Kamat Hotels India

Viewpoint

Attractively priced but tough time ahead

CMP:Rs115

Key points

- Kamat Hotels (India) Ltd's (KHIL) room inventory is expected to increase by 37% to 773 rooms by FY2010 from 565 rooms at present. Thus, we expect KHIL's revenue to grow at a compounded annual growth rate (CAGR) of 19.8% to Rs222.7 crore over FY2008-10 backed by volume growth.
- KHIL intends to focus on management contracts, as such contracts are expected to add to the revenue growth and enhance the brands without incurring huge capital expenditure (capex). The company currently has 250 rooms under management, which is expected to go up to 980 rooms by FY2009.
- The company's revenues are heavily dependent on two properties, *The Orchid*, Mumbai and *VITS*, Mumbai, which together contribute about 90% to the revenues. These properties are likely to face fierce competition with incremental supply of rooms from Sahara Star. We believe the occupancy rate and average room rate (ARR) of these properties might remain suppressed on account of economic slowdown.
- On the valuation front, the stock is attractively priced at 4.2x FY2010 earnings estimate. But the price does not factor in the possible equity dilution of around 30% from conversion of foreign currency convertible bonds (FCCBs) at a reset price of Rs170 per share. Moreover, the inability to raise the required resources to fund its expansion plan is a key potential risk to the earnings estimate for FY2010. Consequently, we have a cautious view on the stock.

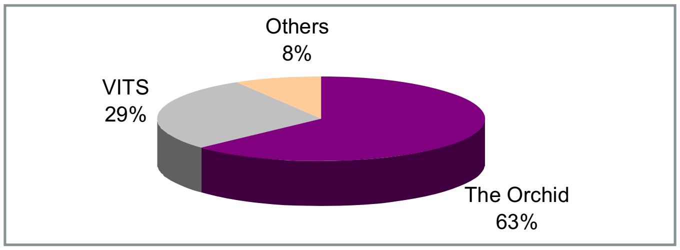
Company background

KHIL, promoted by the Mumbai-based Kamat group in 1986, is one of the fastest growing hospitality groups in the country. The company operates the 245-room five-star hotel *The Orchid* located adjacent to Mumbai's domestic airport and the 190-room four-star hotel *VITS* (formerly known as "Lotus Suite") situated close to the Mumbai international airport for international tourists as well as business travelers. *Fort JadhavGadh*, a heritage hotel, is the company's latest initiative in the space of heritage hotels and resorts, targeted to provide customers with heritage experience. The heritage hotel, which is located in the outskirts of Pune, currently has 38 rooms (room capacity expected to go up to 150 rooms by 2011). The company has also undertaken the management of six properties in tier II and tier III cities like Aurangabad, Belgaum, Pune and Baroda. KHIL has a 60% stake in Concept Hospitality, which is engaged in providing consultancy services (including technical, start-up and promotion of hotels) to the hospitality sector.

KHIL's portfolio	Location and operations
The Orchid (an Ecotel)	Asia's first certified eco-friendly five-star hotel in Mumbai with 245 rooms; room capacity expected to go up to 365 rooms by 2010. Three hotels under "The Orchid" brand are coming up in Nagpur, Raipur and Coimbatore by 2012.
VITS (luxury business hotel)	Four-star hotel targeted at families seeking five-star facilities at a four-star price in Mumbai.
Fort JadhavGadh (a heritage hotel)	The company's initiative into Fort Heritage hotels. Located in Pune, the total property is spread over 17 acres with the actual palace admeasuring about 2 acre, which is taken for lease of 60 years by the company.
Lotus Resorts	Resort for leisure in the vicinity of a river, a sea and waterways. Currently, operational in Baroda.
Vithal Kamats	Proprietary brand of Vithal Kamat for a chain of restaurants. Currently operational at Nasik and Konkan.

The *Orchid* and *VITS*, KHIL's two major brands, contributed 63% and 29% respectively to the company's top line in FY2008. The company follows a distinct business strategy of keeping its ARR lower compared with that of its competitors, thereby enjoying a high occupancy rate throughout the year. While *The Orchid* enjoyed an occupancy rate of 80% and ARR of Rs10,089, *VITS* enjoyed an occupancy rate of 73.2% and ARR of Rs6,754 in FY2008.

Revenue contribution (FY2008)



Building the future (capex plan)

Room inventory	FY07	FY08	FY09E	FY10E
Owned property				
Orchid (Mumbai)	245.0	245.0	245.0	365.0
Orchid (Nagpur)				-
Orchid (Raipur)				-
VITS (Lotus Suite) (Mumbai)	190.0	190.0	190.0	190.0
Leased propeties				
Heritage Hotel (Fort JadhavGadh), Pune	- -	38.0	80.0	120.0
Kamat Hotel Siddarth, Nasik	-	33.0	33.0	39.0
Tourist Reception Center, Konkan	-	18.0	18.0	18.0
Hotel Sunny International, Nagpur	-	41.0	41.0	41.0
Under KHIL management	**435.0**	**565.0**	**607.0**	**773.0**

KHIL has a capex plan of Rs503 crore for the next four years. The capex covers some of its premium projects like *The Orchid*, Nagpur and *The Orchid*, Raipur. The company has acquired a plot adjoining *The Orchid*, Mumbai and has signed a memorandum of understanding with the Plaza Hotels to expand the current room inventory by 120 rooms to 365 rooms by 2010 (project cost estimated at Rs135 crore), which will make *The Orchid* one of the biggest hotels of the city in terms of rooms. The company has identified *Fort JadhavGadh Heritage Hotel* as a future growth driver and is planning to expand the hotel's room inventory by another 80 rooms to 120 rooms by 2010.

Key strengths

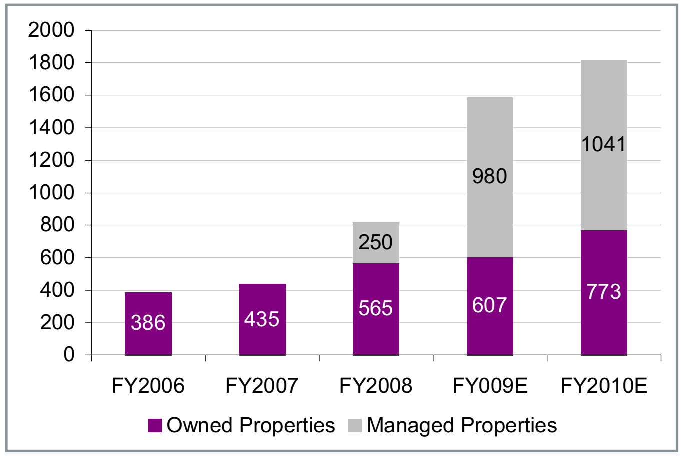
Volume-led growth

KHIL's current inventory of 565 rooms is expected to go up to 773 rooms by FY2010. The company is focusing on expanding presence in tier II and tier III cities of western India and other business districts. Thus, we expect KHIL's revenue to grow at a CAGR of 19.8% to Rs222.7 crore over FY2008-10 backed by volume growth.

Management contracts to enhance KHIL's brands

KHIL intends to focus on management contracts, as such contracts are expected to add to the revenue growth and enhance the brands without incurring huge capex. The company currently has 250 rooms under management, which is expected to go up to 980 rooms by FY2009.

KHIL's portfolio



Key concerns

FCCB may lead to higher than expected equity dilution

The company floated USD18 million (Rs79.6 crore) worth of 5.5% FCCBs in March 2007 to part finance its three projects, the expansion of *The Orchid*, the construction of *Fort JadhavGadh Heritage Hotel* and *The Orchid*, Nagpur. The bonds are convertible into equity at the option of the bond holders at any time during a tenure of five years at Rs225 per share. The FCCB conversion would lead to further equity dilution of 25.6% to Rs17.32 crore (Rs1.73 crore equity share of Rs10 each). If 50% rooms in each of the three projects become operational by 2010, KHIL has an option to insist conversion of the FCCBs into equity. As per the terms of FCCB issue the reset price could be Rs170 per share, which might lead to equity dilution of 29.6% to Rs17.88 crore (Rs1.79 crore equity shares of Rs10 each). The company has already utilised the funds raised through the FCCB issue for its three projects. The bonds are, otherwise, redeemable in 2012 at yield to maturity of 8.80% per annum.

The company intends to fund the remaining capex through internal accrual and debt. For FY2008, the debt:equity ratio of the company stood at 1.3x, which is expected to go up to 1.5x in FY2009.

Economic slowdown to impact occupancies

With the current economic slowdown and hence reduction in business travel, the occupancies may take a hit in the coming quarters. As KHIL caters mainly to business clients it would also feel the heat of the ongoing slowdown in the hospitality sector. Consequently, a drop in the occupancies would also pressurise the company's ARRs going forward.

Competition to intensify in Mumbai

To sustain occupancies in current economic conditions, Grand Hyatt has reduced room rates in Mumbai. Sahara Star is planning to add 400 rooms, which may lead to over supply of room inventory in Mumbai. This might be a matter of concern for KHIL, as *The Orchid,* Mumbai and *VITS* Mumbai together contribute about 90% to the total revenues.

Outlook and view

We like KHIL's focus on expanding in tier II and tier III cities, as the strategy augurs well for the company's growth. KHIL's growth would be driven by a 37% increase in its room inventory to 773 rooms by FY2010. Also, an increase in the properties under management contracts would contribute to the top line growth. On the negative side, the company's revenues are heavily dependent on two properties, *The Orchid,* Mumbai and *VITS,* Mumbai (contributing around 90% of the revenues). These two properties are likely to face stiff competition with incremental supply of rooms from Sahara Star. We believe the occupancy rate and ARR of these properties might remain suppressed on account of economic slowdown.

On the valuation front, the stock is attractively priced at 4.2x FY2010 earnings estimate. But this does not factor in the possible equity dilution of around 30% from FCCB conversion at a reset price of Rs170 per share. Moreover, the inability to raise the required resources to fund its expansion plan is a key potential risk to the earnings estimate for FY2010. Consequently, we have a cautious view on the stock.

Earnings table Rs (cr)

Particulars	FY06	FY07	FY08	FY09E*	FY10E*
Operating income	81.5	111.9	155.2	168.6	222.7
Total income	82.3	112.8	158.4	173.6	227.7
Total expenditure	46.3	59.7	86.7	94.9	125.7
Operating profit	35.2	52.2	68.5	73.7	97.0
OPM (%)	43.2	46.7	44.2	43.7	43.5
Adjusted PAT	15.6	20.6	28.7	30.1	37.6
Shares Issued	13.8	13.8	13.8	13.8	13.8
EPS (Rs)	11.3	14.9	20.8	21.9	27.3
% y-o-y change	-	*32.1*	*39.5*	*5.0*	*24.8*
PER (x)	10.2	7.7	5.5	5.3	4.2
Debt/Equity (x)	1.4	2.0	1.3	1.5	1.6
RoNW (%)	25.4	15.7	19.1	17.6	19.2
RoCE (%)	20.4	12.8	15.1	15.3	16.5

*Rough-cut estimate

The author doesn't hold any investment in any of the companies mentioned in the article.