7th March 2017

hardman&co

Travel & Leisure

Source: Eikon Thomson Reuters

Market data	
EPIC/TKR	PPH
Price (p)	790
12m High (p)	815
12m Low (p)	556
Shares (m)	42.2
Mkt Cap (£m)	333
EV (£m)	950
Free Float (%)	26%
Market	Main

Description

PPHE owns, co-owns, leases, franchises and manages a portfolio of 4* hotels with 8,300 rooms in Europe, with a strong emphasis on Central London. Real net asset value per share is significantly higher than the share price.

Company information

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CFO	Chen Moravsky
Chairman	Eli Papouchado

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Next event

Q1 IMS	Apr 2017

PPHE Hotel Group

2016 Final Results: Continuing to create value

PPHE's 2016 final results surpassed our expectations with a pickup in the UK in the final quarter and a notable performance from the new Croatian subsidiary. Although the year has started well, with a continuation of recent trends, we have left our 2017 forecasts largely unchanged and made conservative assumptions for 2018, given further renovation programmes in London and The Netherlands over the next 18-24 months. The shares trade at a significant discount to book value as adjusted for the real value of the assets, and at a significant discount to peers on earnings-based measures, which is unwarranted.

- **Results:** Full year results came in ahead of expectations with London enjoying quite a strong Q4, probably helped by the weakness of sterling, both in a trend to "stay-cations" and a better inbound market. The Croatian acquisition was also much stronger than we had forecast.
- **Forecasts:** We have left numbers for 2017 largely unchanged and introduced 2018 forecasts for the first time. These are both struck on quite conservative assumptions, as it's hard to predict the time taken for new hotels to become established and in the face of growing supply in London.
- **Valuation:** On almost any metric, the group's valuation remains at a significant discount to peers, and out of line with the past and forecast performance. The group has reported the latest property valuation, and the adjusted book value/NAV is now c.£17.50/share on our calculations.
- **Risks:** The main risks are the London hotel market, and new openings; although the balance sheet is indebted, the company has now extended the average debt maturity to 9 years which gives it a more solid balance sheet structure. As a major property owner, we expect some level of gearing.
- **Investment summary:** PPHE has an outstanding track record especially in delivering significant growth in the real asset value. UK property stocks are currently trading at discounts to book, but the asset values here are growing much faster and the discount is unrealistic. The shares continue to look lower rated than peers, yet growing faster.

Financial summary and valuation

Year end Dec (£m)	2015	2016	2017E	2018E
Sales	169.3	272.5	299.9	316.9
EBITDA	80.1	94.1	102.9	108.5
Operating profit	61.0	68.8	74.9	79.0
Underlying PBT	29.8	31.7	36.9	41.0
EPS (p)	71.5	67.9	80.8	90.2
DPS (p)	20.0	121.0	22.0	24.0
Net (debt)/cash (€m)	-397.7	-590.2	-616.3	-575.4
Net debt/EBITDA (x)	5.0	6.3	6.0	5.3
P/E (x)	10.6	11.2	9.4	8.4
EV/Sales (x)	4.2	3.3	3.1	2.8
EV/EBITDA (x)	9.0	10.0	9.4	8.5
Dividend Yield (%)	2.6	15.9	2.9	3.2

Source: Hardman & Co Research

Analysts

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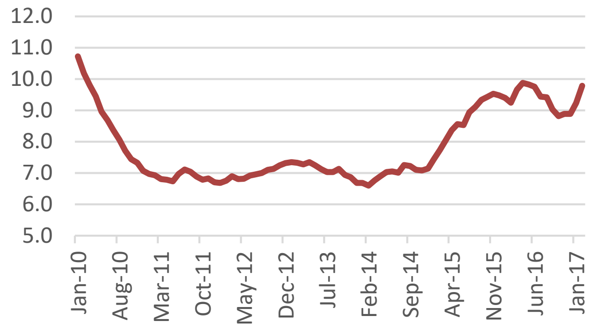
EV: Sales Prospective

- The stock has been re-rated on this measure, but note that debt build-up for construction projects is not matched in the revenue line so an increase in the level of this parameter would be expected, ahead of sales coming through when the new sites are opened. There is also an fx impact from the weakness of sterling vs the Euro.
- The absolute level of EV: Sales is acceptable for a company reporting an operating profit margin of mid-20s% and with significant sales growth ahead.

EV: EBITDA Prospective



- Again, note that the debt and EV is built up ahead of new units generating any revenues and profitability. Hence the multiple will start to fall in 2017 and later.
- The absolute level is not stretched and at a discount to peers, with IHG and Marriott for example still trading at c.13x prospective, but without the same growth prospects as PPHE, given its pipeline, and without the asset backing.

P/E Prospective

- Estimates of sub 10x 2017 P/E for the group continue to look attractive against the UK market and against sector peers, particularly given growth to come through from new openings in 2017 and beyond.
- Some of the major hotel stocks are currently trading at twice PPHE's prospective p/e multiple, without the same eps growth prospects or asset backing.

Dividend Yield Prospective

- The share price uplift had been reflected in a declining dividend yield but the special dividend clearly bumped up the income significantly. The yield on offer remains attractive, with reasonably secure dividend growth ahead.
- PPHE is not really an income stock, but investors are being paid to hold it, especially given current bond yields.

Source: Company data; Hardman & Co Research

2016 Final Results

Overview

Results for the period were better than our expectations which had been trimmed after a weak H1, not helped by the aftermath of tragic terrorism in Europe. Ironically, H2 was better than expected, especially in London, where the weak pound no doubt helped. The results were also boosted by the Croatian acquisition which was also significantly better than expected and which has proved a great deal for PPHE.

Total

	GBP as reported			Like for Like GBP		
	2016	2015	% Chg	2016	2015	% Chg
Total revenue m	£272.50	£218.70	24.6%	£269.80	£254.60	6.0%
EBITDAR m	£103.00	£88.50	16.4%	£103.10	£102.50	0.6%
EBITDA m	£94.10	£80.10	17.5%	£94.20	£93.70	0.5%
Occupancy	76.0%	84.3%	-8.3 pts	77.0%	78.0%	-1.0 pts
Average Room Rate	£111.00	£109.10	1.7%	£110.90	£102.10	8.6%
RevPAR	£84.40	£92.00	-8.3%	£85.40	£79.60	7.3%
Room Revenue m	£183.20	£147.70	24.0%	£181.00	£167.90	7.8%

Source: Hardman & Co Research

Total revenue increased by 25% as reported and by 6% like for like, which was much better than our forecast. This was offset by cost inflation, especially in London, which we expect to continue to be a feature in the current year. With more London hotel capacity coming onstream, for PPHE and citywide, the ability to pass on costs in room rates is more restricted than in past years, a reflection of a cooling market, which is perhaps not such a bad thing.

The company flagged in the outlook statement that “Trading in the year to date is in line with the Board's expectations in all markets, with the improved market conditions experienced in the second half of 2016 continuing into 2017. In the year ahead we expect further benefit from our new room inventory in London and Nuremberg where our market presence will be strengthened significantly.

"We remain focused on the creation and realisation of shareholder value and we will continue to invest in our existing portfolio, with extensive renovations at several of our hotels in London and the Netherlands, to ensure that our hotels continue to improve on their strong market positions."

We explore the detail by division below.

UK

The UK is the largest contributor in the group, and is driven primarily by London. Revenue was flat as was EBITDA as can be seen in the table. There was a small drag from the initial soft opening period of the new hotel at Waterloo which is the exclusion to derive the like for like in the table.

UK Revenues

	Reported 2016	Like for Like 2016	Reported 2015	% Chg
Total revenue m	£148.70	£148.30	£147.40	0.6%
EBITDAR m	£52.50	£52.90	£55.70	-5.0%
EBITDA m	£51.10	£51.60	£54.40	-5.1%
Occupancy	84.2%	85.2%	87.3%	-2.1 pts
Average Room Rate	£143.80	£143.90	£139.60	3.1%
RevPAR	£121.10	£122.60	£121.80	0.7%
Room Revenue m	£102.10	£101.80	£100.00	1.8%

Source: Company, Hardman & Co

While it might appear disappointing to have a flat result, investors should note that this comes after several quarters in prior years of extremely strong growth, driven by a hot London market. In the first half, revenues fell by 3%, and EBITDA by 14% so this results reflects a much better H2, helped by a slightly difficult December 2015 in the comp. This is creditable given also an effect from the heavy construction works at Park Plaza Riverbank.

Trading improved in the second half of 2016 with London enjoying a particularly strong December. More rooms (+2.7%) and demand growing more slowly (+1.8%) in Greater London resulted in a 90 bps decrease in occupancy to 81.3% for the market in 2016, with room rates flat. Hence the PPHE room rate improvement of 3% is creditable.

Outside London, the group's hotels increased RevPAR by 4% in Leeds and Nottingham, with the latter outperforming peers.

Going forward, the story in London is the new hotel openings. The new Park Plaza in London Waterloo soft opened last year and we are factoring in 3 months of soft and 3 quarters of full contribution this year; this is significant as there are nearly 500 rooms.

There will also be a benefit at Riverbank from the lack of construction as well as the new rooms, and a relocated restaurant – the Chino Latino restaurant was located in the hotel interior but has been moved upstairs with a view of the river. The site in Park Royal should soft open this quarter and we are factoring in one quarter of soft opening and two quarters of full operation into forecasts. This is as much art as science as we have no history, but we have been relatively conservative.

The new hotels are likely to be loss making in the initial period, which will naturally affect the group results, while the impact of weaker sterling should be beneficial for inbound tourism, and may result in some additional "staycation" spending.

We should also repeat earlier comments from the analyst meeting with the 2015 final results one year ago, when management felt that after several strong years in London, growth would inevitably slow; they continue to express some caution on the underlying trends:

- Business rates in London are a real issue, with the group facing increases of some 30%
- There continues to be pressure from increases in the minimum wage
- Weaker sterling will inevitably impact the cost of imported food

- Against this, the group should enjoy some further benefits of scale and expects further savings from central procurement

With the full opening of the Park Plaza Waterloo, the group will be uniquely placed in being able to offer events and rooms in close proximity to cater for a 1000 strong conference in central London; this is likely to be an extremely lucrative opportunity, given the obvious attractions of a central London venue to potential delegates.

Clearly a large part of the valuation upside stems from London, and the latest asset values show an extraordinary uplift of over £10 over book value, driven by the London assets.

We have previously stated that we would not be surprised if we have seen the peak in London hotel values, with residential developments mushrooming and the large scale conversion of central offices to residential likely over. We expect further uplift in the group's asset value, driven by the new developments and refurbishments which are highly accretive rather than market appreciation. We do not expect PPHE to do a formal revaluation this year, but there will likely be a revaluation in the next 2-3 years.

Netherlands

The Dutch business had a strong first half in Euros, and the Sterling results additionally benefited from the translation effect of a weaker pound. The performance in the second half was weaker, although sterling weakness continued to contribute. Local currency revenues were up 4% in H1 and were down 2% in the second half.

Netherlands

	GBP as reported			Local Currency Euro		
	2016	**2015**	**% Chg**	**2016**	**2015**	**% Chg**
Total revenue m	£48.30	£42.30	14.2%	€ 59.00	€ 58.50	0.9%
EBITDAR m	£14.80	£13.50	9.6%	€ 18.10	€ 18.70	-3.2%
EBITDA m	£14.60	£13.40	9.0%	€ 17.90	€ 18.60	-3.8%
Occupancy	83.3%	81.9%	-1.4 pts	83.3%	81.9%	-1.4 pts
Average Room Rate	£104.40	£93.30	11.9%	€ 127.40	€ 129.00	-1.2%
RevPAR	£87.00	£76.40	13.9%	€ 106.10	€ 105.70	0.4%
Room Revenue m	£35.60	£31.20	14.1%	€ 43.40	€ 43.10	0.7%

Source: Hardman & Co Research

The weakness of the pound contributed to a softer inbound UK market to Amsterdam, as did the aftermath of the terrorism incidents. The Park Plaza hotels outperformed the weaker market in Utrecht and Eindhoven.

The group is conducting renovation at Park Plaza Utrecht and Park Plaza Vondelpark, Amsterdam in 2017, and hence we have been conservative in forecasts. In Sterling, the results look rather more impressive with a 14% increase in revenues and a 9% hike in EBITDA (H1 16%).

Germany and Hungary

Germany and Hungary had the opposite performance to the Netherlands – the first half was weaker and the second half was stronger. Berlin has been a highly competitive market for some time, reliant on leisure and government but the Dresden market was weaker.

Germany/Hungary

	GBP as reported			Local Currency Euro		
	2016	2015	% Chg	2016	2015	% Chg
Total revenue m	£25.00	£21.80	14.7%	€ 30.50	€ 30.20	1.0%
EBITDAR m	£7.00	£6.30	11.1%	€ 8.60	€ 8.70	-1.1%
EBITDA m	£0.90	-£0.40	-325.0%	€ 1.10	-€ 0.50	-320.0%
Occupancy	70.9%	80.4%	-9.9 pts	70.9%	80.4%	-9.9 pts
Average Room Rate	£69.70	£54.50	27.9%	€ 85.00	€ 75.30	12.9%
RevPAR	£49.40	£43.80	12.8%	€ 60.30	€ 60.60	-0.5%
Room Revenue m	£19.10	£16.50	15.8%	€ 23.20	€ 22.80	1.8%

Source: Hardman & Co Research

The second half result was boosted by the opening of the Park Plaza Nuremberg which has outperformed its local competition in average room rates and RevPAR, while EBITDA was boosted by a €1.0m lower incentive rent. Total revenue for the region decreased by 6.3% or €0.7m in H1 and increased by €1.0m or 6% in the second half, both in Euros.

Like for like revenues were down and this led to a small decline in EBITDAR, but the lower rents helped the group achieve higher EBITDA. Average room rates increased which with lower occupancy led to a small decline in RevPAR. These underlying trends are shown in the next table.

Germany/Hungary LFL

	GBP Like for Like			Like for Like Euro		
	2016	2015	% Chg	2016	2015	% Chg
Total revenue m	£22.70	£20.70	9.7%	€ 27.70	€ 28.60	-3.1%
EBITDAR m	£6.70	£6.00	11.7%	€ 8.10	€ 8.30	-2.4%
EBITDA m	£0.60	-£0.40		€ 0.70	-€ 0.50	
Occupancy	74.2%	79.9%	-5.7 pts	74.2%	79.9%	-5.7 pts
Average Room Rate	£66.40	£55.90	18.8%	€ 81.00	€ 77.40	4.7%
RevPAR	£49.20	£44.70	10.1%	€ 60.10	€ 61.80	-2.8%
Room Revenue m	£17.20	£15.50	11.0%	€ 21.00	€ 21.50	-2.3%

Source: Hardman & Co Research

The company had hoped at the H1 stage that with the opening of the new Park Plaza in Nuremberg, the completion of the renovation of the art'otel berlin mitte to complete in Q3, and an ongoing strong performance in Budapest that results from this division should improve, and this is reflected in a better H2 and a 2017 forecast of positive EBITDA.

Croatia

The newly consolidated Croatian subsidiary was reporting full year results for the first time and we had been waiting for some more detail on the underlying performance of the operation in the peak H2 period. The group reported results above our expectations, with the results obviously highly seasonal, with the main trading months being June to September.

Croatia

	GBP Like for Like			Like for Like Local HRK		
	2016	**2015**	**% Chg**	**2016**	**2015**	**% Chg**
Total revenue m	£46.10	£37.10	24.3%	423.1	391.2	8.2%
EBITDAR m	£17.50	£14.20	23.2%	160.4	149.7	7.1%
EBITDA m	£16.80	£13.60	23.5%	153.9	143.0	7.6%
Occupancy	61.3%	59.2%	+2.1 pts	61.3%	59.2%	+2.1 pts
Average Room Rate	£81.30	£67.20	21.0%	746	707	5.5%
RevPAR	£49.80	£39.80	25.1%	457	419	9.1%
Room Revenue m	£26.50	£21.10	25.6%	243	222.6	9.2%

Source: Hardman & Co Research

Revenues in local currency were up 8.2% overall, driven by a 9.2% increase in room revenue. This was the function of occupancy up 2 points and rates up 5.5%. All this drove an increase at the EBITDA level of just under 8%.

The company's improvement of the Croatian assets has begun, with 12 rooms being added as renovation work was completed on an apartment complex. The company has growth plans for this exciting area, and we should expect to see further small deals, new openings and refurbishments going forward.

We deal with the overall outlook below, but it is worth making a few points about the Croatian expansion.

- The group has limited its investment by taking an indirect 65% stake in the Zagreb-quoted Croatian holding company. It has acquired the outstanding 80% interest, which it did not formerly own, in its joint venture in Croatia for an aggregate cash consideration of €51 million; and it has taken up a €30 million loan facility with Zagrebačka banka d.d. to partially fund the acquisition of the 80% interest in the joint venture. It also made a further placing, and its equity invested is thus limited to €10-15m.
- As a next step in its transition, Arenaturist is now planning a capital increase of ordinary shares from 3.274m to 4.274m- 5.274m through a non-pre-emptive public offering of new shares in Croatia. The public offering is a further step in the strategy to develop Arenaturist into a Central/Eastern European leisure and hospitality company.
- The returns from this investment have already been significant, with the group now consolidating £16.8m of EBITDA less a minority of £3m. Profits should have a run rate of over £10m (although this is not all additional), and earnings of something around £4m, after paying interest, tax and deducting minorities – excellent in view of the limited investment.
- Because the business is highly seasonal, this means that the 2016 results, which are consolidated for 9 months excluding the loss-making first quarter, will actually be HIGHER than the full year results in 2017, even allowing for some improvement, year-to year. The highly seasonal nature of profits, with all the

profit effectively being earned in the peak summer months, skews group results a little more to H2.

There is clearly a good long term opportunity for the business in Croatia and this could be highly accretive for shareholders. The company showed in its annual report the timeline of the various transactions which we summarise below, although readers may find it easier to review the original on page 46-47 of the accounts. The PPHE shareholding in Arenaturist should have an effective value now of c. £150m.

The timeline of the group's involvement in Croatia is delineated below:

- **2008:** Group acquires a minority interest in the entity which controls Arenaturist and is awarded management agreements for Arenaturist's properties and the properties of three Croatian private companies held by the jv.
- **2008- 2011:** Improvement of quality and profitability, and plan for renovations and redevelopments
- **2012 -2015:** Renovations of half of hotel rooms, rebranding of three hotels and one self-catering apartment complex to Park Plaza, and one hotel to Sensimar Hotel Medulin
- **2016:** Acquired a controlling interest in Arenaturist, mandatory takeover offer of Arenaturist and sale of shares to two local institutional investors. The 3 properties are sold to Arenaturist. In December, the group injected 7 German hotels and one in Budapest to Arenaturist in exchange for £51.2m of new shares in Arenaturist.
- **2017:** In February Arenaturist acquired the freehold interests in art'otel cologne and art'otel berlin kudamm from a third party. PPHE Group leases and manages the hotels and the purchase price was €54.5m with an adjustment for VAT.

PPHE transferred its German and Hungarian operations to Arenaturist, together with an exclusive right in certain countries within the CEE Region to develop and manage hotels under the Park Plaza brand in exchange for £51m of new shares in Arenaturist.

Arenaturist proposed a capital increase from 3.27m ordinary to 4.27-5.27m ordinary through a public offer.

The net effect of all this from the perspective of the PPHE shareholder is to simplify the structure of the group, and to give a visible valuation to the Croatian and Central and East European interests and to establish Arenaturist as an international leisure and hospitality company with excellent growth prospects.

Our conversations with management suggest that they are extremely excited about the Croatian opportunity. Although improving profitability in the shoulder months is a potential significant win, they may be constrained in the short to medium term by issues such as flight availability – there are good connections from the UK and Europe in the peak months, but air flights in the shoulder periods are more difficult. This will likely improve over time, which could be significant for profitability in the longer term.

Other

Management and holdings operations EBITDA declined slightly, as the Croatian results are now consolidated and in a separate line, and because of some exceptional or one-off costs associated with the various corporate transactions. We list the adjustments made to eliminate these non-recurring items separately below. This is an entrepreneurial company which likes to do deals, so it might be sensible to assume there will always be some level of corporate activity costs, but not to the degree this year.

HQ Line Key Financials

(£m)	2016	2015
Revenue before elimination	29.2	32.6
Revenue within the Group	24.8	25.4
External reported revenue	4.4	7.2
EBITDA	10.7	12.6

Source: Company, Hardman & Co

Net interest increased from £19m to £25m, reflecting the higher net debt on the back of the extensive development programme. Our cash flows show a further outflow in 2017 but there is a full year benefit of the lower interest rate post the refinancing.

There is a slight complication in that the group has raised more long term finance than its immediate needs, so there will be an adverse arbitrage as it earns very little on its cash balances (just under £150m at year end) and of course is paying interest on the long term debt. The good news is that the group therefore has firepower for further acquisitions, and sufficient cash for the extensive newbuild capex programme and renovations going forward.

Tax charge was effectively zero and for the first time there is a minority interest deduction which relates to the publicly quoted Croatian subsidiary.

Exceptional Items/Normalised Profit Adjustments

(£000s)	2016	2015
Loss on buy back of Income Units	372	582
Loss - fair value adjustment previous interest in Croatia	712	
FX adjustment - Croatia	250	
Hedge accounting adjustment	15,586	
Other refinance expenses	7,811	
Restructuring expenses	720	
Pre-opening expenses	1,744	
Total expenses	27,195	582
Gain on Arenaturist acquisition	27,157	
Income from forfeited deposits	6,543	
Capital gains		77
Fair value adj bus combination		377
Total Income	33,700	454
Net	6,505	-128

Source: Company, Hardman & Co
Note: The table is taken from note 24, page 125 to the accounts.

Balance Sheet and Cash Flow

The group was in an investment phase in 2016 with the construction of the new Waterloo hotel, the new build on the Park Royal A40 site, and the extension of the Riverbank Hotel. It also completed the acquisition of the Croatian business in the first half, and paid the special dividend of £1/share, increasing the cash spend on the dividend to c.£50m.

Hence net debt climbed from £398m to £597m during the year, including a number of special items relating to the refinancings. For simplicity, we have netted off the various one-offs and special items into the £75m "Other" adjustment shown in the table, but there is a more granular breakdown in the cash flow statement on page 91 of the report and accounts. Our representation is simplified, but we find it a better basis for forecasting.

During the year, a number of new long term facilities have been agreed, with refinancing of £564m of debt, extending the tenure of the debt from 3 years to 9 years.

Summary Cash Flow

(£000s)	2015	2016	2017	2018
EBITDA	80.1	94.1	102.9	108.5
Working Capital	5.0	-12.8	-2.0	-2.0
Operating Cash flow	85.1	81.3	100.9	106.5
Interest - cash impact	-32.5	-37.3	-38.3	-40.0
Tax paid	-0.1	0.0	-1.0	-1.0
Cash flow after financial items	52.5	44.0	61.6	65.5
Capex	-63.1	-87.7	-77.0	-15.0
Acquisitions	-3.3	-22.0		
Buyback of income units	-3.2	-1.3		
Total capital outflow	-69.6	-111.0	-77.0	-15.0
Cash flow after capex etc	-17.1	-67.0	-15.4	50.5
Dividends	-8.4	-50.6	-9.3	-10.1
Cash flow after dividends	-25.5	-117.6	-24.6	40.4
Share issues	0.6		0.5	0.5
FX/other/exceptionals	1.9	-74.9	-2.0	
Overall move	-23.0	-192.5	-26.1	40.9
Opening Net Debt	-374.6	-397.7	-590.2	-616.3
Closing Net Debt	-397.7	-590.2	-616.3	-575.4

Source: Company, Hardman & Co

Debt looks higher than normal relative to income because of the capital Work in Progress, which amounted to £137.5m at year-end (up from £77.8m at end-2015), and this also depressed the return on capital. A number of points should be noted:

- The group has a very significant asset backing. Net debt to equity on a reported basis amounts to £590m vs £330m of equity but the latter deducts the hotel rooms sold to private investors from equity, as they are treated as a financial liability under GAAP.
- Not adjusting for this, the pro forma debt to equity falls to £590m vs £330m + £439m of value uplift to today's value; this more realistic measure gives 590/769 or 77% if the equity is adjusted for the market value of the properties today.
- This also flags up that the equity of £769 less minority interests of £30m give £739m, which is £17.50 per share, i.e. a multiple of the current share price. We expect further uplifts with the completion of Park Royal and the refurbishment

of the Sherlock Holmes, and most significantly when Park Plaza Waterloo is incorporated in the valuation, although the company has no plans for a further valuation at this time. Management do not see this as a property company requiring an annual valuation, although we would be surprised if shareholders did not see another external valuation in the next 2-3 years which will show a significant further uplift.

- The majority of the facilities have now been renewed and the weighted average tenure of the debt is some 9 years, which gives the group a huge amount of flexibility.
- When the new hotels and extensions all come into operation, EBITDA will increase significantly, further improving coverage ratios.

There is one other point which is probably worth making here. PPHE's balance sheet is quite complex for a company of this size. The treatment of the hotel rooms (income units in the balance sheet which were sold to help finance the Westminster development during the credit crunch, an innovative solution to what was probably an intractable problem for many operators at the time) sold to investors is also, we think, complicated. The group is fully compliant with all the GAAP rules here, but the GAAP treatment is itself confusing. We outline later in this note some of the accounting issues and attempt to explain them.

PPHE is unusual in the hotel industry in that it is both an operator and an asset owner. Some of the majors have been pursuing an asset-light strategy, which has resulted in higher returns on capital and improved stock ratings. Yet PPHE is making returns in two ways – through capital appreciation on the capital invested and in the operational return on capital achieved. Last year PPHE produced £31.7m of normalised profit before tax on equity of £330.2m or a return of nearly 10%, yet £137.5m was tied up in developments which were not producing a return last year.

We intend at some point in 2017/18 to produce a composite return showing the real returns on capital being generated in terms of cash and asset value uplift, once the new assets are operational.

Balance Sheet		
As at 31 Dec £000s	**2016**	**2015**
Noncurrent assets:		
Intangible assets	25,158	21,878
Property, plant and equipment	1,069,702	813,026
Investment in associates		16,483
Investment in joint ventures	18,409	17,328
Other noncurrent assets	3,090	16,900
Restricted deposits and cash		5,235
Deferred income tax asset	713	
	1,122,307	885,615
Current assets:		
Restricted deposits and cash	25,513	3,206
Inventories	2,412	999
Trade receivables	12,576	9,154
Other receivables and prepayments	10,370	7,721
Cash and cash equivalents	144,732	50,623
Total assets	**1,317,910**	**957,318**
Equity:		
Issued capital		
Share premium	129,527	129,140
Treasury shares	-3,208	-3,208
Foreign currency translation reserve	14,450	-19,449
Hedging reserve	-895	-14,944
Accumulated earnings	159,755	176,365
Attributable to equity holders of the parent	299,629	267,904
Noncontrolling interests	30,573	
Total equity	330,202	267,904
Noncurrent liabilities:		
Borrowings	642,120	440,110
Provision for litigation	3,392	
Provision for concession fee on land	2,885	
Financial liability in respect of Income Units sold to private investors	133,983	136,203
Other financial liabilities	22,979	45,198
Deferred income taxes	9,345	8,028
	814,704	629,539
Current liabilities:		
Trade payables	10,754	10,455
Other payables and accruals	43,959	38,045
Borrowings	118,291	11,375
Total liabilities	987,708	689,414
Total equity and liabilities	**1,317,910**	**957,318**

Source: Hardman & Co Research

Outlook and Forecasts

Our forecasts for the current year and next are shown in the table. We have used today's fx rates to roll forward and think we have been relatively conservative on 2017 and 2018, as it is difficult to gauge the impact of the new developments opening and a number of hotels being closed for refurbishment.

Summary P&L

	2015	2016	2017	2018
UK Sales £	147.4	148.7	181.0	192.0
Netherlands Sales £	42.3	48.3	41.3	44.1
Germany Sales £	21.9	25.0	26.6	28.0
Croatia Sales £		46.1	48.0	49.0
Management Sales £		4.4	3.0	4.0
Total Revenue	169.3	272.5	299.9	316.5
UK EBITDA £	54.4	51.1	63.5	66.0
Netherlands EBITDA £	13.4	14.6	11.8	13.5
Germany EBITDA £	-0.4	0.9	1.3	1.5
Croatia EBITDA £	0.0	16.8	13.3	14.0
Management EBITDA £	12.6	10.7	13.0	13.5
Total EBITDA	80.1	94.1	102.9	108.5
Depreciation and amortisation	19.1	25.3	28.0	29.5
EBIT	61.0	68.8	74.9	79.0
Margin	36.0%	25.2%	25.0%	24.9%
Associates	-1.9	-1.8	0.0	0.0
Other income	1.3	-0.2	0.0	0.0
Income units liability payments	-11.6	-10.7	-10.7	-10.7
Interest	-19.4	-24.6	-27.6	-27.6
Profit before tax (adjusted)	29.8	31.7	36.9	41.0
Tax	0.1	-0.1	-0.1	-0.1
Profit after tax	29.9	31.6	36.8	40.9
Minorities		-3.0	-2.7	-2.8
Earnings	29.9	28.6	34.1	38.1
EPS (pence)	71.5	67.9	80.8	90.2
DPS (pence)	20.0	121.0	22.0	24.0
Shares in issue	41.8	42.2	42.2	42.2

Source: Company, Hardman & Co

Current year earnings will be constrained by cost pressures, with increases in business rates, labour cost hikes as a result of the minimum wage, and weaker sterling leading to food cost hikes. Nevertheless, overall we see good progress in earnings and dividends over the next couple of years and as highlighted earlier, the debt should start to come down if the expansion programme slows; debt reduction could be faster if the company realises interest in some of its developments as is under consideration.

Just to repeat, the company flagged in its outlook statement that "Trading in the year to date is in line with the Board's expectations in all markets, with the improved market conditions experienced in the second half of 2016 continuing into 2017. In the year ahead we expect further benefit from our new room inventory in London and Nuremberg where our market presence will be strengthened significantly.

"We remain focused on the creation and realisation of shareholder value and we will continue to invest in our existing portfolio, with extensive renovations at several of our hotels in London and the Netherlands, to ensure that our hotels continue to improve on their strong market positions."

We see several structural trends in the global hotel industry:

- a move to greater concentration
- the separation of asset ownership from hotel management
- ongoing desire for trophy assets, notably now including from Chinese operators
- further moves overseas into Europe and elsewhere by Chinese players; it's clear that outbound Chinese tourism is going to be a major global growth area for the next 10 or 20 years, unless something significant happens to derail the Chinese economy (clearly also possible); this has to be positive for the hotel players
- increasing concern among smaller and mid-sized operators at the capture of distribution by on-line travel operators such as Priceline, Expedia and now TripAdvisor. These have been commanding substantial commissions, impacting operators' profitability, but they in turn could come under pressure from the launch of the new Google Destinations service.

These trends overall look to be positive, rather than negative, for PPHE. As trophy assets in central London continue to be revalued up, the mid-tier assets look even cheaper; as the business grows, it offers mid-sized operators an opportunity to bulk up; and the deeper the market for hotel real estate, the greater the liquidity and the better financing is available. Meanwhile, PPHE can piggyback on the Carlsson linkup (the company has been acquired by HNA Group, a Chinese travel conglomerate) and punch above its weight in distribution. Hence we see these trends as being positive for PPHE shareholders.

Accounting Overview

PPHE has a remarkable track record in the hotel industry as an outstanding acquirer of sites, as a builder and, finally, as an operator. However, some investors might have found it difficult to understand some of the complexities in the accounts. This note seeks to address these issues.

To fully appreciate PPHE investors need an understanding of the following:

1. Allocation of overheads
2. Wholesale undervaluation of assets
3. Used to report in Euros
4. Treatment of Croatia
5. Related party transactions
6. Income units

Management and Holdings

PPHE operates three different business models across the portfolio.

Ownership and operation of freehold hotels: The major advantage of ownership is that the group benefits directly from the gain in the value of the asset, which is a product of the purchase price paid, with the management demonstrating adeptness at spotting undervalued opportunities. This has proved the most effective strategy for shareholders, but it's inherently asset intensive, and although the combined returns (return on initial investment plus asset appreciation) have been excellent, the group's capacity to grow in this fashion is limited by the availability of debt and by the share price's reflection of inherent value. Currently, the shares trade at a significant discount to the real value of the assets and management, who are the largest block of shareholders, understandably don't want to issue equity.

Hotel groups benefit from scale advantages, notably bulk purchasing, the amortisation of group central costs over a larger number of rooms, and brand investment and distribution. Hence PPHE also operates two other forms of management and ownership.

Operation of leasehold hotels: The major advantage is that the group can generate a high return on limited capital and this gives benefits of scale.

Management contracts: Here the group has no commitment in terms of capital or lease rentals, but is simply paid by the owner of a hotel asset to manage that asset on their behalf. The asset owner benefits from PPHE's operational expertise, takes a share of revenue and enjoys the appreciation in the asset value. PPHE gains scale and generates high returns on limited capital.

In all three cases, PPHE's hotel unit will pay the group HQ a fee for the central services supplied – accounting, HR, brand advertising, distribution etc. This income is shown as inter-segment revenue in the management and holdings line – it was £24.8m in 2016, and it is eliminated on consolidation as it is merely an inter-company, intra-group charge.

The impact of these charges varies according to business model:

For owned properties, the charge is a smaller proportion of profit, as the operating unit does not have to pay rent and is therefore inherently much more profitable. For the leasehold and managed hotels, however, the central costs charged can be significant relative to their profit. In Germany, for example, until now, the group has not owned any freeholds and all the hotels were leasehold – the imposition of the central charge was enough to swing the operating unit into loss. This is why the German division appears to be loss-making – the profits appear in the management line. Croatia used to be similar, but there was an added complication in that the operating losses appeared in the associates line.

There is an argument that the central charges must be too high, for the operating units should really be profitable on a standalone basis, but the amount of the inter-company charge should not really be considered particularly significant to shareholders - they benefit from the overall result, and it matters little in which division the result is booked. In one sense, it might be easier for investors to see where the money was really made with a different treatment, but PPHE's argument is that the operating units would in any case need to incur these costs, whether they are centrally or indeed externally provided.

The actual results of the management line reflect this internal income and the head office costs, including directors' fees etc. Because the group has been very active in buying and refinancing assets in recent periods, the central line reflects a lot of corporate costs and advisers fees etc. Some companies would report these as exceptionals.

We don't have any issue with the way that PPHE accounts for the costs recharged, but we understand that investors looking at the accounts for the first time might have wondered why the German operation appeared to be loss-making, and hence we thought further explanation might be helpful here.

In 2016, the Management and holdings operations EBITDA declined as the Croatian results are now consolidated and in a separate line, and because of some exceptional or one-off costs associated with the various corporate transactions.

The reporting of the Croatia results used to be slightly complicated - the management agreement which formed the bulk of the profit was formerly reported under the management line, while the group's share of the profits was reported in associates; the management fee was considerably more lucrative than the share of profits, hence there used to be a large associate loss and a profit under management and holdings.

Asset Values

One of the main attractions of PPHE stock is that investors can buy the shares at a significant discount to the value of the assets. At the 2016 interim results, the company disclosed the value of the property plant and equipment as determined by the valuers involved in the various refinancings in H1 2016. The uplift was an astonishing amount – over £10 per share.

The interim release stated "The fair value of properties has been determined in the last six months, these have been prepared by market leading independent valuators such as Savills Plc and Knight Frank LLP, which were engaged by each of Aareal Bank AG, AIG and Mass Mutual Financial Group for their respective financings. The fair value takes into account approximately £30.0 million planned Capex and **all properties under development are stated at cost**."

Real Asset Value

£m	2016
Shareholders' funds Opening	267.9
Other adjustments, incl fx effects	47.9
Earnings	35.1
Dividends	-50.6
Shareholders' Funds Closing	299.6
Property uplift	439.0
Adjusted shareholders' funds	738.6
£ Per share	17.50

Source: Hardman & Co, Company accounts

The emphasis is ours – we believe there could be significant further uplifts in valuation. For example, the office block at Waterloo has been converted into a new hotel and, as it opens and becomes established, the value of this asset should rise significantly, we believe.

In addition, the Park Royal asset, which is at the intersection of two major roads in London – the North Circular which is the inner ring road north of the river and the A40, which is one of two main arteries into and out of London to the west should have a significant, albeit a smaller value uplift than the Waterloo site.

Management have been relatively quiet on the issue of asset values, but it's obvious that the group has an impressive record of creating value, and it's clear that the process is far from complete.

Reporting Currency

The group formerly reported in Euros, which created slight discomfort among UK based private investors as the share price was quoted in sterling but the operational performance was reported in Euros. This was further complicated by the fact that the main producing assets were no longer European but British – hence the performance reported in Euros would be flattered and year on year growth enhanced by any strengthening of the pound against the Euro.

It involved significant work for the accounting function to change the reporting currency to sterling but this was implemented in 2016 and although analysis of the long-term trends and divisional performance requires some analysis and fx calculations, the group is now much easier to understand, as the main assets are denominated in sterling which is now the reporting currency.

Croatia

The group has simplified its associates structure by taking an indirect 65% stake in a Zagreb-quoted Croatian holding company. It has acquired the outstanding 80% interest, which it did not formerly own, in its joint venture in Croatia for an aggregate cash consideration of €51 million; and it has taken up a €30 million loan facility with Zagrebačka banka d.d. to partially fund this acquisition. It has also made a further placing. Hence its equity invested is limited to €10-15m.

The returns expected from this are significant, with the group now consolidating profits with a run rate of over £10m (although this is not all additional), and earnings of something around £4m, after paying interest, tax and deducting minorities.

The business in Croatia is highly seasonal; the 2016 results for the Croatian subsidiary will be consolidated for 9 months and this will exclude the loss-making first quarter. This will skew results a little more to the second half for the group as whole. Meantime, the group sees good opportunity to improve the offering in Croatia by renovating assets, adding luxury features like a spa and improving the catering spend. The resorts are now catering to a wider range of European inbound tourists, the attractions of the region are becoming better known, and 'dislocation' in other Mediterranean holiday areas will also help.

There is clearly a good long term opportunity for the business in Croatia and this could be highly accretive for shareholders.

Related Party Transactions

PPHE is an insider-controlled company, and it is therefore helpful to understand the nature of related party transactions, which are all detailed in the accounts, and the data is reproduced in the table below.

Related Party Transactions

£ 000s	2016	2015
Loan to associate – WH/DMREF Bora B.V.	–	28,199
Loans to joint ventures	17,045	15,670
Loan to Red Sea Hotels Limited	–	10,189
Short-term receivables	178	235
Trade receivables – the Arenaturist group	–	241
Construction liability WW Gear Construction Limited	5,155	10,824
b. Transactions with related parties:		
Management fees income – the Arenaturist group	–	1874
Sales and marketing fees – the Arenaturist group		
Construction charges – WW Gear Construction Limited	51099	43155
Interest from associate – WH/DMREF Bora B.V.	651	2334
Interest from Red Sea Hotels Limited	1128	952
Interest income from jointly controlled entities	415	398

Source: Hardman & Co, Company accounts

The Arenaturist relationship, where there were formerly external investors involved, has now been put on even more of an arms' length basis, as the interest is via a separately quoted intermediate holding company in Croatia.

The main relevant related transactions are therefore with WW Gear Construction, a company in which the Chairman of PPHE and his family have an interest. The construction company is building the two new London hotels and the extension at the Park Plaza Riverbank (a site which we visited, and found impressive). The sums involved are large, but the contracts are at arms' length and the tender for the construction of the Park Plaza Waterloo was independently reviewed to ensure that it was competitive.

The construction costs per room look very competitive, with Waterloo coming in at £157k per room, Park Royal at £115k and the Riverbank extension, which is being built while the hotel is in full operation, at £184k. These costs are certainly very commercial for PPHE, and the effectiveness of this relationship is demonstrated by the value uplifts achieved on developments.

Income Units

Post the GFC, PPHE had limited ability to tap conventional sources of finance and in order to complete the construction of the Park Plaza Westminster Bridge Hotel, it developed an innovative financing method – selling rooms to private investors who would receive a turnover-related rent. The accounts explain the treatment of the income units at Park Plaza Westminster Bridge as follows:

"In 2010, the construction of Park Plaza Westminster Bridge London was completed and the hotel opened to paying customers. Out of 1,019 rooms, 535 rooms ('Income Units') were sold to private investors under a 999-year lease. The sales transactions are accounted for as an investment scheme in which the investors, in return for the upfront consideration paid for the Income Units, receive 999 years of net income from a specific revenue-generating portion of an asset (contractual right to a stream of future cash flows). The amounts received upfront are accounted for as a floating-rate financial liability and are being recognised as income over the term of the lease (i.e. 999 years). Changes in future estimated cash flows from the Income Units are recognised in the period in which they occur.

On completion of each sale, the Company, through a wholly owned subsidiary, Marlbray Limited ('Marlbray'), entered into income swap agreements for five years with the private investors. The income swap agreements included an obligation of the investors to assign the right to receive the net income derived from the rooms to Marlbray and an undertaking by Marlbray to pay to the investors an annual rent guarantee of approximately 6% of the purchase price for a five-year period commencing from the date of the completion of the sale. The income swap has been accounted for as a derivative. In 2014 and 2015, Malbray entered into 56 income swap agreements for a further 5 years from the expiry date.

Income Units sold to Private Investors

£000s	2016	2015
Balance Sheet Financial liability	133,983	136,203
P&L Charge	-10,680	-11,588
Annual Rate	7.9%	8.4%

Source: Hardman & Co, Company accounts

The entire hotel is accounted for at cost less accumulated depreciation. The replacement costs for the sold rooms are fully reimbursed by the investors. An amount of 4% of revenues is paid by the investors on an annual basis ('FF&E reserves') and is accounted for in profit and loss. The difference between the actual depreciation cost and the FF&E reserve is a timing difference which is recorded on the statement of financial position as a receivable or liability to the investor in each respective year."

The effect of this transaction is that PPHE has a virtually perpetual loan. On that loan it pays the unit owners an interest rate which is effectively the room rate, (hence the weighting of the charge to H2). The group benefits from these rooms being filled as the occupiers continue to spend on catering etc. It has turned out to be an excellent deal for the private client investors as they effectively have an inflation-linked high coupon bond. It has been less good for PPHE, as the financing rate is expensive, but the group has enjoyed a massive capital uplift on the construction of the hotel, and at the time, conventional credit markets were effectively closed during the GFC.

One wrinkle with this is that we do not have an insight into how the external valuers treat these rooms, but given the nightly rate “belongs” to a third party, we assume that these rooms will be excluded from the valuer’s calculations.

Overall therefore, we could treat these rooms as debt, and while the nomenclature is perhaps confusing, the treatment is quite straightforward. And if anything, we would consider this less as debt and more as a form of preferred equity – it has no repayment obligation, and could be considered as perpetual debt.

Conclusion

The group’s change of its reporting currency to sterling highlighted that management understands the idea that their company is not exactly simple to understand, and demonstrates a desire to be transparent with investors and straightforward to analyse. We have found management helpful in clarifying the history behind the adoption of some of the practices and many of the complications have arisen because it was a small company growing quickly and doing entrepreneurial deals; most notably, this was the case with the income units.

We have included this section in our results note on our own initiative, and we have discussed the contents with management. Given the unusual nature of PPHE in the hotel industry, as a developer, owner and operator, and the fact that it operates in many countries, the accounts will always be somewhat complex. The accounting practices should not, however, be a deterrent to investors, but, rather, the spread of the activities should be an encouragement. Once the essential financial characteristics are explained, then the accounting policies and practices fall naturally into place.

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