Hilton Grand Vacations: An Undervalued Timeshare Opportunity

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Summary

Hilton Grand Vacations presents a buying opportunity with 36% upside potential.

Strong revenue and net income growth.

Operationally superior to peers.

Capital efficient growth opportunities.

Recently spun off from Hilton Worldwide which could act as a catalyst.

Are HGV good at what they do?

Hilton Grand Vacations (NYSE:HGV) was spun off from Hilton Worldwide (NYSE: HLT) on 3 January. HGV is a fast-growing capital-efficient timeshare business which has a long-term relationship with Hilton. They develop, market and operate high quality vacation ownership resorts in select vacation destinations.

HGV operates in a fragmented industry and two of its key competitors are Marriott Vacations Worldwide Corporation (NYSE:VAC) and Interval Leisure Group (NASDAQ: ILG). HGV has 46 resorts representing 7,402 units; VAC has 61 resorts (12,807 units) and ILG has 38 resorts (6,000 units). In terms of scale, HGV is at the lower end of an industry which has recently seen consolidation with ILG acquiring Vistana Signature Experiences.

As per their 'Form 10' HGV properties are concentrated in non-seasonal locations like Las Vegas, Hawaii and Orlando (accounts for 78% of total units), which are in demand and provides an enviable and difficult to replicate portfolio. HGV has managed to separate itself from its peers by adopting a capital-efficient model to acquire additional inventory which currently generates 78% of revenue (LTM, 2015). Revenue generated for the year ended 31 Dec 2015 were split among the following timeshare unit acquisition methods:

- Fee for service (58%) - HGV sells and manages timeshare units which have been developed by third parties.
- Just In Time (20%) - HGV sources inventory which closely correlates the timing of the acquisition with the sale of inventory to purchasers.
- Developed (22%) - HGV develops timeshare resorts which is capital intensive.

Traditionally, the development of timeshare inventory is capital intensive which can limit a timeshares business's ability to grow and develop new revenues. Adopting a capital-efficient model of revenue growth is a potential solution to this problem and has allowed HGV to deliver strong revenue and net profit growth:

- Revenue grew 6.8% for the 9m ended 2016 vs. 2015 ($1,168m vs. $1,094m).
- Net profit increased 4% for the 9m ending 30 September from $125m to $130m.
- Revenue CAGR 8% from Dec 2011 to 2015 ($1,007m to $1,475).
- Net profit CAGR 19% between Dec 2011 and 2015 from $73m to $174m.

However, adopting a capital-efficient model means that HGV will be required to share revenue with third party developers which could impact their margins. Whilst not currently available, it would be interesting to understand the different margins earned on each of the inventory sourcing methods.

HGV management explained in their 'Form 10' that over time, they want to move towards a 50/50 revenue split between capital-efficient and developed inventory. Revenue generated from developed inventory accounts for less than 25% currently (LTM, 2015), and this could be difficult to grow in the future given HGV's level of debt which is currently almost double compared to its peers based on their Q3 2016 results (HGV $1164m; ILG $651m; VAC $631).

For 2015, HGV reported volume per guest of $3,508 (LTM, 2015), which is a traditional timeshare metric which divides sales volume by the number of tours. By comparison, VAC reported $3,386 (LTM, 2015) and ILG reported $3,554 (LTM, 2015), which suggests that HGV's sales force is operating effectively and on par with its peers.

Like the rest of its peer group, HGV offers sellers financing to its buyers. For 2015, HGV reported a low default rate of 2.84% (after 120 days past due) with an average FICO of 743, which is the best in the industry. By comparison, VAC has a 3.3% default rate (after 150 days past due) with an average FICO of 736 and ILG has a 10.9% default rate (after 180 days past due) with an average FICO of 703.

HGV is particularly efficient at generating returns for shareholders and currently has an industry-leading ROIC (21.30%, 2016E), which will be supported by their capital efficient model to developing timeshare inventory.

Furthermore, HGV has strong FCF generation ($141m, 2016E), which is superior to VAC ($112m, 2016E) even though it has significantly less scale. This suggests that HGV's margins have not been significantly impacted by adopting a capital-efficient model and lends further support to the strength of HGV's property portfolio in exclusive locations. However, when this is broken down to FCF per share, VAC has a far superior level of FCF available to distribute to each individual shareholder.

Given the above, HGV appears operationally superior to its peers and well-placed to continue delivering strong results.

	HGV	**ILG**	**VAC**
Free Cash Flow (in M), 2016E*	$141	$67	$112
Free Cash Flow PS, 2016E*	$1.44	$0.50	$4.14
ROIC, 2016E*	21.30%	9.74%	21.08%

*2016E (expected) figures calculated using Q3 2016 results (projecting them for 12 months) and HGV full year expectations per spin-off investor day presentation.

HGV Valuation

By comparison to its peers, HGV generates significant levels of EBITDA ($329m, 2016E) and currently has an Enterprise Value of $3,946m (as at 30 Jan 2017). As a result, it has an enterprise multiple of approx. 12 ($3,946m/$329m). This is at the lower end of the industry and given its operational superiority to its peers. An enterprise value multiple of 15 would seem reasonable, which is significantly lower than ILG and slightly lower than VAC.

Based on an enterprise multiple of 15, Hilton Grand Vacations would have a revised market capitalisation of $3,776m (($329m * 15)-$1,164m) and a revised share price of $38.49 offering 36% share price upside potential.

	HGV ($)	ILG ($)	VAC ($)
Share Price as at 30 Jan 2017	28.36	18.54	84.91
Market Cap (in $M)	2,782	2,500	2,300
Net Debt excl restricted cash - Q3 30 Sept 2016 (in $M)	1,164	651	631
TEV (in $M)	**3,946**	**3,151**	**2,931**
EBIT (2016E* - in $M)	341	151	189
Depn & Amortisation (2016E - in $M)*	23	56	25
EBITDA (2016E* - in $M)	364	207	215
Non-Inventory CAPEX (2016E - in $M)*	(35)	(56)	(29)
EBITDA (2016E* -in $M)	**329**	**151**	**185**
Enterprise Multiple	**11.98**	**20.91**	**15.82**
TEV based on multiple of 15 ($M)	4,940		
Revised Market Cap (in $M)	3,776		
Revised Share Price	**38.49**		
Share price % Change	36%		

*2016E (expected) figures calculated using Q3 2016 results (projecting them for 12 months) and HGV full-year expectations per spin-off investor day presentation.

Conclusion

HGV is a good business that efficiently generates returns for shareholders and is currently undervalued by the market offering 36% share price upside potential.

Disclosure: I am/we are long HGV, HLT.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.