Hotel Leela Venture (HTLE.BO)

Strong 2QFY07, but no surprises

- Results marginally ahead of estimates — Leela reported healthy revenue and EBITDA growth of 15% and 34% respectively, 2-4% ahead of estimates. Net profits grew a strong 58% on higher other income and lower tax provision. While growth momentum is strong, growth rates are likely to taper off ahead due to high base
- Margin expansion, not surprising — EBITDA margin grew 730bps YoY to 49.9% vs. estimated 49%, benefiting from high operating leverage following strong ARR growth of 25% yoy, while occupancy declined to 75% in 2Q vs. 77% last year. We believe most of EBITDA expansion is captured; as there is high risk of ARR peaking with occupancy on a decline given company's high dependence on Bangalore
- Growth limitations — Despite a robust growth outlook for sector, we see growth limitations for Leela given its: 1) high dependence on the Bangalore market (50% of FY06E revenues) where growth is peaking; 2) limited room inventory of 1,000 rooms; and 3) lack of presence in growth markets for the next two years
- Large capex in pipeline, but growth back ended — Leela has capex of Rs8bn to build four hotels, increase capacity in Bangalore and refurbish rooms at Mumbai. With Mumbai and Bangalore expansion available by 4QFY07, this is already built in our estimates. However, the gestation period of two to three years for commissioning four new hotels will not allow growth to kick in until FY10E
- Retain Sell — Leela is the most expensive stock in our India hotel universe at 25.5x P/E for FY07E. While growth momentum is strong, we believe near-term growth upside is priced in. The stretched valuation does not leave much margin for error from potential execution delays for upcoming hotel projects, in our view

Sell/Medium Risk	**3M**
Price (30 Oct 06)	Rs65.35
Target price	Rs54.00
Expected share price return	-17.4%
Expected dividend yield	0.6%
Expected total return	**-16.8%**
Market Cap	Rs24,199M
	US$537M

Figure 1. Statistical Abstract

Year to 31-Mar	FD EPS (Rs)	EPS Gr. (%)	P/E (x)	ROCE (%)
2005	1.1	350.0	nm	6.2
2006E	2.0	72.9	33.3	5.5
2007E	2.6	30.3	25.5	6.6
2008E	3.4	34.5	19.0	8.2
2009E	3.0	(13.7)	22.0	6.9

Source: Company Reports and Citigroup Investment Research

Figure 2. 2QFY07 Earnings Summary

Mar-end	2QFY06	2QFY07	YoY
Net Sales	669.3	766.7	14.6
EBITDA	285.0	382.4	34.2
Mgn (%)	*42.6*	*49.9*	730bps
Interest	84.4	83.1	-1.5
Other Income	3.9	33.8	764.5
Depreciation	64.9	82.3	26.9
PBT	139.7	250.8	79.5
Prov. for tax	0	30.2	
PAT before Ext.	139.7	220.6	57.9

Source: Company Reports

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See page for Analyst Certification and important disclosures.

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Figure 3. 2QFY07 & 1HFY07 Earnings Summary (Rs.mn)

Mar-end	2QFY06	2QFY07	YoY	1HFY06	1HFY07	YoY
Net Sales	669.3	766.7	14.6	1344.6	1575.0	*17.1*
EBITDA	285.0	382.4	34.16	615.0	774.0	*25.9*
Mgn (%)	*42.6*	*49.9*		*45.7*	*49.1*	
Interest	84.4	83.1	-1.51	174.1	161.7	*-7.1*
Other Income	3.9	33.8	764	10.8	107.3	*889.9*
Depreciation	64.9	82.3	26.89	148.6	164.8	*10.9*
PBT	139.7	250.8		303.09	554.8	*83.0*
Prov. for tax	0.0	30.2		0	112.2	
PAT before Ext.	139.7	220.6	57.89	303.09	442.6	*46.0*
Extra-ordinary Items	7.4			7.4	405.8	
Reported PAT	147.1	220.6	49.95	310.5	848.4	*173.2*

Source: Company Reports

Hotel Leela Venture

Company Description

Hotel Leela Venture is a well-known hotel chain in India catering primarily to the premium segment. The company operates four hotels (estimated 1,000 rooms) under the 'The Leela' brand across India. The company has a marketing alliance with Kempinski for properties in India. Its luxury properties cater to both business and leisure travelers. With rapid growth in room demand, the company plans to expand its presence in the growth cities of Hyderabad, Chennai, Pune and New Delhi through management contracts. It is the flagship company of Leela Group, which holds a 49% stake in Hotel Leela Venture.

Investment Thesis

Leela's hotels are concentrated in Bangalore (50% of FY06 revenues), Mumbai and Goa. These markets have a strong growth outlook for ARRs and occupancies, except Bangalore (where ARRs have risen significantly and are at record levels). However, limited room inventory, high dependence on the Bangalore market (where ARR growth is peaking) and lack of a presence in key growth markets – Hyderabad, Pune, Chennai and Delhi – are our main concerns on growth prospects for the next two years. Management has planned capex of Rs8bn for four new hotels but these are not likely to contribute to earnings until FY10 given the long gestation periods. With the likelihood of ARR peaking in Bangalore, we estimate a 7% ARR CAGR for FY06-08 and then a 16% decline for FY09. Considering this, a similarly declining trend in the occupancy rate and 14% equity dilution following FCCB conversions, we forecast the company to achieve 15% earnings CAGR for FY06-09. Leela is the most expensive stock in our hotel universe.

Valuation

Our 12-month price target of Rs54 is based on 18x September 2007 P/E, placing it at a 15% discount to sector valuation of 21x. This implies a -17% expected total return. We attribute the discount to: 1) risks to Leela's ARR growth given its high dependence on Bangalore; 2) low earnings CAGR of 15% for FY06-09E vs. the industry average of 26%; and 3) limited room inventory with no immediate presence in growth markets such as Delhi, Hyderabad, Chennai and Pune. Although the growth outlook for the company appears strong, current high valuations discounts most of this and liquidity gains from the recent stock split, in our view. With valuations at 25.5x FY07E PE, we believe the upside potential is priced in. Leela is the most expensive stock in our hotel universe. The stretched valuation does not leave much margin for error from potential execution delays for upcoming hotel projects, in our view.

Risks

We rate Leela as Medium Risk based on our quantitative risk-rating system, which tracks 260-day stock volatility. Company-specific risks include the following:

- Any positive developments on pending projects: 1) Mumbai project on leased property from the Airport Authority of India, which has been held up for approvals; and 2) release of funds outstanding worth Rs1.6bn from HUDCO, which was earlier deposited for a hotel project in Delhi.

- Sale of non-core assets, such as excess land, would result in unlocking of real estate value and increase cash flows for expansion.

- Developments on strengthening ties with alliance partner Kempinski to increase their presence in India as well as overseas.

- Significant depreciation in the rupee of more than 10% would be positive given that 70% of revenues are earned in foreign currencies. If any of these risk factors has a greater impact than we expect, the share price would likely move above our target price.

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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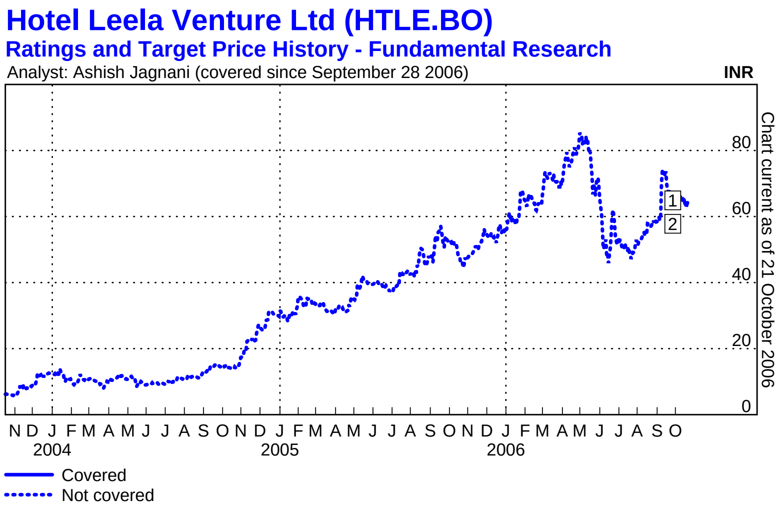

#	Date	Rating	Target Price	Closing Price
1:	27 Sep 06	3M	54.00	66.70
2:	27 Sep 06	3M	54.00	66.70

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