Company In-Depth

9 January 2007 | 11 pages

Indian Hotels (IHTL.BO)

Buy: Top Sector Pick

Rating change ☐
Target price change ☑
Estimate change ☑

- **Target raised to Rs.187** — Strong ARR growth in Oct'06 to Mar'07, ahead of estimates in peak season, prompts upward revision in earnings. While we raise our target price, we have lowered the target multiple to 22x FY08E (vs. 24x Sept'07E P/E) to factor in risk of increased room supply; but given scale, Indian Hotel's (IHC) pan-India presence, we expect the stock to trade at a premium to the sector (18x).

- **Key drivers** — 1) Room demand-supply scenario remains favorable for ARRs; 2) Most of IHC's domestic businesses (hotels, air catering) are doing well; 3) Six 'Ginger' hotels rolled out, plans to have 10 by Mar'07; 4) Other expansions progressing on course; and 5) New hotel in Bangalore, new management contracts for Gateway hotels and five service apartments in metro's in the cards.

- **Earnings revised 10-12% upward over FY06-09E** — We raise estimates on 7% higher ARR growth in FY07E; this has increased ARR CAGR estimates to 14% over FY06-08E (vs. 10% earlier) and then a 1% decline in FY09E. Consolidation on merger of five subs/associates also positively contributed to upward revision in earnings, despite a 2% equity dilution.

- **Overseas properties well positioned** — Macro environment for IHC's hotels in London, Sydney and New York favorable; RevPARs on the rise. Intent to acquire 100% of Ritz Carlton, Boston for $170m appears aggressive, but this is a high-end luxury hotel in Boston, a go-to market having high entry barriers.

- **Re-rating potential** — Indian Hotel is our top pick. With earnings CAGR of 30% over FY06-09E, improved stock liquidity post split and improving capital efficiency, we see P/E of 18x FY08E appreciating.

See page 9 for Analyst Certification and important disclosures.

Buy/Low Risk	**1L**
Price (08 Jan 07)	Rs152.00
Target price	Rs187.00
from Rs168.00	
Expected share price return	23.0%
Expected dividend yield	0.9%
Expected total return	**23.9%**
Market Cap	Rs88,775M
	US$2,009M

Price Performance (RIC: IHTL.BO, BB: IH IN)

Figure 1. Consolidated Statistical Snapshot

Year Ended March	Net Profits (Rs)	EPS	EPS Gr	P/E	P/BV	EV/EBITDA	ROE	ROCE
		(Rs)	(%)	(x)	(x)	(x)	(%)	(%)
FY05	1,283	2.6	103.8	60.3	5.9	31.6	9.7	5.6
FY06	2,487	4.3	66.9	36.2	4.8	19.9	13.1	9.4
FY07E	4,185	7.1	65.6	21.4	4.1	12.9	18.8	12.1
FY08E	5,067	8.5	21.1	17.9	3.5	10.7	19.1	12.5
FY09E	5,576	9.4	10.1	16.2	2.9	9.9	18.0	12.7

Source: Citigroup Investment Research

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	59.5	35.7	21.6	17.8	16.2
EV/EBITDA adjusted (x)	30.8	19.9	12.6	10.5	9.8
P/BV (x)	5.8	4.7	4.1	3.4	2.9
Dividend yield (%)	0.7	0.9	0.9	0.9	1.0
Per Share Data (Rs)					
EPS adjusted	2.55	4.26	7.05	8.54	9.39
EPS reported	2.56	4.26	7.05	8.54	9.39
BVPS	26.26	32.41	37.51	44.59	52.30
DPS	1.00	1.30	1.30	1.30	1.50
Profit & Loss (RsM)					
Net sales	13,135	18,373	24,020	28,055	30,733
Operating expenses	-10,931	-14,563	-17,683	-20,478	-22,823
EBIT	**2,204**	**3,810**	**6,337**	**7,577**	**7,909**
Net interest expense	-1,356	-1,456	-1,062	-1,031	-982
Non-operating/exceptionals	945	1,350	1,167	1,338	1,633
Pre-tax profit	**1,794**	**3,704**	**6,443**	**7,885**	**8,560**
Tax	-721	-1,073	-2,105	-2,648	-2,797
Extraord./Min.Int./Pref.div.	213	-144	-152	-170	-187
Reported net income	**1,285**	**2,487**	**4,185**	**5,067**	**5,576**
Adjusted earnings	1,284	2,487	4,185	5,067	5,576
Adjusted EBITDA	3,322	5,084	7,805	9,289	9,782
Growth Rates (%)					
Sales	31.0	39.9	30.7	16.8	9.5
EBIT adjusted	143.3	72.8	66.3	19.6	4.4
EBITDA adjusted	86.2	53.0	53.5	19.0	5.3
EPS adjusted	103.9	66.8	65.6	21.1	10.1
Cash Flow (RsM)					
Operating cash flow	**4,409**	**5,231**	**5,458**	**6,097**	**6,595**
Depreciation/amortization	1,117	1,274	1,468	1,712	1,872
Net working capital	1,059	622	-471	-988	-1,178
Investing cash flow	**-6,434**	**-2,297**	**-3,628**	**-3,543**	**-2,369**
Capital expenditure	-6,713	-2,880	-3,998	-3,780	-3,395
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**-1,464**	**-5,257**	**-1,418**	**51**	**-2,329**
Borrowings	-1,056	-4,684	-529	915	-1,465
Dividends paid	-407	-573	-889	-864	-864
Change in cash	**-3,488**	**-2,322**	**413**	**2,605**	**1,896**
Balance Sheet (RsM)					
Total assets	**41,043**	**42,977**	**46,061**	**52,019**	**54,386**
Cash & cash equivalent	4,714	3,899	4,011	6,224	6,950
Accounts receivable	999	1,342	1,974	2,690	2,947
Net fixed assets	23,725	24,599	27,426	29,539	30,317
Total liabilities	**25,541**	**21,646**	**21,247**	**22,833**	**20,434**
Accounts payable	1,427	1,997	2,632	3,305	3,200
Total Debt	19,693	15,010	14,481	15,396	13,931
Shareholders' funds	**15,502**	**21,331**	**24,813**	**29,186**	**33,952**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	25.3	27.7	32.5	33.1	31.8
ROE adjusted	10.7	15.5	20.3	20.8	19.4
ROIC adjusted	5.5	9.2	13.4	14.3	13.7
Net debt to equity	96.6	52.1	42.2	31.4	20.6
Total debt to capital	56.0	41.3	36.9	34.5	29.1

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Key Points

Increasing our earnings estimates and target price

We are increasing our net profit estimates for IHC by 10-12% over FY06-09E, to account for 1) Strong high ARR growth ahead of estimates in Oct'06 to Mar'07, across key properties in peak business season and 2) Impact of consolidation on merger of five subsidiary/associates with the company, despite 2% equity dilution. Increase in estimates is triggered by 7% higher ARR growth in FY07E, largely driven by key properties in Mumbai, Delhi, Chennai and also its Leisure destinations in new season starting Oct'06 to Mar'07. Consolidation is expected to increase room inventory by approximately 725 rooms in key cities like North Mumbai, Bangalore and Goa and provide better control and efficient management. Building this in our estimates we forecast ARR CAGR of 14% over FY06-08E (vs. earlier ARR CAGR of 10%) and then a 1% decline in FY09E. We expect this to increase earnings CAGR to 30% over FY06-09E compared to our earlier estimate of 26%.

With the change in earnings, we have also increased our target price to Rs187 (Rs168 earlier) as we roll over to FY08E earnings based on 22x P/E.

Figure 2. Earnings Revision

Year to	FY07E			FY08E			FY09E		
31-Mar	New	Old	% Chg	New	Old	% Chg	New	Old	% Chg
Revenue (Rs.mn)	24,020	22,597	6.3	28,055	26,425	6.2	30,733	28,978	6.1
Net Profit (Rs.mn)	4,185	3,740	11.9	5,067	4,441	14.1	5,576	4,973	12.1
EPS (Rs.)	7.05	6.40	10.1	8.54	7.60	12.3	9.39	8.51	10.3

Source: Citigroup Investment Research

Strategy to grow overseas

Key drivers for Indian Hotels' strategy to grow overseas are 1) Establish ‘Taj’ brand in key gateway international locations in US, Europe, Australia, South Africa, Dubai 2) Position itself as a luxury brand in global markets, similar to the domestic market and 3) De-risk business model, reducing significant dependence on India (80% of FY06 consolidated revenues). While this strategy may not fit well in the short term when India is the go-to destination and among the strongest growth markets, over the long term positioning in key business/leisure cities across the globe should help it manage the downturn better than in the past.

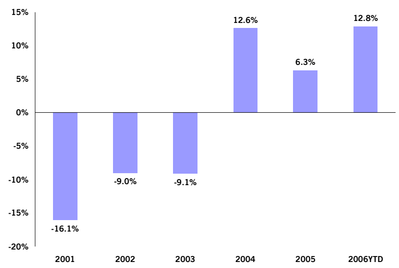
This is not to say the company is substituting capex plans in India for growing overseas; it has aggressive plans of adding 25% additional rooms across key growth cities over the next 2 years on its existing room inventory of 9000-plus rooms. While the company's primary strategy to grow overseas remains 'asset light' through management contracts, of late they have been looking at acquisition, as management believes this will drive management contracts. This said, we are equally cautious on its aggressive approach to acquire assets overseas as the company continues to explore growth opportunities in China, the Middle East and some S.E. Asian markets. Extent of capital commitment toward these acquisitions will, however, be crucial, in our view. We have not factored in any likely acquisitions in our forecasts.

Acquisition of Ritz Carlton, Boston

Indian Hotels has entered into an agreement to acquire 100% of *Ritz Carlton, Boston* for $170m from current owners Millennium Partners by 11th Jan'07, after which it will be re-named *'Taj Boston'*. This acquisition is a part of its international expansion strategy. The 273-room high-end luxury hotel is a rich heritage property in Boston's premier retail district. This would primarily be funded through outstanding FCCB funds of $90m and debt. Management believes this acquisition will 1) Demonstrate capabilities of owning and managing a heritage property in Boston, key US market; 2) Strengthen 'The Taj' brand in US; and 3) Drive more management contracts revenues.

Prima facie, the acquisition price appears aggressive in our view. We interacted with our US Lodging analyst, to get a better understanding on the acquisition and growth prospects ahead. The key takeaways are as follows:

Figure 3. Boston RevPAR Gr. (%)



Source: Citigroup Investment Research

- Boston is a go-to market for both business/leisure travelers with high entry barriers. REVPAR gains have been strong despite the high supply growth environment due to robust room night demand.

- Demand driver for rooms has been the new Boston Convention and Exposition Center, built in the summer of 2004 with over 1.7 million sq. ft of exhibit and meeting space. This has resulted in a REVPAR increase of 19.6% driven by an occupancy gain of 10.9% in the Group segment YTD.

- Outlook for the Boston lodging market is strong, especially for luxury and upper-upscale hotels in the downtown area - PricewaterhouseCoopers estimates that REVPAR will increase by 10.0% in Boston in 2007.

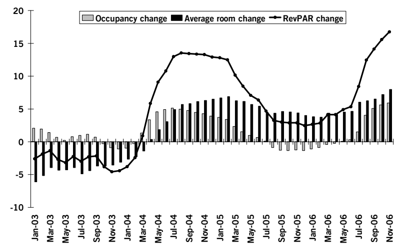
- Valuation of $618,000/room paid for *Ritz Carlton, Boston* is in-line with recent luxury hotels transactions. Positioned in the high-end luxury segment in the downtown area, growth potential is strong in current environment.

Factoring in this, we believe the acquisition is strategic in nature. Although short-term returns could be stressed due to debt funding for this property, this would provide long-term benefits through increased management contracts. We have currently not included this property in our consolidated estimates given the limited data available.

Overseas properties well positioned

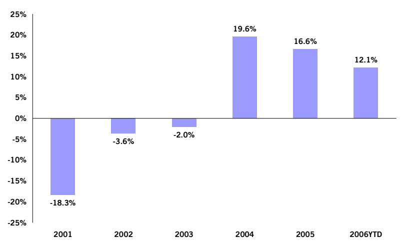
Macro environment for IHC's hotels in key international destinations like London, New York and Sydney are favorable with RevPARs on the rise. We did some channel checks with our Lodging analysts in the US and Europe on the operating environment for hotels in the region. Highlighted below are some key takeaways:

Figure 4. London ARR & RevPAR Gr. (%)



Source: Citigroup Investment Research

Figure 5. New York RevPAR Gr. (%)



Source: Citigroup Investment Research

London

- Most European hotels markets are in their mid-cycles with typical cycle lasting 7-8 years – expects another 2 to 3 years of RevPAR growth before we reach the next peak.
- The London hotel market in particular dipped last year following the bombings, but the negative impact has been short-lived, and the industry is now bouncing back.
- RevPAR of London hotels is now back to 2000 peak level in nominal terms, but 15% below the peak in real terms (excluding inflation). Expects further recovery and forecast 7/8% RevPAR growth in London hotels next year.
- As per management, *St. James in London* is doing well with ARRs firm and occupancies at 80%-plus levels.

New York

- New York is one of the largest hotel markets in the U.S. and a critical gateway city, the market has been strong for the third consecutive year, with REVPAR up 12.1% YTD.
- Robust residential real estate environment and high barriers to entry have resulted in historically low supply growth over the last 5 years. This with strong demand lead to robust REVPAR growth, particularly for the business transient segment, which has experienced a 15.8% REVPAR increase YTD.
- The outlook for the New York lodging market is strong, especially in the downtown area and on the island of Manhattan. Supply growth in the city of New York should remain low for at least the next 2-3 years as demand growth remains solid. PricewaterhouseCoopers estimates that REVPAR will increase by 9.8% in New York in 2007, among the highest growth rates in the US.
- As per management *'The Pierre'* is a high-end luxury hotel in New York, enjoying high occupancies of ~80% and ARRs of ~$620 in the current season.
- Building for the favorable environment and ongoing refurbishments at the public places of the hotel and expected room renovations in phases over the next 1-year - we foresee the property turning around from a loss of $0.57m in FY06 (first-year operations post control by IHC) to $6.6m profits in FY09E.

Sydney

- After initial hiccups post taking over control of *BLUE, Woolloomooloo Bay, Sydney (erstwhile 'W')* from Starwood Group last year, the hotel is stabilizing with corporate contracts renewed and occupancies having improved to ~75% levels (vs. 65% when acquired).
- Strategic location in up-market business district of Sydney largely drives its leadership in ARRs of ~$195.
- With limited data available, we have not included this property in our consolidated estimates for FY06-09E.

'Ginger' to target business/religious destinations

The company eyes solid growth opportunities in the ‘budget hotel’ segment, and has aggressive plans to set up 30 such hotels in phases across the country under the ‘Ginger’ brand over the next 2-3 years. These hotels would target the economy and mid-market segment in business/religious destinations, which we see as a big growth opportunity in India, given lack of a large organized ‘budget’ hotel chains. This venture is routed through a 100% subsidiary, Roots Corporation, to differentiate it from the Taj brand.

The company already has six hotels operational, plans to have 10 hotels running by Mar'07 – already tied land requirements for 23 sites of the 30 hotels and is in the process of negotiations for the rest. This would entail an investment of Rs.4bn, largely funded through debt and internal accruals. The hotels will have approximately 100 rooms per hotel priced around Rs.1000 per room (size increased and prices could be increased to offset, rising costs of land). While incremental revenues and profits from this venture would be initially insignificant (less than 5% in FY08E), we believe the growth potential is large over the long term. We believe this will strengthen IHC's pan-India presence and provide the company with the benefit of higher ARRs and improved occupancies as activity picks up in these key locations.

Figure 6. Some Operational/Upcoming Ginger Hotels in Key Industrial/Leisure locations

Location	Comm/Scheduled Dt.	Key Interests
Bangalore	Jun'04	IT Hub
Haridwar	1QFY07	Religious place of Hindu's
Bhubaneshwar	1QFY07	Place Heritage Temples/Upcoming Steel Centre
Mysore	2QFY07	Industrial/Tourist location
Trivamdrum	2QFY07	Centre in Kerela, increasingly sought Leisure destination
Pune	Nov'06	Industrial/IT centre
Nashik	Dec'06E	Developing Manufacturing destination
Durgapur	Mar'07E	Zone for Alloy Industries
Goa	NA	Most popular holiday location

Source: Citigroup Investment Research

Indian Hotels

Company description

Indian Hotels (IHC) is the largest hotel operator in India with a presence in the luxury, business and leisure hotel segments. It owns the 'Taj' brand and operates 76 hotels (9,182 rooms) across India and some international locations. The company is looking to enter the budget hotel segment through its new brand 'Ginger', and make a foray into the adventure business with wildlife lodges. It already operates three budget hotels, and plans to expand these to more than 10 cities in FY07E, with an investment of Rs1bn. The company is also looking to expand overseas through acquisitions/ management contracts. Other new revenue streams being explored include serviced apartments, spas and F&B outlets. IHC is the hotel-sector flagship company of Tata Group, which holds a 30% stake.

Investment thesis

IHC is our top pick in India's growing hospitality sector. We increase target to Rs.187 based on 22x FY08E P/E (vs. 24x Sept'07E earlier), a premium to the sector average (18x) and increased earnings on sustained high ARR growth. We have, however, lowered our target multiple to factor in risk of increased room supply expected to start in FY09E.

We expect the favorable macro environment to increase business and leisure travel traffic to India. This should trigger strong demand for hotel rooms, drive up occupancies and further increase average room rates (ARRs). Leveraging on its large room inventories across key growth cities, its premium brand positioning with 'Taj' and its leadership in domestic markets, we believe IHC is poised for growth. Initiatives to de-risk the company's business model and further aid growth and profitability include: 1) Forays into budget hotels; 2) Expansion of the company's service offering to spas, serviced apartments and F&B outlets; 3) Increasing focus on growth through management contracts; and 4) a greater presence in overseas markets. We see IHC's large room inventories in the key growth cities of Mumbai, Delhi, Chennai, and Bangalore as its most valuable assets providing it with competitive advantage over peers and significant pricing power to drive earnings growth. Given the above and a scenario of a depreciating rupee and benefits accruing from high operating leverage driving margins, we expect earnings CAGR of 30% over FY06-09E. With growth fundamentals intact, improving capital efficiency and the stock offering better liquidity post split, we foresee a re-rating of current stock valuations of 18x FY08E P/E.

Valuation

Our increased 12-month target price of Rs187 is based on 22x FY08E P/E (vs. 24x Sept 07E earlier), a premium to average sector valuations of 18x. This implies an expected share price return of 21% over a 12-month horizon. The lower target multiple is primarily to factor in risk of increased room supply expected starting FY09E.

The stock is currently trading at 18x FY08E P/E, toward the median of its three-year historical range of 15-22x P/E, largely on par with domestic peers, which we believe is unwarranted given: 1) IHC's market leadership and advantage of large room inventory; 2) The company's premium brand positioning with 'Taj'; 3) Our expectation of strong earnings growth; and 4) The company's stronger business model with reasonable (and growing) presence in international markets. With growth fundamentals seemingly intact, improving capital efficiency and stock offering improved liquidity post split (1:10), we foresee a re-rating of current stock valuations.

Risk

The stock should be rated Medium Risk according to our risk rating system, which is based on historical 260-day share price volatility. However, we assign a Low Risk rating to the stock due to: 1) The sustained growth outlook for the hotel industry given the conducive macro environment; 2) The company's leadership position in domestic markets, advantage of scale and strong business model; and 3) The company's strong brand positioning and pan-India presence.

The main risks to our investment thesis and target price are:

1) Bird-flu hitting India, which would be bad for sentiment in the hotel sector;

2) Any delay in the rollout of 'Ginger' hotels and planned room increases;

3) The company overpaying for hotel acquisitions in international markets given management's push to expand its brand franchise in global markets; and

4) Any slowdown in economic activity, which could lead to lower hotel room demand.

Analyst Certification Appendix A-1

I, Ashish Jagnani, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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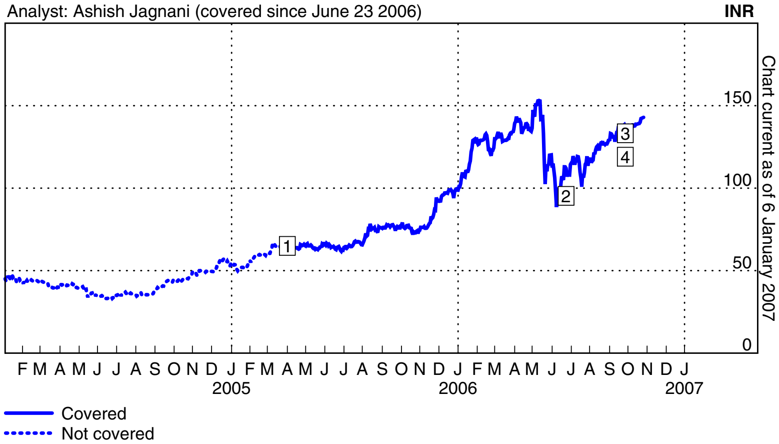
Indian Hotels Co Ltd (IHTL.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Ashish Jagnani (covered since June 23 2006)



#	Date	Rating	Target Price	Closing Price
1:	1 Apr 05	3L	54.80	63.39
2:	23 Jun 06	*1M	*141.00	112.06
3:	27 Sep 06	*1L	*168.00	137.34
4:	27 Sep 06	1L	168.00	137.34

*Indicates change.

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Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).
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