KIM: STAY a high quality hotel chain at a bargain price

Mickey Kim
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We recently purchased shares of Extended Stay America (STAY), a U.S. hotel chain owning and operating 629 hotels with about 70,000 rooms.

We believe STAY is significantly undervalued because it is misunderstood by investors. We've had success investing in "special situations" like spinoffs, post-bankruptcy reorganizations and management changes. STAY checks two of those boxes, having reorganized out of bankruptcy in 2010 and bringing in CEO Gerry Lopez from AMC Entertainment in 2015.

STAY operates in an attractive niche of the hotel industry and is far more profitable than its peers. In addition, STAY is on the cusp of two major initiatives we believe will be transformative for the company and stock; a massive property renovation project and transformation to a franchise model.

We think STAY is cheap at 15.7x earnings and an attractive dividend yield of 5.4%, with dividends expected to increase in 2017 after remodels are complete. That certainly beats earning 0% at a bank!

Understanding how STAY makes money is straightforward. STAY operates 70,000 rooms and has an average room rate of $50 per night, generating $1.3 billion in annual revenues. Costs are low because STAY typically cleans rooms only once per week or whenever guests leave. STAY's profits are just under half of revenues.

As the name suggests, STAY targets guests looking for accommodations for more than one week. Indeed, 2/3 of STAY's guests stay 7 nights or more. STAY's guests are typically working on consulting or other long-term engagements. Extended stay hotels have higher average occupancy rates than daily stay hotels and are also more profitable because rooms are cleaned less often.

Extended stay hotels are a hybrid of apartments and hotels, as guests have access to the usual hotel amenities such as free Wi-Fi and continental breakfast, but also get a full kitchen. Within the extended stay niche, STAY is the clear market leader with over twice the number of rooms compared to the next biggest competitors, Candlewood Suites (32,000 rooms) and Marriott (28,000 rooms).

To increase rates, STAY shifted its focus to cater to corporate travelers, which now account for 45% of revenues. STAY initiated a huge renovation program and hired a sales team to pursue corporate travel partners. The renovation program cost $640 million (about $1 million on each hotel ($10,000/room) and should be finished by next March.

STAY has also implemented a sophisticated revenue management system to maximize room rates. With renovations complete and technology systems updated, STAY believes it can grow to 800 hotels over the next few years, building on the coasts and partnering with franchisees in other areas. By 2021, management expects to have 27% of locations franchised, up from 0% today.

We believe STAY offers an attractive risk/reward proposition. Armed with modernized hotel rooms and revenue management system, we have faith in Lopez's ability to create value for investors

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