainly have to issue equity, not ideal in still turbulent equity markets.

There is scope for further industry consolidation of a still pretty fragmented long-tail of the market and there is increasing evidence that being part of a branded network can be much better than holding out as an independent. All of the leading players have extensive budgets to persuade these smaller players to join their network.

Potential for earnings upgrades

A problem with looking at upgrade potential here is that the consensus is, in general, already taking a bullish outlook on the pace and timing of the rebound in business and leisure travel post-Covid. So, if there is a decent run of demand through 2022 that will more likely just see the current consensus fulfilled, and there is little to suggest that demand will exceed the assumptions upon which the current consensus is built. Any risks, therefore, appear more on the downside albeit those risks do not seem especially great at present given the reliance on the more defensive internal travel in the US.

That said, IHG is still pricing in a decent amount of recovery based on its shares trading at a material premium to what has been a very steady and stable PE ratio across an extended period. As the chart (pg22) shows, IHG has seen its shares trade steadily at around a 20x PE based on year 1 EPS forecasts: today the shares are trading at around 26x. This is more likely to be pricing in the rebound from Covid and hitting that 20x line in 2023 than any expectation that there are likely to be positive surprises on EPS.

Momentum of forecasts recently has been mixed and in the last three months a number of analysts have been lowering their forecasts: on average six out of 19 forecasting brokers have reduced their estimates. That said, the average EPS estimate for FY2022

today is 195p per share whereas a year ago it was 175p per share. The pattern is the same for FY2023 with six forecasts recently lowered, but estimates average around 15 per cent higher than a year ago. Overall, and taken with the increased global instability, it does feel unlikely that there will be any material upgrades in forecasts in the immediate future.

The consensus view remains positive with most brokers presenting a 'buy' recommendation and an average target price of above 5,700p (price now below 5,100p). That feels bullish and is only achieved if IHG breaks out of its long-term rating profile – not enough has really changed internally or externally to drive that. Unless the industry dynamics change, industry consolidation takes hold or there is evidence that room rates are growing more rapidly, the share price feels about right at the current level. As the chart at the head of this article shows, the price has hovered either side of 5,000p since the end of 2020 and a breakout feels unlikely.

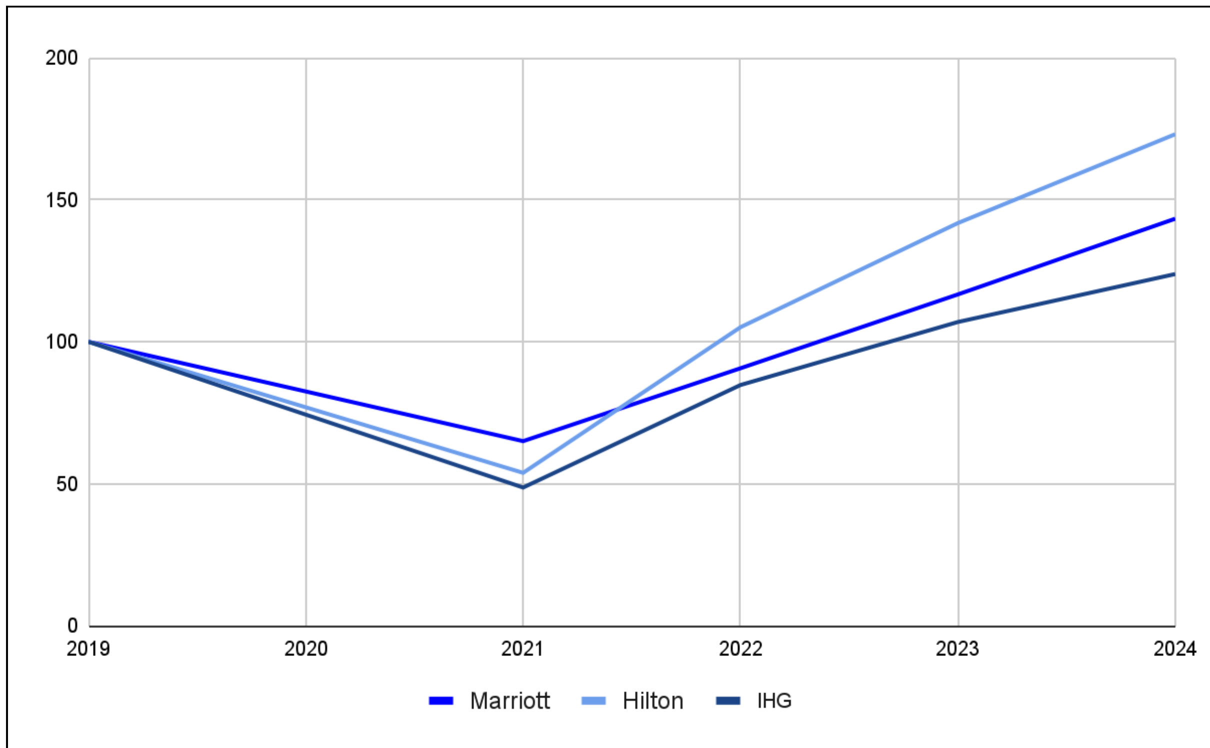
IHG's long-term PE ratio

Source: Factset

One argument for a higher valuation is that IHG is rated lower than its most immediate peers, Hilton and Marriott. This is true with IHG on a Year 1 PE of 26, while Hilton stands on 34x and Marriott on 30x but is not a substantial argument. First, the peers are US listed and US stocks typically trade on a moderate premium to their UK- or European-listed counterparts. Second, as the chart below shows, IHG's EPS fell further from 2019, are recovering more slowly and by 2024 are expected only just to have

passed their 2019 EPS level while the others are forecast to be materially higher. So again, it does feel as if IHG is trading at around the right share price.

Relative EPS profile IHG vs peers – base: 2019 EPS =100



Source: FactSet

Investors' Chronicle | Alpha

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ISSN 0261-3115.