ELLERSTON CAPITAL

Ellerston Global Investments (ASX: EGI)

Investment Update – December 2017

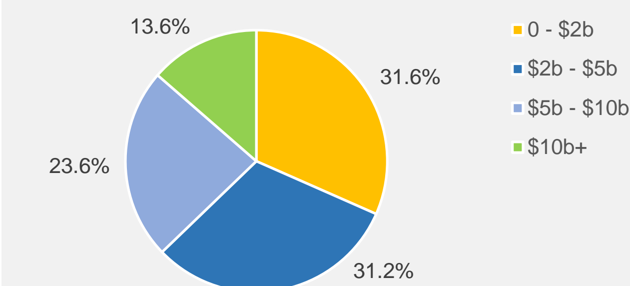
Fund Performance (Net)

	1 Month	3 Months	6 Months	1 Year	3 Years p.a	Annualised Return^	1 Nov 2014
EGI*	1.82%	6.65%	12.36%	18.27%	11.36%	12.37%	44.67%
MSCI World Index (Local)	1.10%	5.30%	9.45%	18.48%	9.64%	9.83%	34.56%

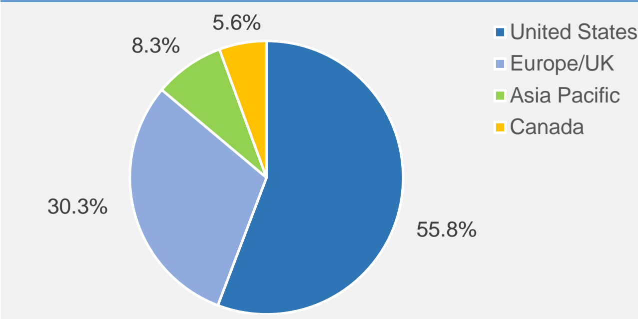
*Net Return (before tax)
^1 Nov 2014 p.a

Key Facts	
Listing date	Oct 2014
NTA (before tax) **	**$1.2628**
NTA (after realised tax)	$1.2634
NTA (after tax)	$1.2168
NTA Fully Diluted (after realised tax)	$1.1891
Share price at 31/12/2017	**$1.16**
EGI Market Capitalisation	$91.3m
Management Fee	0.75%
Option price (ASX: EGIO)	$0.155
Exercise price	$1.00
Dividends Paid FY 2017	2.0 cps
Dividends Paid (YTD) - FY 2018	1.5 cps
Dividend Profit Reserve ^^	9.1 cps

Market Capitalisation (% of Invested Capital)



Geographic Gross Exposure (% of Invested Capital)



Top 10 Holdings	Weight
Entertainment One Ltd	7.79%
Zayo Group Holdings Inc	5.73%
Stars Group Inc-The	4.67%
Equiniti Group Plc	4.41%
Interxion Holding NV	4.20%
Acuity Brands Inc	3.81%
Playa Hotels And Resorts NV	3.75%
Venator Materials Plc	3.69%
QTS Realty Trust Inc	3.64%
Hostelworld Group Plc	3.41%

Sector	Portfolio	MSCI World Index
Consumer Discretionary	21.60%	12.26%
Industrials	15.69%	11.65%
Information Technology	11.00%	16.77%
Financials	8.98%	18.09%
Telecommunications	8.26%	2.77%
Materials	7.56%	5.25%
Real Estate	3.64%	3.11%
Energy	0.64%	6.33%
Consumer Staples	0.00%	9.04%
Health Care	0.00%	11.76%
Utilities	0.00%	2.97%
Cash	13.47%	0.00%
Other	9.16%	0.00%
Total	**100.00%**	**100.00%**

** **NTA (before tax)** - Includes taxes that have been paid. **NTA after realised tax** - Includes a provision for tax on realised gains from the Company's Investment Portfolio. **NTA after tax-** Includes any tax on unrealised gains and deferred tax. **NTA Fully Diluted (after realised tax) - If all of the remaining 2018 options had been exercised by 31 December 2017.**
EGI went ex-dividend a 1.5 cent fully franked dividend on the 5th of September 2017, with a payment date of the 6th October 2017.

^^ After the payment of the 2017 final dividend the Company will have a dividend profit reserve of 9.1 cents per share based on shares on issue at 31/12/17. Cps refers to cents per share.

Portfolio Update

The EGI portfolio increased 1.82% net during the month of December. The NTA (before tax) at the end of December was $1.2628.

Contributors to performance included **XPO Logistics**, **Entertainment One** and **Hostelworld**. Detractors from performance included **Equiniti, Philips Lighting**, and **QTS Realty Trust**. EGI had no companies report earnings in December.

On Friday 22nd December, Recode reported that Home Depot was weighing a possible bid for **XPO Logistics** in an attempt to prevent Amazon from buying XPO. The article cited internal discussions at Home Depot with no comments from either company or Amazon. XPO's stock price jumped 14% that day to close at $90.01.

While we have always believed that **XPO Logistics** was undervalued with its contract logistics and last mile businesses underappreciated by the market, we do not think a purchase by Home Depot would be likely given the size of XPO's transportation and logistics business relative to Home Depot's core business. Regardless, the rumour highlights the strategic value of XPO's assets as the world moves to buying goods online. XPO is the largest provider of last mile logistics for heavy goods in North America (appliances, fridges, washing machines etc.) and both Amazon and Home Depot are customers. With brick and mortar retailers such as Home Depot growing online sales to compete with Amazon the strategic value of an effective last mile delivery cannot be underestimated. XPO's stock was up 15.9% in December and closed at $91.59 at the end of the month. EGI took the opportunity to trim its position in XPO. EGI first purchased XPO at $62.95.

After noting a challenging public sector market during the recent UK election cycle, it was a positive sign to see **CityFibre** announce two deals during the month. In December, CityFibre announced its largest public sector award to date extending its existing Gigabit City network in Glasgow to 506 Glasgow City Council owned sites in an agreement with a lifetime value of £15.7m over 19 years (initial contract value of £6.4m with options to extend to a maximum of 19 years). The company also announced a further agreement with Capita, the ICT provider to Aberdeen City Council, to connect additional core public sector sites within the city boundary to CityFibre's metro network. This deal flow comes on the back of the company's transformative partnership with Vodafone to connect as many as 5 million homes and businesses to fiber by 2025, the largest full-fiber investment in the U.K.'s history.

Market Commentary

Global equity markets continued to drive higher in December with the MSCI World Index up 1.10%. Synchronised global growth, solid earnings, the expected benefits from US tax reform and a spike in global and domestic merger and acquisition activity provided markets with the impetus to close the calendar year strongly, despite ongoing geopolitical uncertainty.

US equity markets were the star performers again in December, with the Dow Jones Industrial Average Index (+1.92%) and S&P 500 (+1.11%) ending the calendar year at near record highs with the Dow Jones and the broader S&P500 delivering a 28.11% and 21.83% return for the calendar year, respectively. As widely expected, the FOMC hiked the target range for the Fed funds rate by 25bps to 1.25% - 1.50%. This is the fifth hike of the cycle and the third hike of 2017.

During the month, the controversial US tax reform package was finally approved and signed into law, delivering the Trump administration a significant legislative victory. The headline feature of the tax bill was the reduction in the corporate tax rate to 21% from 35%. The impact on US economic growth is expected to be +0.3 to +0.5 percentage points in 2018 and 2019 - although it's far too early to be definitive. Economic data released in December confirmed that in the third quarter, the US economy grew at a 3.2% annualised rate the fastest pace since early 2015.

In Europe, the Euro Stoxx 50 ended the month down 1.75%, but finished the calendar year up 9.15%. The FTSE 100 had a very strong month (+5.03%) as markets took heart from the breakthrough on the first stage of Brexit talks with the EU. The UK, through its concessions, has secured a transition period post March 2019 (when it is scheduled to leave the EU) and moved to the next stage of negotiations. The UK closed the calendar year up 11.95%. The German DAX was down 0.82% while the French CAC40 was down 0.91% during the month. In the Eurozone, Composite PMI figures in December of 58.0 beat expectations and Eurozone inflation for November came in at 1.5%, up from 1.4% in October and 0.6% in November 2016.

In Asian markets, the Japanese market was broadly flat delivering a return of 0.32%, the Hang Seng was up 2.56% and the Shanghai Index was down 0.30%. Asian market performance was impressive in the calendar year, with the Nikkei up 21.33%, the Hang Seng up 41.17% and the Chinese market up 6.56%.

The **ASX/S&P 200 Accumulation Index** continued to keep pace with rising global equity markets and was up 1.81% in December and delivered a credible performance for the calendar year, up 11.80%.

Playa Hotels & Resorts (Market Cap $1.19b, Share Price $10.79)

Post IPO – Leading owner, operator and developer of 'all-inclusive' resorts with a portfolio of prime beachfront assets listed in March 2017 with little fanfare due to its unconventional route to the public markets. The 'all-inclusive' market is highly fragmented with many resorts run by second/third generation families. Over the past decade Playa has acquired a portfolio of underinvested, unbranded and sub-optimally run resort hotels in prime locations. Ongoing renovation, rebranding and optimised management of the portfolio combined with significant catalysts for growth and consolidation provides material upside for investors.

Founded in 2006, Playa Hotels & Resorts (Playa) owns a portfolio of 13 all-inclusive beachfront properties (6,130 rooms) in Mexico and the Caribbean. Properties are operated by Playa under the *Hyatt Ziva* (family), *Hyatt Zilara* (adults only), *Panama Jack* and *Royal* brands while *The Dreams* and *Secrets* branded properties are externally managed by AMResorts. All-inclusive resorts provide guests with an integrated experience through prepaid packages which include room accommodations, food and beverage services and entertainment activities.

The all-inclusive market has developed from what was perceived as a cheap spring break option to a segment of the travel leisure market that is meeting a change in consumer demand and providing customers with what they are looking for – cost certainty and value for money. The benefits to the operator come in the form of increased visibility in terms of booking patterns as guest's book and pay further in advance with fewer cancellations. This leads to higher yield management potential with the ability to more accurately plan resources such as labour and reduce waste. Playa also benefits from higher margin premium services not included in the all-inclusive package (non-package revenue) such as spa, premium wines, room upgrades, weddings etc. In addition all-inclusive resorts run at very high occupancy levels in the low to mid-80% (Playa at 82% occupancy). It is also more likely insulated from urban hotel disruptors like Airbnb.

The all-inclusive leisure market has favourable leisure travel demographics with higher growth rates and margins than traditional leisure. This space is also highly fragmented with many resorts run by second/third generation families. Many of these properties are unbranded, underinvested and sub-optimally managed. This industry dynamic lends itself to significant consolidation. The veteran management team at Playa, led by CEO Bruce Wardinski, has been a key consolidator in this space and will now be even better positioned to consolidate this highly fragmented market offering an attractive exit strategy to family owners (whether cash, scrip, debt or combination). This is evidenced by the fact that management has publically commented that they are now actively negotiating exclusive deals without competition.

Unconventional Route to Public Markets **–** Playa signalled its intention to commence an IPO process in 2016, but chose to merge in March 2017 with Pace Holdings Corp (PACE.US), a special purpose acquisition company (SPAC) sponsored by an affiliate of the private equity group, TPG. The low profile and unconventional nature of the listing combined with a concentrated shareholder base has resulted in a period of price discovery for the stock.

The Opportunity **– Playa is the only US listed company focused on the highly attractive all-inclusive hotel resort segment.** Playa's management team is in the early stages of a transformation to ultimately scale the company into a truly branded all-inclusive portfolio across market tiers. This has included the recent renovation of half the properties in the portfolio alongside a rebranding strategy that is well underway. **The company has many internal and external growth drivers in the near to medium term that will ultimately drive earnings growth and lead to a multiple re-rating.** These include; taking market share from competitors with the recent hurricanes which left Playa's properties mostly unaffected, the re-branding of some resorts to Panama Jack and the rollout of more Hyatt Zilara's and Hyatt Ziva's, the internalisation of management contracts at expiry, reducing direct distribution costs, asset light external management contracts (recently signed first deal with Sanctuary), M&A opportunities, and the development of Cap Cana, a 40-acre parcel of land purchased in July 2017 to be developed in to a 750 room Hyatt Ziva and Zilara resort.

The vast majority of revenue is in USD and 80% of Playa's costs are in local currencies (e.g. Mexican Peso). Year-to-date, Playa has grown total net revenue 7.8% and Adjusted EBITDA 11.0% over the prior comparable period in 2016. Playa currently trades on a forward EV/EBITDA of 9.6x which is a significant discount to peers and Free Cash Flow Yield of 7.8% (backed by hard assets).

Company Overview

Playa was founded by its current Chairman and CEO Bruce Wardinski in 2006 with the purpose of creating a portfolio of all-inclusive beachfront resorts. Playa owns a portfolio of 13 all-inclusive beachfront properties (6,130 rooms) in Mexico and the Caribbean. Six of the properties are branded Hyatt consisting of three Hyatt Ziva (family), one Zilara (adults only) and one Hyatt Ziva/Zilara (both brands located at the same Jamaican property). Two properties have recently converted to Panama Jack and the rest are branded under the Dreams, Secrets and Royal brands.

Playa's key markets of Mexico, Dominican Republic and Jamaica are gateway vacation destinations and Playa's customers are leisure not corporate (that latter tending to be more cyclical). Playa's guest by origin based on room nights are 58% US, 15% Europe, 10% Canada and 17% Other. Earnings are 57.4% exposed to the Yucatan Peninsula in Mexico (Cancun/Riviera Maya), 16.6% to the Pacific Coast (Los Cabos, Puerto Vallarta) and 25.9% to the Caribbean (Dominican Republic and Jamaica).

Portfolio Overview

Room Count by Region

Jamaica 10%
Pacific Coast 15%
Dominican Republic 31%
Cancún/ Riviera Maya 44%

Pacific Coast

Hyatt Ziva Los Cabos
Hyatt Ziva Puerto Vallarta

Cancún / Riviera Maya

Hyatt Ziva Cancun
Panama Jack Cancun
Hyatt Zilara Cancun
Secrets Capri
THE Royal Playa del Carmen
Panama Jack Playa del Carmen
Dreams Puerto Aventuras

Jamaica

Hyatt Ziva & Zilara Rose Hall

Dominican Republic

Dreams Punta Cana
Dreams La Romana
Dreams Palm Beach

Managed by Playa Hotels & Resorts **Managed by AMResorts (Apple Leisure)**

Portfolio - Resort Examples

Situated in Puerto Vallarta's only private cove

Cancún's most coveted location

Located on the widest stretch of beach in the heart of the Cancún's Hotel Zone

Rebranding and Rejuvenation of the Portfolio

To date, six resorts have been rebranded to Hyatt Ziva/Zilara and two resorts have more recently been rebranded to Panama Jack (December 2017). The remaining five assets are externally managed by AMResorts. Over the last four years, Playa has spent in excess of $250m to rejuvenate half the portfolio.

Hyatt: In 2013, Playa entered into a deal with Hyatt Hotels to franchise the Hyatt All Inclusive Brand (Hyatt Ziva and Hyatt Zilara) with each franchise agreement having an initial 15 year term and Hyatt having the option to extend an additional 10 years. Hyatt also invested $325m in Playa, but at the time of the Pace merger redeemed $225m in preferred shares. Hyatt has effectively invested $100m for the 12% in common shares of Playa it currently owns. The first two Hyatt properties, Hyatt Ziva Los Cabos and Hyatt Zilara Cancun were renovated prior to the rebranding and opened in early 2014 while the Hyatt Ziva and Hyatt Zilara Rose Hall resorts in Jamaica opened in December 2014. The Hyatt Ziva Cancun completed its renovation in Q415. The Hyatt partnership has delivered substantial growth to Playa with the company seeing a significant uplift in average daily rate (ADR), RevPAR (occupancy rate multiplied by ADR) and Adjusted EBITDA to those properties that have converted to Hyatt.

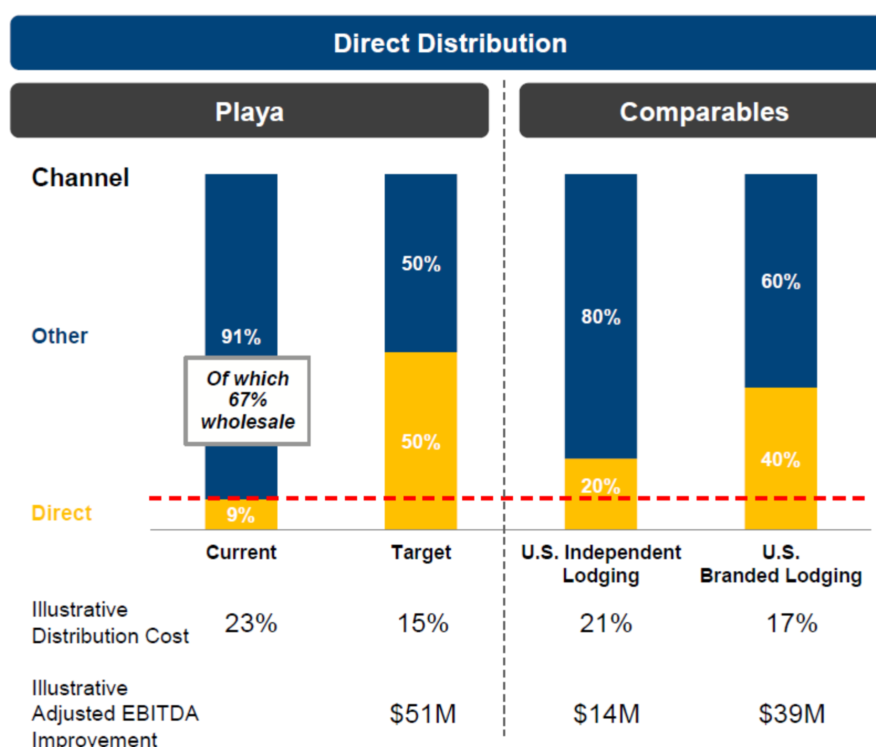
Panama Jack: Panama Jack is a global consumer brand known for its sun-care products and beach apparel. Playa entered into an exclusive licence with Panama Jack in all current markets (Mexico, Jamaica, Dominican Republic) as well as throughout the Caribbean Basin & Central America with a first right of refusal elsewhere. Signed in January 2017 with a 10 year term extendable at Playa's option, the goal is to create a 'retro tropical' theme 4-star brand (that sits right below the Hyatt offering) to create brand awareness and to accelerate demand in consumer markets at a lower price point.

Significant Growth Drivers:

The upcoming catalysts for Playa that should drive shareholder returns:

1. **Fragmented Industry:** There are circa 13 all-inclusive operators in Playa's markets covering operators with as many as 20,000 rooms down to 1,000. Management has stated that it is actively negotiating exclusive deals without competition. Many owners in the industry are family operated and as a listed company Playa can be a very attractive exit strategy for second/third generation owners. The company is looking to buy **underinvested, undermanaged, unbranded** hotels that they can turnaround similar to what they did with the Ritz Carlton in Jamaica which they purchased out of bankruptcy and successfully converted into Hyatt Ziva & Zilara.

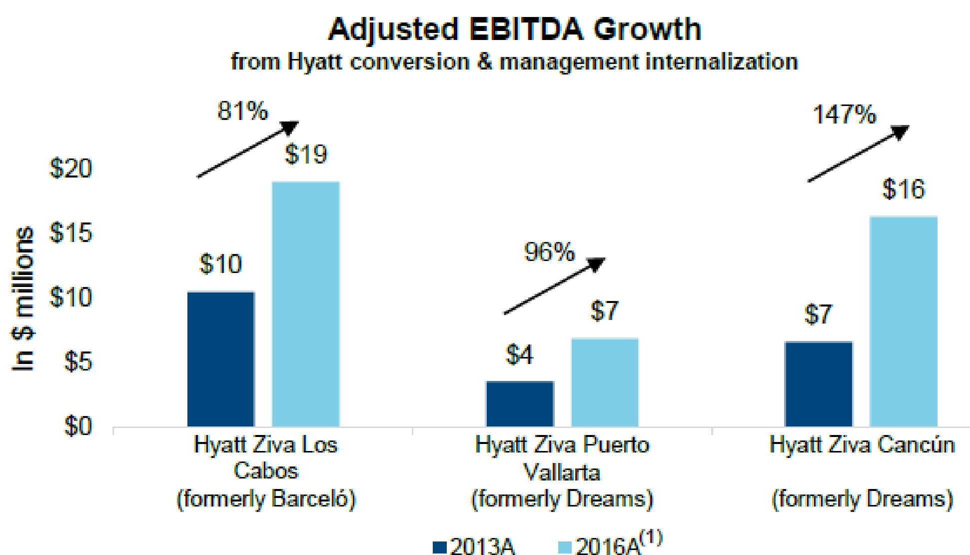
2. **Direct Distribution Costs:** Currently, only 9% of Playa's revenues come from direct distribution. The majority of bookings at the moment come from wholesalers who typically charge 25%-30% commissions as well as online travel agencies (OTA's) who can charge in excess of 20% in commissions. A long-term opportunity for Playa is to improve its direct distribution efforts to reduce costs – if direct distribution moves to 50%, Playa could generate an incremental $51m in EBITDA (approx. 25% of 2018 EBITDA). Playa will continue to push more distribution through Hyatt.com and is beginning to transform its own customer facing platforms. With more brands, Playa will also be able to negotiate better rates within existing channels as annual contracts expire.



3. **Taking Market Share After The Hurricane:** The US, Caribbean and Puerto Rico all suffered the devastating impact of three hurricanes - Harvey, Irma and Maria – in late 2017. While stays at Playa's resorts were initially interrupted and rooms will be out of service, overall there was limited impact to Playa's hotel portfolio. This has created a near-term opportunity for Playa as the CEO on its most recent results call estimated that *"as much as 15% to 20% of the entire Caribbean room inventory is currently offline."* Guests holding reservations at affected hotels will have to go somewhere else and Playa's marketing team is *"aggressively working to gain market share and take advantage of the rooms out of service."* Playa is already seeing strong group demand at their Jamaican resorts in Q417 and more importantly in Q1 & Q2 of 2018.

4. **Brand Opportunity:** The all-inclusive segment is saturated with no-name brands that have limited consumer recognition. Playa has benefited from the repositioning to the Hyatt Zilara/Ziva brands and has recognised the importance of brands to lift room rates and improve direct bookings. By way of example, Playa has seen c30% growth in ADR and RevPAR from its Hyatt conversions. Playa has continued on this branded path with the recent conversion of its Gran-branded assets to Panama Jack and has the potential to create another brand with the recent signing of the Sanctuary management agreement (asset-light).

5. **Internalisation of Management Contracts:** Currently, 5 assets in the Playa portfolio are managed by a 3rd Party, AMResorts. AMResorts is one of the largest managers of all-inclusive resorts globally. Originally it was 7 assets, but Playa has since taken back management of those resorts which has been financially beneficial as the company scales. Playa intends to take back the management of the remaining 5 assets from AMR which will save in distribution costs and fees to AMR (well in excess of the cost to bring in-house). The Dreams La Romana management contract will revert back to Playa in June 2018. The remaining 4 expire in 2022.



6. **Non-Package Revenue:** Playa has a unique opportunity to grow its higher margin ancillary revenue faster than room revenue by selling room upgrades, spa services, premium wines, weddings etc. Currently, net non-package revenue represents 14% of total net revenue for Playa growing mid-high single digits.

7. **Asset Light Management Contracts:** To gain scale, Playa intends to manage hotels of properties that it does not own. The company just signed a management agreement for the Sanctuary Resort in Cap Cana (184 rooms) and this marks the first of what Playa believes will be a rapidly growing business segment in 3rd party management. This is a long-term management contract with a 15 year initial term with two automatic five year renewals for a total term of 25 years. Playa will also receive full rights to the Sanctuary brand name which can be used at other Playa resorts in the future. The resort will begin renovations in April 2018 (Playa is negotiating an option to acquire 30% of the equity interest in the renovated Sanctuary Cap Cana) and will reopen as a 343 room resort with all investment capital coming from the existing owner. The expected stabilized annual management fee in 2020 and beyond is expected to be $2.0-$2.5m at high margins. The only capital outlay from PLYA is $2.7m, a 2-3 year payback.

8. **Cap Cana Development:** Playa purchased a 40-acre parcel of land in July 2017 to be developed into a 750 room Hyatt Ziva and Zilara resort to open in 2019. While we do not factor the Cap Cana development into our valuation, we estimate that it could be worth an additional $1.75 per share in value.

Investment Summary

The management team at Playa has extensive hospitality experience and a track record of creating shareholder value in previous ventures. The CEO has significant skin in the game with his stake in Playa worth c.US$25m. The company owns prime oceanfront real estate in highly desirable destination markets and is at the early stages of its long-term growth strategy.

With a recently renovated portfolio driving earnings, a focused direct to consumer strategy aimed at reducing costs and opportunities to pursue value adding M&A alongside capital light external party management contracts, we believe the company is well on its way to achieving its long term goals as a leader in the all-inclusive leisure market. As Playa continues to execute on its strategic plan the stock should attract more sell-side analyst coverage and investor awareness.

Research Ratings

Independent Investment Research (IIR) is an independent investment research house based in Australia and the United States. IIR conducted research in December 2017 and has assigned Ellerston Global Investments Limited (ASX code: EGI) a **Recommended** rating.

Dividends

If you would like to have dividends re-invested under the Company's Reinvestment Plan, click here

Options

If you would like to exercise your options, click here

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Should investors have any questions or queries regarding the company, please contact our Investor Relations team on 02 9021 7797. All holding enquiries should be directed to our share registrar, Link Market Services on 1300 551 627 or EGI@linkmarketservices.com.au

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