Lemon Tree Hotels Limited

Acquisition Announcement Conference Call
July 08, 2019

Moderator

Ladies and gentlemen, good day and welcome to the Lemon Tree Hotels Limited Conference Call. As a reminder, all participants' lines will be in the listen only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference, please signal the operator by pressing '*' then '0' on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Anoop Poojari from CDR India. Thank you and over to you, sir.

Anoop Poojari:

Thank you. Good afternoon everyone and thank you for joining us on Lemon Tree Hotels conference call to discuss the recent announcement regarding the acquisition of Berggruen Hotels Private Limited, owner of Key Hotel in India.

We have with us today Mr. Patanjali Keswani – Chairman and Managing Director; and Mr. Kapil Sharma – Chief Financial Officer of the company. We will begin the call with opening remarks from the management, following which we have the forum open for a question and answer session.

Before we start, I would like to point out that some statements made in today's call may be forward-looking in nature and a disclaimer to this effect has been included in the invite shared with you earlier. I would now like to request Mr. Keswani to make his opening remarks.

Patanjali Keswani:

Good afternoon everyone and thank you for joining the call. I hope all you would have gone through our disclosure to the stock exchanges that the board of directors of Lemon Tree Hotels has approved the acquisition of 100% ownership in Berggruen Hotels Private Limited that owns the Keys Hotel portfolio.

Keys Hotels operates 21 hotels across 19 cities with an aggregate of 1911 Keys. The portfolio consists of 7 owned and leased hotels with 936 rooms in 6 cities in India. In addition to the above Keys Hotel operates under the 14 hotels with 975 rooms in 14 cities under management/franchise agreements. Keys Hotel operates under three different brands, Keys Prima, Keys Select and Keys Lite in the midmarket segment.

Let me now take you through the deal structure. The acquisition has been done through our subsidiary, Fleur Hotels in which Lemon Tree owns a 58% stake while the balance 42% stake is held by the Dutch Pension Fund Manager APG. The acquisition of Keys involves payment of Rs. 471 crore for an enterprise value of Rs. 605 crore. Lemon Tree and APG was subscribed to compulsorily convertible preference shares of Rs. 61 crore for Lemon Tree and Rs. 360 crore for APG and the rest will be funded through cash already available in Fleur. The deal is economically lucrative and synergistic being in the same midmarket hotels segment as we are. The acquisition will help Lemon Tree fortify its leadership position in the midmarket hotels segment, increasing its owned and leased room by about 24% and it's managed rooms by 50%, taking it's room count to approximately 7800 rooms which is about 15% of the all India branded midmarket hotel supply. The acquisition also provides the larger repeat customer base and will increase our bargaining power with our customers as well as help us capture outbound guest traffic from the 11 new cities we will be present in after this acquisition.

Further in line with our asset light strategy Lemon Tree has proposed amalgamation of our wholly owned subsidiary Meringue Hotels into Fleur which owns our recently commissioned 303 rooms Lemon Tree Premier Hotel at Andheri in Mumbai. After the completion of both the above transactions the shareholding of Lemon Tree and APG in Fleur will remain almost the same.

We would also like to use this opportunity to highlight the impact of the new accounting standards AS-116 which came into effect from April is, 2019. As you are aware, we operate a portfolio of leased assets, leasing expenses under the previous accounting standard were disclosed and above the EBITDA line under it. The new accounting standard mandates recognition of a lease liability in the corresponding right to use assets. This will lead to increase in the size of the balance sheet. Interest shall be provided in the P&L account on the lease liability and depreciation shall be provided on the right to use assets. Hence absolute EBITDA and EBITDA margins will increase depreciation and finance costs are also expected to go up under this new standard which will be frontloaded over the period of the lease. As we have always maintained the metric, we track is cash profits. We would like to highlight that the new accounting standard is merely an accounting adjustment and there may be some actually some positive impact on cash flows due to probable reduction in tax liabilities under MAT.

I would now like to touch upon various aspects of this acquisition post which we will be happy to answer any questions in this regard.

So, the first broadband I would like to cover is the merger of Meringue Hotels with Fleur; here we will continue to retain our 58% ownership in Fleur but effectively since we manage the hotels owned by Fleur, we will continue to get a 65% economic share due to the fees we levy. Now if you look at the valuation of Meringue Hotel transfer, if you look at it broadly by FY21 we expected this hotel to earn about 15 lakhs per Key. So, effectively what we have done is there has been a 14% discount rate applied and if you do that the present value today is about 13 lakhs per Key. So, this is the rate at which it has been merged. Now if you look at the Keys acquisition, what we are doing is really the owned hotels are going to Fleur and the management contracts are going to Carnation Hotels. So, the merger of LTP Mumbai from Meringue plus the 61 crore that Lemon Tree is putting into Fleur plus the 360 crore APG is putting into Fleur will fund the entire acquisition of Keys and Lemon Tree shareholding still remains at little over 58%.

What do we hope to achieve with this acquisition; so I would like to broadly cover first the current financials. So, if you're looking at Keys Hotels, in FY19 they did revenue of 81 crore in owned rooms and management fees of about 6 crore, so the total revenue was 87 crore. The operating expenses were 49 crore and the EBITDA was 38 crore in FY19. Below this there was lease rent of 2.7 crore and corporate office expenses of 15 crore, so the net EBITDA was 20 crore which is roughly equal to 30X on the enterprise value of the acquisition which was 585 crore. If you look at

FY20, their current performance this year before the takeover they have budgeted owned revenue of 93 crore and management fees of 6 crore which takes the revenue to about 100 crore, operating expenses are expected to increase by 5 crore to 54, so EBITDA would be 45 crore. If you remove lease rental and corporate office expenses the nett EBITDA is 27 crore which means we are buying it in current year multiple of 22.5. Now what we have done is we have evaluated the what else which are owned by Keys and compared them on an average to the same micro-markets where we operate and we have found that Keys ARR on an average is 25% below us and the occupancy is less than 10% than ours and the main reason for this is the distribution is much weaker than ours. Just for everybody's information we have about 250 sales people in about 34 cities in India. We also have much stronger relationships with online travel agents and corporate. So, if you add this together, we are fairly confident that we will be able to take the performance of Keys Hotel up fairly significantly. So, really in FY21 we have taken two cases, one is the base case and one is the target case. In the base case we have only increased the ARR by 5% and the occupancy by 10 and in the target case we have taken the ARR up by 9% and the occupancy by 10%. But in FY21 we expect the following to work out. The owned hotels revenue will go from 93 crore this year to about 113 to 120 crore, base case and target case, management fees will be transferred to Carnation Hotels, so the total revenue of this asset as it transferred to APG will be between 113 and 121 which will lead to an EBITDA between is 56 to 64 crore, lease rent will be about 3 crore but corporate office expenses due to redundant fees will reduce significantly to about 2 crore leading to a net EBITDA at a minimum range of 51 going up to 59 crore. So, the EV to EBITDA we expect that in the worst-case will be an 11.5X and in the expected target case will be 10X. I want to re-emphasize here that if we managed to increase the ARR to our levels then the EBITDA will grow 70 crore which means it will be less than 9X.

We are also planning to transfer as I mentioned earlier, the management contracts to Carnation Hotels which is roughly 3.5 crore of these management contracts, we will transfer at about 6x and this will be subject to Lemon Tree board approval. So, what is the outcome economically for Lemon Tree once this transaction is consummated? If we looked only at Lemon Tree with the 100% ownership in Mumbai, our expected EBITDA at 15 going up to 18 lakhs a Key in the next 2 years would be between 45 to 55 crore, say if 50 crore, so on an as is basis Lemon Tree would have gotten an EBITDA of about 50 crore, 1.5 to 2 years out. Now with this acquisition you will see that 1.5 to 2 years out Mumbai EBITDA will continue to obviously be 45 to 50 crore, the Keys EBITDA of owned hotels only will be 51 to 59 crore. So, put together we expect that the total EBITDA of Bombay plus Keys will be between 96 to 113 crore from which please remove fees which Lemon Tree will get from these assets directly which will be between 13 to 16 crore that we lead to a net EBITDA of 83 to 97 crore and Lemon Tree's share in that will be 49 to 57. Now the three key flow through Lemon Tree are the fees from the owned assets which will be 13 to 16, Lemon Tree's fees from the Keys managed assets which will be 4 to 5 plus Lemon Tree's share of the net EBITDA which will be 49 to 57 crore if you add the three together it adds up to 66 to 78 crore which means that if you look at what we have treaded off, we have fundamentally increased our standalone EBITDA, our pro forma share of EBITDA by about 45% to 50%.

Now some other points I'd just like to quickly point out is that the capture of traffic in demand from the 11 new cities that we operate in post the Keys acquisition will have a network effect because typically when we open hotels in new cities we capture a disproportionate share of the outbound traffic from those cities to the cities where we operate. The next point is Lemon Tree will increase its market share from currently 11% to about 15% of the branded midmarket supply in India. Also, in keeping with Lemon Tree stated strategy of unlocking value through monetization of assets, the transfer of Meringue Hotels has achieved that. This will also lead to dominance in two key micro markets for us which is Bangalore Whitefield and Electronic City also in Bangalore where we will control over 50% of midmarket supply. We will also in this process Lemon Tree will acquire three new brands which will help us to target hotels for management contracts will do not qualify for Lemon Tree standards which has been a big issue for us in the past.

Just to give you an example of how asset monetization helps us increase our economic share with our joint venture in Fleur with the 59% ownership our economic interest is about 65%. When we reduce this to 50% our economic interest is 57 and should we ever go down to 25%, our economic interest will be 36%. So, clearly there is a very strong case for us going forward to monetize all our assets to the maximum extent possible in order to maximize the return which really comes from the management fees.

The next point I would like to touch upon is the impact of the change in accounting norms. If I synopsize it and I'm normalizing it for 100% revenue in Lemon Tree hotels today, our EBITDA at an aggregate hotel level is 50.4%. Below the line there are two expenses that will be affected which are lease rentals and Ind-AS which will reduce by 4.4% thereby increasing our EBITDA by this 4.4%. However, interest and depreciation will increase by 7.3%, so effectively what this means is it impact PBT by -2.9%. Tax in turn we expect will be impacted by -0.6% and therefore PAT will be impacted by -2.3%. All these percentage numbers relate to the revenue.

Now if I summarize it, the cash profit going forward will be PAT plus depreciation plus other non-cash expenses minus lease rental. So, if you look at cash profit vis-à-vis our old way of defining it which was PAT plus depreciation, cash profit for Lemon Tree will increase by 3.5% of revenue. Thank you and we are now open for questions.

Moderator: Thank you very much. We will now begin with the question and answer session. The first question is from the line of Ratish Warrier from Sundaram Mutual Fund. Please go ahead.

Ratish Warrier: You told about this acquisition giving you, positioning using different new brands which you don't have, so you talked about the Bangalore experience, so could you talk a little bit about that little bit in detail in terms of positioning and pricing and what's the different type of customers you are going to serve of there and what could be the opportunity at those sub-brands?

Patanjali Keswani: If you look at the branded midmarket segment in India, it comprises of about 53,000-54,000 rooms pan India. But if you look at the unbranded legal standalone hotels in India, the numbers are approximate, so that's a disclaimer but it is between 350,000 to 450,000 rooms. As you know we have a subsidiary of ours called Carnation Hotels which is a third-party manager for hotels which are part of this segment but we have found in the past year or two that we have been unable to take some hotels on management contract because they do not meet the very specific brand standards of Lemon Tree Hotels. My view is that the three brands that Keys has which is also positioned at 2 Star-3 Star and 4 Star levels, these brands will be acquired by Lemon Tree Hotels in this transaction and will be used to manage hotels which do not meet our brand standards. We estimate that this opportunity is in the many tens of thousands of rooms and with the acquisition of these three brands we feel we will be able to aggressively target these hotels. Now this is fairly common globally. If you look at the real big players like Hyatt or Hilton or Marriott, they have multiple brands at the same price points which are targeting different products and also different customer segments. If I get to some specifics for example in Electronic City, we already have a 175-room hotel and Keys owns a

150 odd room hotel. So, we have combined the two with 325 rooms we will control I would reckon about 75% to 80% of the midmarket supply in Electronic City. Similarly, if you take Whitefield, we already have a 130 hotel, Keys owns a very nice 220 room-cum-service department hotel there, put together this gives us about 350 rooms which would be about 50% of all midmarket supply in Whitefield. Now the advantage of supply aggregation for us is very simple. It enables us to control pricing to a large extent.

Ratish Warrier: And over the medium term what kind of capital allocation you think will go into this part of the business?

Patanjali Keswani: My expectation is that these hotels that we have acquired from in this Keys portfolio, probably Whitefield and Pune will be rebranded as Lemon Tree Hotel, so they will require some capital infusion. We have estimated it will be about 10 to 11 crore. The rest of the portfolio which is the other 5 hotels will require some minor investment which will be sub-5 crore. So, put together over the next 2 to 3 years we will invest about 15 crore in upgrading these hotels. There will be no more capital allocation.

Moderator: The next question is from the line of Himanshu Shah from HDFC Securities.

Himanshu Shah: Firstly, are we any other potential target or we would be in discussion with for any other strategic asset buy besides Keys?

Patanjali Keswani: Well, no. We want to integrate Keys and do a good job there. However as I said we are always open to partnerships with large funds who are willing to own assets for which we will be very happy to manage/brand them.

Himanshu Shah: Is it fair to assume that as you highlighted just in the previous question we would continue with the Keys brand in the foreseeable future? So, now we would be like technically operating 6 brands and 2 brands and 6 sub-segments.

Patanjali Keswani: So, Himanshu to answer your point Keys Lite and Red Fox will be positioned similarly at 2 Star levels with 3 Star service. Lemon Tree Hotels and the main Key brand will be at 3 Star, Keys Prima and Lemon Tree Premier will get the 4 Star. As you know we are launching also another brand called Aurika which is going to be at the upscale level and we have two hotels opening, one is in Udaipur in another three months and one will be the new Bombay hotel. So, these are targeted at the very large underserved segment of upscale hotels in India and basically what we are trying to do is very simple, we are trying to capture maximum share of wallet of our customers from 2 to 4.5 Star. Let me give you an example; the other day I was talking to a customer of ours who has stayed 20 times in Lemon Tree in the last three years of which 17 times he had stayed in the Red Fox in Jaipur and 3 times in our Lemon Tree Hotel in Goa. In Jaipur he paid Rs. 2000 a night for 17 visits and in Goa he paid Rs. 9000 per night staying in our Lemon Tree Hotel in winter. So, I asked him why he did that and he told me I like your brand because when I go for work I just need a room which has air conditioning which is clean which is safe which is hot water and clean linen which is what Red Fox gives me and I go for business to Jaipur. When I go for a holiday I am relatively price insensitive and therefore I like your hotel although it is at Rs. 9000. So, my broad view is we have been talking to multiple customers over the last 2 to 3 years and my broad view is that the Indian consumer operates from 2 to 4.5 Star and he's willing to take anything based on value for money and his specific need in that visit. So, we would like to capture this entire share across both business and leisure and we would also like to fundamentally aggregate as many hotels as we can in the midmarket segment because that leads to greater choice for customer, it leads to a greater customer base for us and a larger loyalty program and it enables us to also build more traffic across cities and negotiate better with our large corporates.

Himanshu Shah: Are the management contract terms similar to all contracts of Keys Hotel or there is any potential upside or maybe downside of risk of loss of property or anything?

Patanjali Keswani: Their contracts are I would say 60% equivalent to ours. There is always the risk of losing contracts or strengthening contracts. It is a little early for us to say this because we are now in conversation with the owner. We however feel that we will be able to add very significant value to the owners of Keys Hotels which are managed by Keys and I think our relationship with them will continue and will in fact even strengthened for mutual benefit for both sides.

Himanshu Shah: When you are saying 60% is it more on fee percentage terms or on what parlance you are referring to that number?

Patanjali Keswani: Their fees are less than ours per room.

Himanshu Shah: If you can just help me with why the current promoters have sold out or cash out, is it just due to the inherent inefficiencies and higher corporate expenses etc. or there is something beyond that?

Patanjali Keswani: I think there are multiple reasons, so I have not spoken to Nicolas Berggruen who owns the hotel—though we have exchanged a couple of e-mails—my assessment is that it's a call taken by him that he does not want to invest further in the hotel business in India and since this is not been able to scale up perhaps therefore regional plan, it's become subscale and therefore inefficient and which is why I think he decided to exit from it. I can't comment more because actually interestingly I never asked them why they are selling. But I have visited all their owned hotels and I can tell you they are very nice assets.

Himanshu Shah: The Mumbai property, is it fair to assume it has been valued at around 1.4-1.5 times the investment, is the ballpark calculation correct or I am grossly incorrect on this number?

Patanjali Keswani: You can work it backwards Himanshu but all numbers are there. You can easily work it back. Let me add one last point; it has been valued very well I can promise you that.

Moderator: The next question is from the line of Dhruv Jain from Ambit Capital.

Dhruv Jain: Just wanted to check on your debt repayment plan, when you had started the other business, the lease rental business you had said that you will push the debt repayment plan to about one year. So, what will happen to that after this acquisition?

Patanjali Keswani: Nothing significant. In fact, if you have noticed our system debt equity has reduced after this transaction not increased. Keep in mind that 360 crore of Fleur from APG which is coming in as pure equity. So, even if you hypothetically take 240 crore as debt which it is not actually, the debt to equity in this transaction is roughly 0.66:1 which is less than our system average. More importantly the total EBITDA that we expect to earn at the asset-co level will be at the least will be 4.5X of the debt but more likely 3.5X. So, it's very safe in cover and I don't see any issue in servicing this debt from the EBITDA that we earn and our target to write down 100% debt in the group in the next 5 years still remains very much there.

Dhruv Jain: How is the lease rental business progressing, any updates there?

Patanjali Keswani: Yes, so there are multiple assets that are close to fruition. As I think I had mentioned earlier in analyst call we are being conservative, initial assets are only being taken on long lease, so capital requirements are very little. Of course, the P&L will change now with these new accounting standards but broadly I can tell you that we are looking at a fairly significant addition in the next 12 months to this portfolio of leased assets in Hamstede. If I remember right about 5000 rooms are under discussion right now and I expect most of them will close but as long leases, 30-year leases basically.

Moderator: The next question is from the line of Nihal Jham from Edelweiss.

Nihal Jham: You mentioned that on an average the ARR for Key's brand is 25% lesser than what Lemon Tree does. So, is it similar across all the three brands that you compare right now Keys Lite and Red Fox and Lemon Tree and Keys?

Patanjali Keswani: It is similar wherever we have comparable hotels. In other places in fact the ARR is my guess is about 40% less than what we would like it to be. So, the numbers I gave you on the base case and the target case; if you noticed talked only about a 5% to 9% increase in ARR. We are obviously expecting a far more significant increase over the next 2 years but the numbers I gave you gentlemen was what we would do if we went to sleek basically. Let me give you an example, in Whitefield we have a 130-room hotel where we do 87% or 88% occupancy at about Rs. 4000. 500 m or 800 m from us is the Keys Hotel which is a very pretty hotel. It has about 120 rooms and about 100 apartments or maybe if you less apartments. Sorry but the total number is 220 keys. This does 73% occupancy which is 15% less than ours at an ARR of about Rs. 3000. Now if you simply insert our numbers into this hotel then the acquisition on an aggregated basis make sense even if I do nothing with any other hotel. Similarly, in Pune we are in a very exciting market which is Pimpri-Chinchwad which is currently going through a bit of a slowdown because of the Auto sector. But on a medium-term basis, this hotel in our opinion is also about 30% less than what we would like it to be and about 8% less in occupancy. If you go to our Electronic City where we have an adjoining hotel, we are doing Rs. 4000 ARR, they are doing I think Rs. 2700 ARR. The occupancy is about 67%, our occupancy is 86%. So, I'm just giving you flavor, if we achieve the target which I'm very sure we will; we will increase the revenue only by 30% but if we achieve what we think we could achieve in the next 3 years then this acquisition multiple will be below 7.

Nihal Jham: You have obviously given the business plan of thought in terms of the numbers you are expecting from this acquisition. But just as a counter thought that ideally all these hotels have been in existence for say more than 5-6 years and this group has been operating since 2006; so is it that still after being as a descent player with 2000 rooms is still not been able to achieve the kind of distribution within operating as such discount to say your property or in general what we should be getting?

Patanjali Keswani: Of course, I will give you an example; the Whitefield hotel which is Lemon Tree's was brought from Asian Hotels (West) a few years ago when the ARR was Rs. 2000 and the occupancy was 50%. Today, the ARR is Rs. 4000 and the occupancy is 88%. I think that should answer your question.

Moderator: The next question is from Suman Kumar from Motilal Oswal.

Suman Kumar: Can you discuss about the balance sheet post the deal? How things are going to change?

Patanjali Keswani: What do you mean, Kapil, will you like to answer that?

Kapil Sharma: Exactly which item you are referring to by this question?

Suman Kumar: Addition of asset and loan size also, how much increase and all?

Kapil Sharma: So, this entity currently is having loan of 134 crore, so that is the amount which will come in the total group, loan portfolio and rest of the thing is that 471 we are paying so, EV is 605.

Suman Kumar: So, the asset size will be at addition of 605, right?

Kapil Sharma: Yes.

Suman Kumar: Anything else?

Kapil Sharma: No not significant, it's a very simple entity. There has not much subsidiary into it, that another there is no subsidiary. All the assets are in the same company so very simple structure and quite a simple balance sheet. There is nothing which is kind of extraordinary item which will be coming to us.

Patanjali Keswani: Two points I would like to add here; one is it will be a 100% subsidiary of Fleur Hotels. Number two, is that out of this 605 crore, 20 crore is being paid by Carnation Hotels to acquire the management contracts. So, it is really an acquisition is 585 crore.

Suman Kumar: So, the asset is 588 crore?

Patanjali Keswani: 585.

Suman Kumar: The fixed effect will be 585 crore?

Patanjali Keswani: 7 assets, 936 rooms. So, the effective cost of acquisition is sub 65 lakh a key; just to give a number. Today the replacement cost of assets like that will be north of 85 lakh a key.

Moderator: Thank you very much. That was the last question in queue. I would now like to hand the conference back to the management team for any closing comments.

Patanjali Keswani: Thank you everybody. Thank you for patiently listening and understanding our rationale and also the impact of the lease rental, the change in accounting standards and we are always there if anybody has questions. You can drop us an email and we will be more than glad to give you clarifications. Thank you everybody.

Moderator: Thank you very much. On behalf of the Lemon Tree Hotels Limited, that concludes this conference. Thank you for joining us. Ladies and gentlemen, you may now disconnect your lines.