This hotel stock defied odds in bad times, should outshine now

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(Kolkata's Arun Mukherjee, who dropped out of college to turn a full-time investor at an early age, and Soumya Malani, a London School of Economics alumnus, have come to be known as smallcap aficionados within India's investor community. They would show up at most AGMs, visit the remotest factories of a company and go chasing end-users to understand their experience with a product in their passionate hunt for good smallcaps. Arun and Soumya share their experiences with such companies from the ground in this space every now and then.)

The stock market is always full of opportunities and sometimes throw up full tosses good to be hit for over-boundaries. Today's one is one heck of a case of mispricing.

To start with, we aren't votaries of hotel companies. Leveraged to the core, bleeding with losses, siphoning of funds, under-reporting with no prior history of wealth generation are big turn-offs.

Sinclair, though, seems to be an exceptional case, as it has been managed very efficiently till date. It's a very clean company with honest pedigree. Its properties offer great value for money and are rated highly on the various industry and tourism websites.

Including its ongoing project of the Rajarhat hotel in Kolkata, the company has beautiful properties, operates in eight different locations with about 400 rooms under its belt. The company has further expansion plans to have an inventory of 600 rooms in next 2-3 years.

From a valuation perspective, it is important to understand the dynamics of hotel stocks. On a EV (enterprise value)-to-Ebitda basis, smaller hotels like Oriental Hotels, Taj GVK Hotels and Sayaji Hotels command multiples of 8-15 times. Bigger plays like EIH and Mahindra Holidays quote at double digits to high teens EV/Ebitda. The biggest, i.e. Indian Hotels, has got an EV/Ebitda multiple of over 20 times.

Recently-listed Lemon Tree Hotels quotes at over 25 times its expected FY20 EV/Ebitda. Debt is a major issue in this sector and so is interest cost. The listed hotel space in India has over Rs 15,000 crore debt and servicing that loan pile does take away quite a bit of profit.

Profitability has remained a major concern in the hotels space. Even though the listed hotel space logs over Rs 10,000 crore in revenues (consolidated), the companies are yet to even break even, put together everything.

In last 18 months, the hotel sector has been witnessing a gradual demand recovery. The occupancy rate rose to 65 per cent in FY18 from 57 per cent in FY13 and average room rates increased by 2-3 per cent after a long stagnancy during FY13-FY17. According to hotel consultancy firm Horwath HTL, between FY17 and FY21, demand for rooms is expected to rise 12.4 per cent annually, while supply is expected to grow at a slower pace at 7.8 per cent.

Sinclairs has a capable management team and aims to expand the chain faster by taking properties on lease/management contracts. After several years, the hospitality sector in the country is witnessing an upswing and the company expects this to further drive occupancy and ARR, resulting in growth in both revenues and profitability this year.

It has negotiated the headwinds well over the past several years and closed financial year 2018-19 with Rs 22 crore Ebitda on Rs 50 crore sales. Net profit stood at Rs 10 crore. Ebitda over last 10 years has grown at a respectable pace of over 22 per cent CAGR. Not only is the company debt-free, it also possesses liquid cash reserves of Rs 51 crore. At Rs 330, the stock quotes at a trailing EV/Ebitda of just about 6 times, which is unheard off in this sector. It would be prudent to note that replacement costs of the company's assets will be many times more than its current enterprise value.

Sinclairs is confident of growing 20 per cent this year, which further makes the valuation more enticing. The company has recently announced Rs 6 dividend, which at current stock price gives a dividend yield of 2 per cent. That clearly shows this stock may turn out to be a hidden gem.

By the way, there is also a buzz in the market that the promoter might sell the company to a bigger player at a huge premium. In case that happens, Sinclair could well move into a different orbit.