MTR 17/11/2015 **FAT-AUS-748**

MTR AUD $4.22 Special **MED.** **B**

Is this another case of stronger for longer?

Having introduced Members to Mantra Group (MTR.ASX) in FAT-AUS-718 as a Traffic Light, we now upgrade our rating to a Buy. While Mantra Group's share price has materially outperformed the broader market listing on the ASX last year, we believe the favourable outlook for leisure travel activity in Australia, in combination with the expectation for modest growth in room numbers over this period, will provide sufficient returns over the medium-term to justify the current price tag.

Recap

Mantra is an Australian-based accommodation operator with the second largest network of hotels, resorts and serviced apartment properties in Australia (by total room number). Mantra has a total portfolio of 114 properties and over 11,700 rooms across Australia, New Zealand, and in Indonesia. Mantra provides both leisure and business accommodation, and accordingly offers a range of accommodation options from luxury retreats and coastal resorts to serviced apartments.

Mantra markets its properties via three brands: Peppers, Mantra and BreakFree. These brands seek to attract business and leisure consumers from both the domestic and international visitor segments of the accommodation market. In addition to the provision of accommodation, Mantra's core services include management of guest relations and reception areas, restaurants and bars, conference and function centres, pool and entertainment facilities and offices.

	mantra hotels resorts apartments	PEPPERS RETREATS · RESORTS · HOTELS	BreakFree HOTELS · RESORTS · APARTMENTS
Properties	58	29	26
Rooms	7,524	2,166	1,932
Positioning[1]	4-4.5 star	4-5 star	3-4 star
Property type	Hotels, resorts and serviced apartments	Hotels, resorts, retreats and serviced apartments	Hotels, resorts and serviced apartments
Brand attributes	• Created in-house • Spacious rooms, fresh decor, quality service and well located • Dual business and leisure focus	• Luxury range of escapes selectively located in destinations selected for their qualities • Combines personal and friendly service with quality food and wine	• Holiday locations, city highlights and holiday attractions • Quality but affordable resort provider
Recent awards	• Australian Traveller Magazine Readers Choice Awards 2013 – Best Affordable Hotel Brand in Australia • TripAdvisor 2013 – Certificate of Excellence: Broadbeach on the Park	• TripAdvisor 2014 – Best Hotel for Families in Australia: Broadbeach • HM Awards[2] 2013 – Best upscale property: Broadbeach • TripAdvisor 2013 – Travellers' Choice Award: Airlie Beach	• TripAdvisor 2013 – Certificate of Excellence: Eco Beach • HM Awards[2] 2012 – Best budget property

Source: Mantra Group

Mantra derives the bulk of its income from the sale of accommodation and related services to its customers. Mantra reports its revenue via three business divisions. These are CBD, Resorts, and Central Revenue and Distribution. Importantly, Mantra does not own the properties in its portfolio, and instead derives commissions, fees, and revenues under long-term contractual arrangements with the property owners.

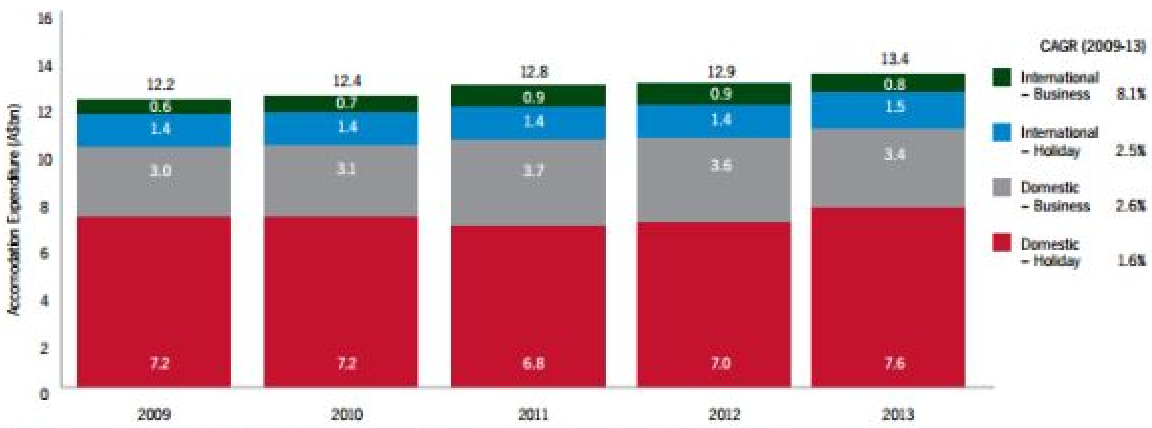
What's new?

The key point to note about Mantra Group since we last updated our thoughts on the name in FAT-AUS-737 is that the company's share price has been on a tear. That is, since the beginning of September 2015, Mantra Group's share price has outperformed the broader market by around 25 percent, adding to its overall outperformance since inception of around 140 percent. With little in the way of material corporate announcements of late, we take a fresh look at our investment case.

In our view, there are three factors to consider. **First, the S&P Dow Jones' quarterly rebalancing of its S&P/ASX 200 for three months ending September 2015, which included the addition of Mantra Group**. While this does not have an immediate effect on Mantra Group, it is positive for the company's share price given the fact that the S&P/ASX 200 is used by a lot of investment managers as a benchmark for their respective funds.

The second and third factors are somewhat related. **That is, the resurgence of Australia's tourism industry on the back of the lower Australian dollar**. As evidenced by Mantra Group's most recent investor presentation, the company is positively leveraged to increasing tourism activity, both in terms of international visitation and domestic demand. While Mantra Group is also leveraged to business travel, it is the leisure segment of its market that is currently grabbing the headlines.

FIGURE 4: ACCOMMODATION EXPENDITURE BY ORIGIN OF VISITOR AND PURPOSE OF VISIT (2009-2013) (A$BN, SEPTEMBER YE)



Source: Tourism Research Australia, National Visitor Survey and International Visitor Survey (September 2013 release).

Source: Mantra Group's Prospectus

While not identical, the composition of Mantra Group's revenue and EBITDA by division is broadly comparable to the industry splits outlined in the previous graphic. That is, **while Mantra Group derives around half of its operating earnings from its CBD segment, the primary focus of which is on business travellers, around one quarter of the company's overall operating earnings comes from its Resorts segment,** which by virtue of their respective locations, focuses on the leisure market.

FIGURE 12: **MANTRA GROUP – EBITDA BY DIVISION (2013) (JUNE YE)**

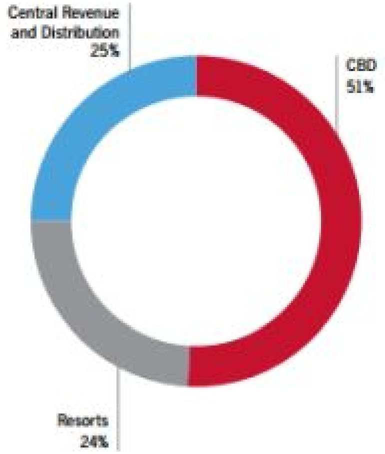
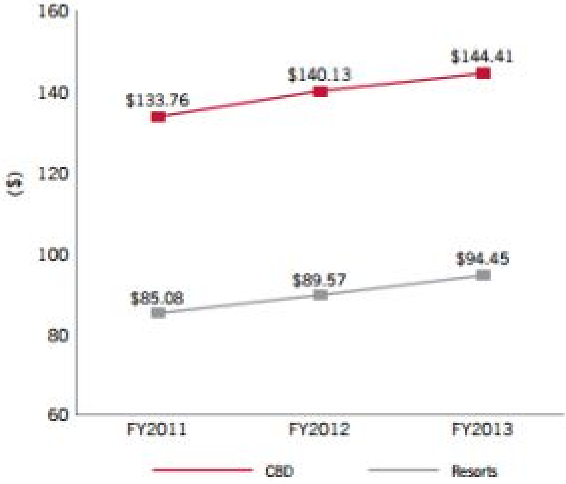


FIGURE 13: **MANTRA GROUP – REVPAR BY DIVISION (2011-2013) (JUNE YE)**

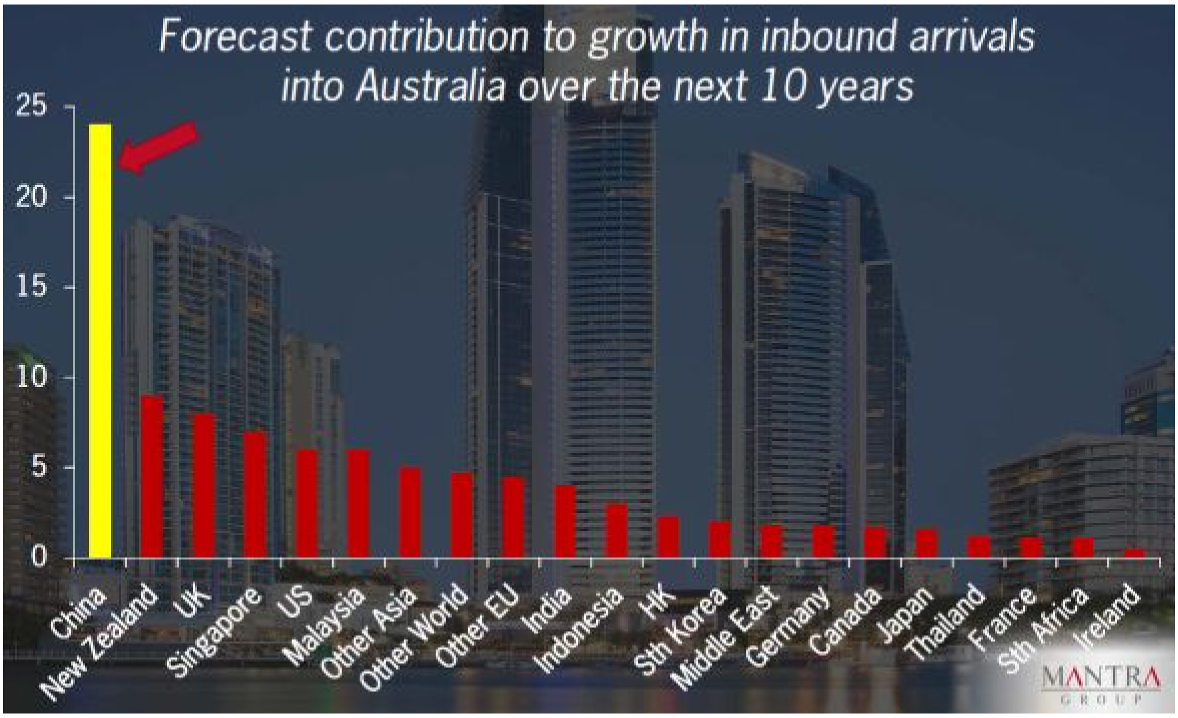


Source: Mantra Group's Prospectus

While we do not expect the proportionate revenue and earnings contributions to vary too much going forward, there is the potential for the 'leisure' component of Mantra Group's sales mix to outperform on a relative basis over the next several years. This is based on our view that while there is a mix of new properties scheduled to enter the CBD and Resort portfolio over the near-term, we expect leisure travel to increase at a greater rate than business travel for the foreseeable future.

To the extent that this does eventuate, **we would expect the proportionate earnings from Mantra Group's Resorts segment to be the key driver of Group earnings**. This reflects our belief that the quality and location of Mantra Group's Resorts will ensure that the Group maximises the earnings benefit stemming from increased leisure travel by increasing its room rate, occupancy rate, and ancillary income, and thus its overall profit margin (given some of the operating cost base is fixed).

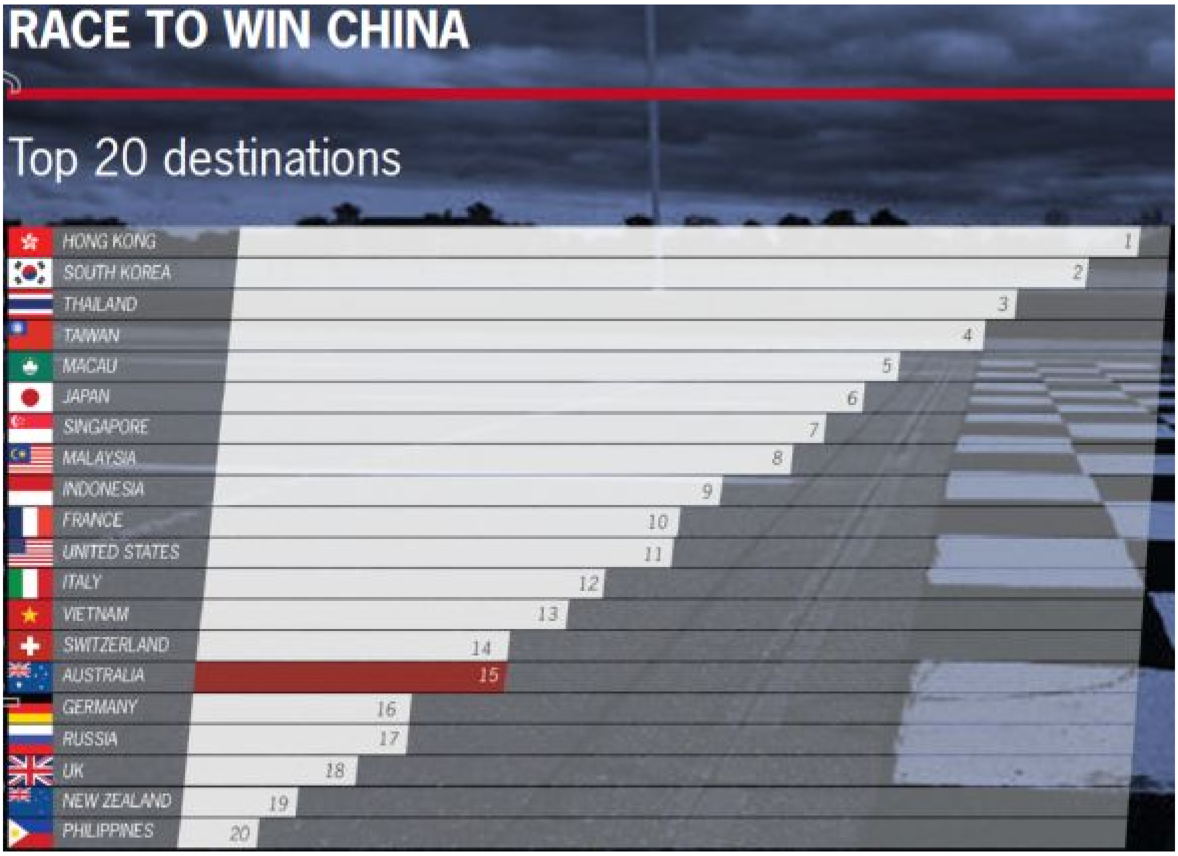
Mantra Group's most recent investor presentation focuses largely on the broad macro trends that management expects will underpin the company's business over the next 5-10 years. In doing so, the company does, in our view, make a fairly compelling case for being more positive on Mantra Group's future growth prospects. As illustrated in the following graphic, which is based on Tourism Research Australia's estimates, it is mostly about China.



Source: Mantra Group

Of course, it is important to be aware that these are just estimates, and that they include a lot of important assumptions. However, with China's economy continuing to surprise many by tracking at or close to its medium-term growth target 7 percent, with this likely to be revised to 6.5 percent for 2016-2020, and with China's transition to a more balanced (i.e. rising internal demand for its goods and services) economy continuing, Tourism Research Australia's estimate is not that much of a leap.

Looking into Tourism Research Australia's inbound arrival estimates for Australia in a little more detail, we note that it is based on two key variables. First, an estimate from investment house CLSA that China's outbound tourism will increase at a CAGR of 11 percent between 2014 and 2020, which will boost outbound Chinese tourists from 90 million in 2013 to 200 million by 2020. Secondly, Australia remaining a destination of choice for China's outbound tourists.



Source: Mantra Group

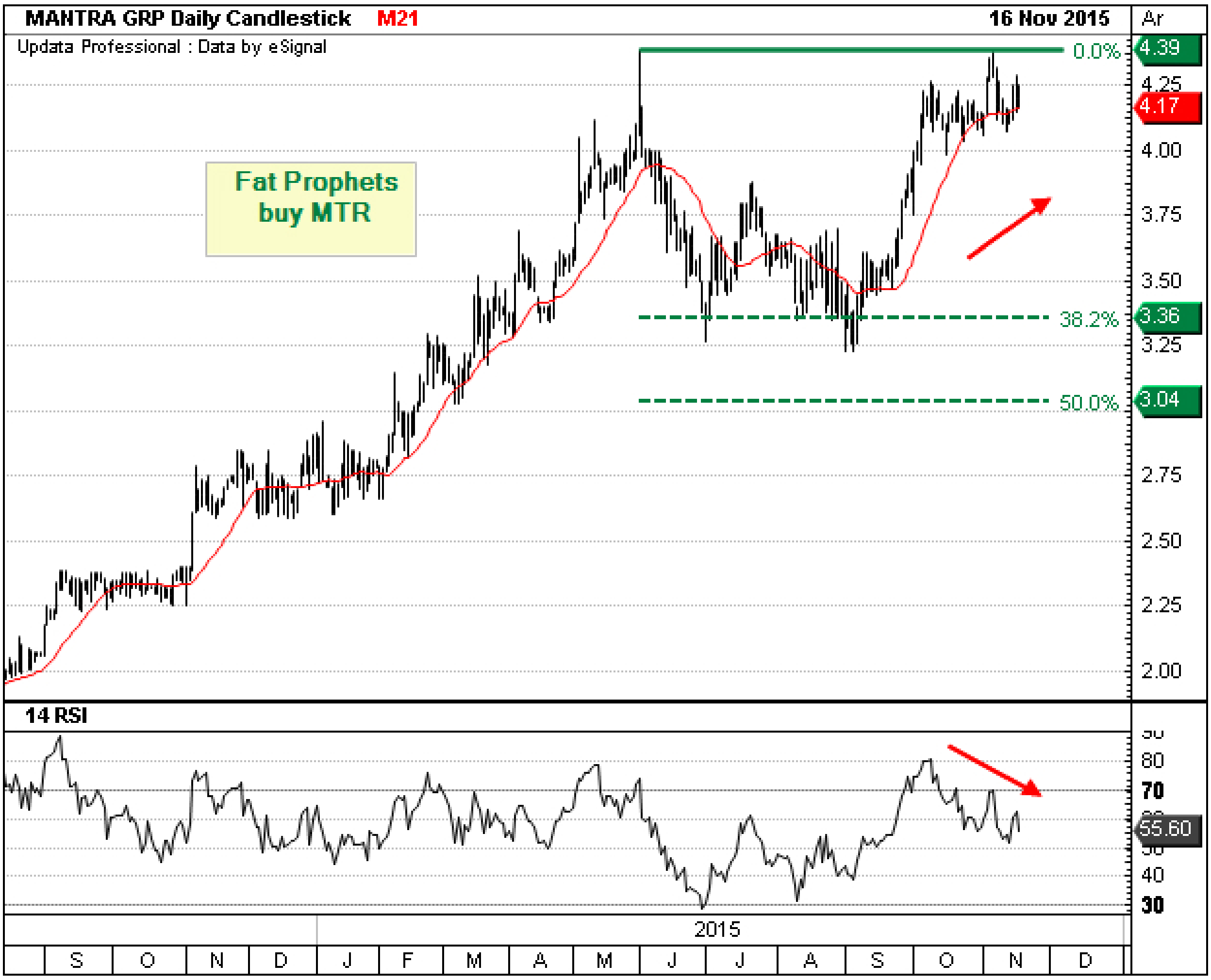
While growth in China's outbound tourism and Australia's attractiveness (particularly in the context of a weaker Australian dollar) underpin the demand side of the equation, the lesser known but equally important aspect to Mantra Group's business is hotel room supply. Given the long lead times and the cost (i.e. financing) of bringing new hotel rooms to market, it is important to continually monitor this balance, particularly given how variable accommodation demand can be.

On this front, or at least relative to the expected increase in demand, **the estimated increase in hotel room in Australia's major cities looks set to remain at palatable levels.** While this obviously excludes regional room numbers, and thus the vast majority of Australia's resorts, this nonetheless suggests to us that Mantra Group is well positioned to benefit from a cyclical upswing in its room rates and occupancy levels, particularly across its Resorts portfolio. Is this another case of stronger for longer?

Source: Mantra Group

Key takeaways

Looking beyond FY16, we make three observations. First, there is limited evidence to suggest that the accommodation market is moving into oversupply. Second, while Mantra's FY15 operating cash flow was relatively weak, there was some improvement in 2H15, with net debt still comfortable at 1.0 times (1.2 times in 1H15) FY15 EBITDA. Last, Mantra Group has a number of properties scheduled to enter the portfolio in FY16 that will add to the company's medium-term growth.



Turning to the technical outlook and the charting set up is quite positive. Following the bullish double bottom formation at the 38.2% Fibonacci retracement, prices have rotated to the upside, with current levels printing a series of interim higher lows below resistance of $4.39. With bearish divergence currently in play, we would not rule out a pullback in the interim, however the medium term technical outlook is highly constructive.

Summary

Having listed on the ASX at $1.80 per share or 12.7 times pro-forma FY15 and an implied yield of 5.5 percent, Mantra Group is now trading at $4.22 per share, which equates to 25.4 times the FY16 earnings forecast and a yield of 2.8 percent. While Mantra's price to earnings ratio and yield for FY17 improve to 22.8 times and 3.2 percent, respectively, this still represents a premium to the broader market (an industry which has had a chequered past due to cyclical earnings and high levels of debt).

That said, based on Mantra Group's earnings track record and reasonable capital position, and taking into account the favourable outlook for the accommodation market (i.e. lower Australian dollar and supply-demand dynamic), we now believe Mantra's shares offer reasonable value on a medium-term view.

Accordingly, we now transition Mantra Group from a Traffic Light to a Buy, and thus recommend the shares to Members on this basis.

Disclosure: Mantra is held within the Fat Prophets Small/Mid-Cap Model Portfolio.

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Snapshot MTR

MTR

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Market Capitalisation:$1.15B

	FY1	FY2
Price to Earnings	25.4	22.8
Dividend Yield (%)	2.8	3.2
Price to Book	3.2	3.1
Return on Equity (%)	13.4	14.4
EV/EBITDA	13.4	12.2