04/10/2021: Hoteles City Express (HCITY)

Operators,

Last weekend Alex pitched the bull case for one of our favorite deglobalization beneficiaries, Mexico. Here's a snippet for those that didn't read it (which, if you haven't, what the hell are you doing??):

> *"The investing implications that will be born from this developing trend are endless.* ***One favorite of ours is Mexico.***
>
> *The American cities of LA, Phoenix, Tucson, El Paso, San Antonio, Austin, Houston, and San Diego, all sit less than 300 miles from the US-Mexican border. This border is connected by excellent infrastructure.*
>
> *Turning back to the geopol strategist Zeihan who points out that this "existing integration between Mexico and the United States already makes for the world's busiest manufacturing, energy, financial, and passenger transfer border". This is how Mexico became America's largest trade partner, in 2019 — a title that's unlikely to be supplanted within our lifetimes.*
>
> *Over the last few decades, Mexico has built itself into the manufacturing powerhouse of Latin America. To quote Zeihan again, "Mexico is the most trade intensive Latin American country by a factor of three, and over 80% of its exports are manufactured goods, with nearly all its products flowing north.*
>
> *For these reasons, Mexico stands to be a huge beneficiary from the reshoring and regionalization of the American manufacturing base.*
>
> *They are one of the favored locations for US-based companies looking to move their operations out of China, in a trend that's being called "near-sourcing".*
>
> *Mexico has one of the best demographic profiles of any country in the world, with 28% of its populace under the age of 14."*

We've covered a few Mexican stocks in the past and own a couple in the portfolio (Betterware and Qualitas). Yet like a fat kid at Golden Corral, we can't help but go back for seconds.

Hoteles City Express (HCITY): A Classic Mexico Post-COVID Reopening Play

This idea was passed along to Alex and me from our friend Kuppy who writes over at the Adventures in Capitalism blog.

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This weekend we're covering **Hoteles City Express (HCITY)**. HCITY is a left-for-dead stock that nobody wants to own, yet it's a potential 3-bagger in three years. The current share price paints the worst assumptions, and it won't take much good news to send the stock zooming higher. How do you say asymmetric in Spanish? As the name suggests, HCITY operates and franchises a chain of limited-service hotels in Mexico, Costa Rica, Colombia, and Chile. As of December 31, 2020, it operated 154 hotels under the City Express, City Express Plus, City Express Suites, City Express Junior, and City Centro brands.

The thesis is simple and features a few dynamics we've mentioned in previous write-ups (see GYM and LGRS).

First, the company is a classic post-COVID reopening play. Pre-COVID, HCITY steadily grew revenues and earnings, expanded hotels, and generated ~17% pre-tax profit margins.

Second, HCITY's expansion CAPEX hides the company's actual earnings potential. For example, it takes ~3 years for a new build to generate profits on the bottom line. So there's a natural lag between build CAPEX and flow-through earnings. Most investors mistake this for lagging earnings and overly aggressive spending budgets. The earnings lag helps explain the company's lackluster share price performance over the last three years (-77.6% total, or -39% CAGR).

Lastly, the company got plain unlucky by leveraging up and overexpanding into the heat of COVID-19. HCITY's debt-to-equity ballooned from 27.8% in 2015 to 89.8% by FY 2020. Inflated debt levels coupled with COVID-19 restrictions wallopped the share price, which has declined over 70% since March 2020.

Now, we don't need ***a ton*** of things to go right for us to make a killing in this investment. The stock, as we mentioned, is down ~70% from its 2019/2020 highs. Many investors will miss this stock because a) it trades in Mexico and they won't look, b) it's a hotel chain saddled with long-term liabilities in the middle of a global pandemic, and c) it takes three years for the company to recognize earnings from expansion CAPEX.

Not to mention, the chart is like a rattlesnake ready to strike …

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rockvuecap published on TradingView.com, April 08, 2021 19:36:08 EDT
BMV_DLY:HCITY, 1W 5.88 ▼ −0.09 (−1.51%) O:5.81 H:5.99 L:5.65 C:5.88

To make money on this bet, we need the company to return to its pre-COVID normal. HCITY estimates that by FY 2022, they'll generate MXN 3.14B in revenue and MXN 871M in EBITDA.

Concurrently, the company will prioritize deleveraging. This is important because it (temporarily) ceases expansion CAPEX, allowing more dollars to flow through to bottom-line earnings, which in turn increases the value of the business. Investors will *finally* see a company whose earnings were hidden via CAPEX the entire time.

Let's assume HCITY hits their 2022 revenue and EBITDA targets. Let's also think a reasonable buyer would pay ~15x EBITDA for this post-COVID business. After all, that's not far from historical averages. At 15x EBITDA, we'd have an MXN 13B Enterprise Value business. Add cash (MXN 1.12B) and subtract debt (MXN 6.89B), and you get roughly MXN 7.3B in shareholder value or MXN 19.65/share.

That's over 200% upside from the current share price.

A Leader In No-Frills Hotel Lodging

HCITY is the industry leader in providing no-frills hotel lodging in Mexico. In other words, HCITY delivers only what you need, nothing more, which translates into lower per-room prices. Think GYM with fitness facilities or Sprit Airlines for airplane travel.

The company's hotels accommodate value-conscious domestic travelers. These domestic travelers are a **large** group, accounting for ~90% of all tourism spending in Mexico. HCITY nestles in the

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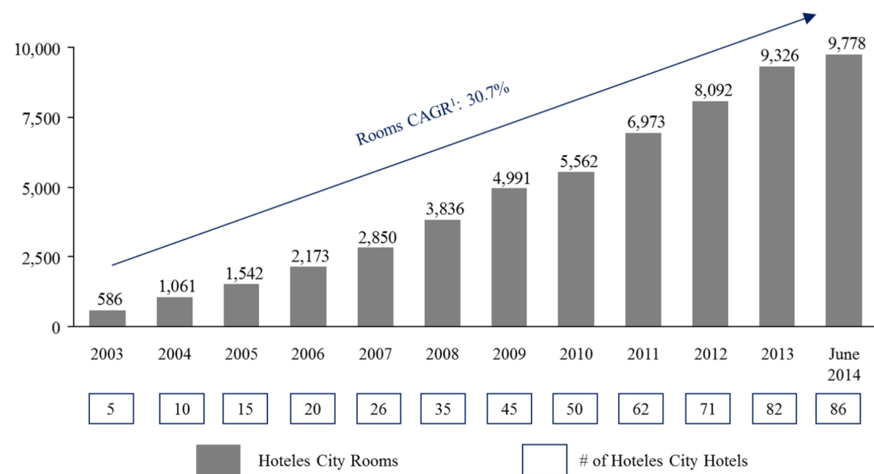
middle of a highly fragmented service sector. Domestic travelers usually have three options when visiting Mexico: 1) 5-star hotel at a resort, 2) AirBnB (which can be pricey), or 3) Hostel.

Most of HCITY's properties are three-star hotels. Again, it's not the Ritz, but that's fine because you don't pay the Ritz price. The company offers five options across the quality/price spectrum:

- *City Express*
- *City Express Plus*
- *City Express Suites*
- *City Express Junior*
- *City Centro*



Source: Company Data
1. Compound Annual Growth Rate

City Express is the company's flagship brand, which caters to managers and other business travelers. Prices for these rooms range from Ps.650 to Ps.1,650 ($32 - $85) per night. *City Suites* offers higher-end, fully-equipped apartment-style rooms. These rooms run guests Ps.900 to Ps.2,300 ($45 - $114) per night. Finally, the company's most affordable option, *City junior.* These rooms cost Ps.500 to Ps.1,100 ($25 - $55) per night.

The strategy and pricing work. From 2003 to 2014, the company grew rooms at a staggering 30.7% CAGR.

Lower Costs = Higher Margins & Greater ROICs

By offering a no-frills hotel experience, HCITY can charge lower prices while commanding above-average ROIC profiles (~12%) and EBITDA margins (37%). There's also a tremendous downside to "batteries-included" protection with a low-cost operating model. In its 2004 IPO filing, the company noted that it could **profitably operate at 30% occupancy across all rooms.**

Another reason for the company's growth is *where* they decide to build hotels. Much of the country's existing hotel inventory is obsolete. In return, HCITY offers a simple value proposition (I'm paraphrasing) …

> *"Stay with us, we'll charge about the same as that obsolete building, but you'll have nicer showers, walls, and beds."*

At that point, it's a no-brainer.

Plus, as one of Mexico's most prominent hotel operators, the company benefits from scale advantages. HCITY can negotiate more friendly terms with hospitality suppliers. They can also

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streamline backend operations across all their room inventory and work seamlessly with larger clients that need more rooms.

Business Model Hides True Earnings Capability

It's important to emphasize that the company's earnings lag its *actual* business performance. It takes ~3 years for HCITY to generate bottom-line profits from its new hotel builds. The interim translates to increased CAPEX and reduced net income, resulting in lower (reported) FCF generation.

The company's had this "issue" since its IPO as it opened a new hotel every 6.8 weeks (according to the IPO document).

Now, forced to delever, the company can switch from "growth mode" to "cash flow generation mode." That means we *should* see increased net income *plus* reduced capital expenditures resulting in substantial FCF growth over the next few years.

Dave Waters of Alluvial Capital explains the accounting situation in his 2018 investor letter (note: I don't know if Dave still owns HCITY … and emphasis mine):

> *"The biggest reason for this undervaluation is the company's development business. Because Hoteles City Express is always adding additional properties, trailing financial results always under-report the company's profit potential. It takes three years for a new property to stabilize, and until then, the property will under-earn.* ***So Hoteles City Express is doomed to appear less profitable than competitors who refrain from development activities and stick to owning or purchasing seasoned hotels.****"*

Save the massive debt on the balance sheet, and I don't mind HCITY looking unprofitable for years as they expand their hotel reach. Hopefully, the company will return to growth mode after moderating its leverage ratios.

A Highly Asymmetric Bet On Mr. Market's Assumptions

The stock trades ~Ps. 5.88/share, or MXN 2B market cap. In other words, Mr. Market's having a nastily-pessimistic palm-reading session. The current market price assumes the company will generate MXN 2.24B in revenue by 2025 with ~33% EBITDA margins. While I understand the EBITDA assumptions, Mr. Market is overly pessimistic about HCITY's revenue generation capabilities.

As we noted earlier, the company expects to generate MXN 3.14B in revenue by 2022! Three years ahead and ~ MXN 1B higher than Mr. Market's take.

Let's say they get to MXN 3.14B by 2022. If we assume a modest ~8% revenue CAGR till 2025, we get MXN 3.94B in revenue and MXN 1.3B in EBITDA at 33% margins. Even at 10x EBITDA, we bring nearly Ps. 16/share, or 250% higher than the current stock price.

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Concluding Thoughts

There's **a lot** that can go wrong with this investment. First, the company's leveraged to the gills with nearly 100% of its equity smothered in debt. Should we get another strain of COVID and lockdowns to continue, it puts HCITY's equity in a rough spot. In short, there is a non-zero percent chance that the equity could go to zero.

Second, management could say, "screw it, let's keep growing," and forgo their deleveraging efforts. Again, putting further stress on the balance sheet and squeezing margins as the company suffers higher interest payments.

The stock is still worth a shot, given the potential upside. Remember, we don't need meteoric growth or rapid margin expansion. All we need is a return to some semblance of normal. If we get that, we'll make a boatload.

We'll likely put on a position Monday, so keep your eyes peeled for a trade alert.

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