

**Hotels in for a bumpy ride, weighed down by overcapacity challenges – By Jihad Jhaveri, Kagiso Asset Management Equity Analyst**

South African hotels are expected to face testing times ahead as the industry grapples with major overcapacity challenges against a backdrop of an on-going sluggish global economy.

The current overcapacity situation in the local hotel industry, concentrated in the top end of the market (four and five star hotels across the country) is largely due to industry players possibly over-estimating economic prospects and definitely underestimating total concurrent industry capacity expansion. Going forward, it could take a few years for the industry to absorb the excess capacity.

The overbuild situation, evident in an increase of about 50% in rooms between 2006 and 2010, is similar to what happened in the mid 1990's when there was a major increase in new hotel rooms in the Sandton, Rosebank and Midrand areas as well as in Cape Town and the V&A Waterfront. (see graphs below)

Added to the current excess room situation at hotels, it seems that very optimistic expectations for the World Cup have failed to materialise. As evidence, Match, the official tour operator for FIFA, released a further 300 000 bed nights on 14 April, only retaining 600 000 of the original 1.9 million placed in the market. In addition, low cost airlines have been offering "better than normal" rates around match days and hotel groups have been discounting by stealth (offering free night vouchers for loyalty card holders).

**Overbuild of the mid 1990's**

Chart 5: New hotel rooms (Sandton, Rosebank and Midrand)

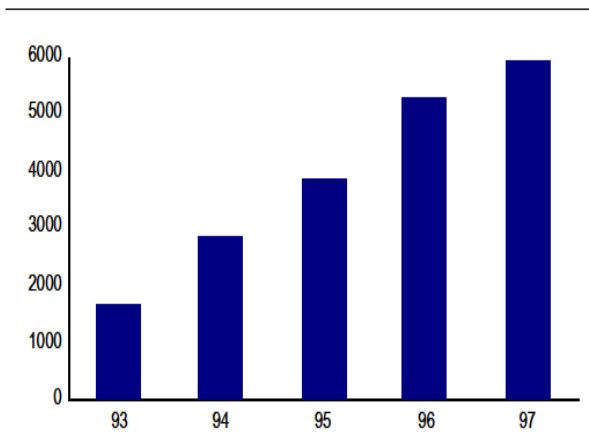
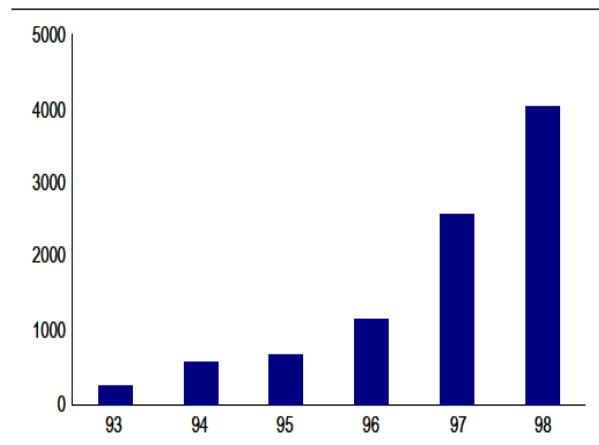


Chart 6: New hotel rooms (V&A Waterfront and Cape Town)



Source: UBS

## Current Overbuild

Chart 8: New hotel beds (Sandton, Rosebank and Midrand)

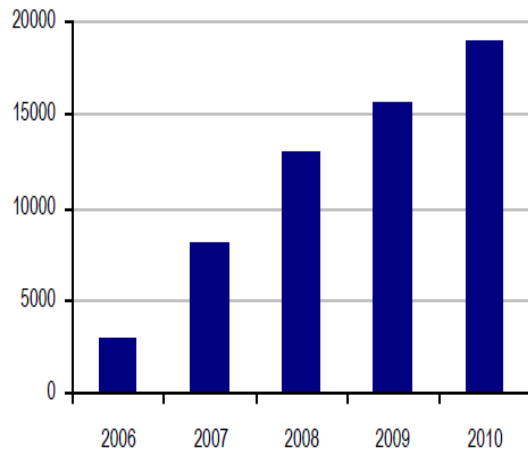
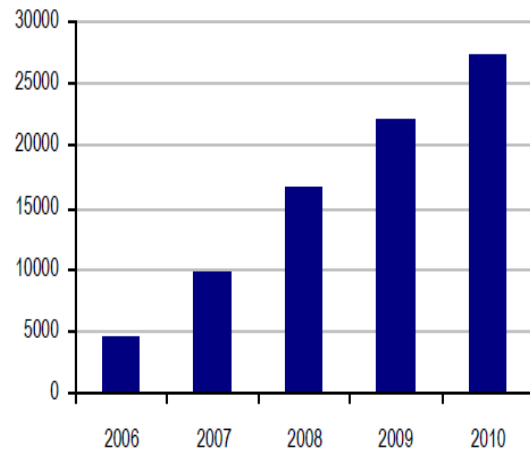


Chart 9: New hotel beds (V&A Waterfront and Cape Town)



Source: UBS

Even a strong operator in the industry such as City Lodge, the only focused listed hotel group on the JSE, which has been operating successfully for 25 years, and has an excellent business structure and earnings track record (net operating cash flow per share grew to 649.2c from 260.4c in the seven years between 2003 and 2009) – while likely to hold up better than its peers - will not be able to escape altogether the effects of the current oversupply of hotel rooms in the industry.

This underlines the fact that an excellent company with a solid track record and business model will be affected by negative conditions in its industry and may not be an excellent investment opportunity.

The hotel group, which operates a number of sought after brands including Courtyard, City Lodge, Town Lodge and Road Lodge, recently embarked on a major growth and development phase, opening new hotels across the country.

Media reports in late June quoted City Lodge CEO Clifford Ross saying the group's Road Lodge operation - which caters for the "affordable" accommodation market as opposed the luxury market - had done extremely well in the first ten days of the World Cup, with a lot of walk in or last minute business (Business Day, 24 June 2010). Ross pointed out that soccer fans were not in South Africa for the luxury or five star brands but to enjoy the World Cup and accommodation was therefore at the bottom of the list of spending priorities. Ross said overall demand was still extremely weak, particularly in the corporate market, and City Lodge did not expect any real improvement before the

second quarter of next year. It would therefore be selective in building new hotels across all brands.

It is tempting to look at City Lodge in terms of long-term average occupancy and long-term average margins. However, this could be fundamentally too bullish as long-term average occupancy levels, combined with a massively expanded hotel room base, translates into a very strong revenue expectation by historic standards. There is no reason why the South African hotel industry revenue pie should now expand structurally just because of new capacity.

Overall, Kagiso Asset Management is cautious on the hotel sector as an investment and we are keen to see if a strong industry operator like City Lodge can grow its market share in a market environment characterised by excess capacity.

9 July 2010

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