

## Legend Strategy International

### Quality accommodation at an affordable rate

to summarize...

- Legend Strategy is engaged in management and operation of boutique hotels business in Guangdong area under the brand name 'Welcome Inn'. Portfolio includes 4 leased-and-operated hotels, 2 managed hotels and 2 JV hotels.
- Welcome Inn provides quality hotel services with location situated at conventional key tourism and business district at an affordable rate.
- Taking advantage of operation experience, Legend strategy commenced hotel consultancy services in 2009, denoted 59% of group's turnover in 1H 12A.
- Assets slight model enables quick expansion with low costs and set up time. Quality 100-suites boutique hotel can be set up with in half year at capex ~RMB10m~11m.
- Company is targeted to scales up hotels chain by adding 5 leased-and-operated in 2013 and 2014

**Legend Strategy (LS)** is engaged in operating and managing chain of boutique hotels under the brand of Welcome Inn (悦来客栈) in Guangdong province since 2006. LS adopts assets slight model that hotels are set up via leasing existing commercial buildings and refurbishing them into hotel accommodations. LS is currently self-operating four leased-and-operated hotels in Shenzhen and granted a franchise right to an operator in Fujian. LS also provides hotel management services to budget hotel owners including operation, training, system supports and operation team, charging 5%~10% of revenue. Apart from traditional hotel operation business, management leveraged on their enterprise and began hotel consultancy service since 2009. Hotel consultancy services deliver full package for hotel investors from location identification to decoration and marketing, charging roughly HK\$2.5m/ job.

**Sales and marketing.** Focused on Guangdong province, LS is targeted to provide the brand, Welcome Inn, as a cleanliness style boutique hotel chain. Pursuant to management information, major customer group is business traveler accounting for roughly 40% income, sales mainly via B2B with national enterprises, remaining 60% distributes equally that 30% from members and 30% from walk in customers. Welcome Inn hotels chain has currently 11,000 registered members with sales of hotel membership cards income of RMB0.16m, RMB0.36m and RMB0.39m from 2009 to 2011 orderly. In terms of retail customers, around 50% of sales are generated via travel agencies, e.g. booking.com, qunar.com, etc. and the rest is walk-in customers. Overall hotel operation income denoted 100%, 74% and 39% of turnover in last three years, table 1 shows the percentage breakdown of income sources:

**Table 1. hotels accommodation income allocation**

Customer Segment	Allocation
Business traveler	40%
Member	30%
Retails	30%
- Travel agency	50%
- Walk-in	50%

Source: SBI E2-Capita, LS

**Strategic locations.** LS's four self-managed and operated hotels are all located in Shenzhen in the Guangdong province. Guangdong is the highest international tourism district in China (2<sup>nd</sup>: Shanghai, 3<sup>rd</sup>: Beijing), while Shenzhen is the heart business district in the Guangdong province as one of the highest GDP growth region. Welcome Inn's hotels accommodations are situated in strategic locations, near 1) central business district, 2) key tourism parks (e.g. Window of the World), 3) Baoan Airport & 4) key transportation hubs and the Huanggang Boarder.

Ticker	8160 HK
Rating	Not Rated
Price (HK\$)	1.59
Target Price (HK\$)	-
12m Price Range (HK\$)	0.92-1.68
Market cap. (US\$m)	36.7
Daily t/o (US\$m)	0.1
Free float (%)	32.2

#### Financial summary

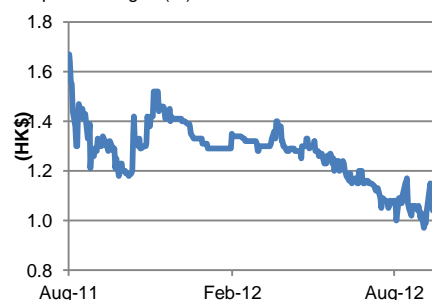
Year to Dec	09A	10A	11A
Turnover (HK\$m)	19.6	37.3	69.6
Net Profit (HK\$m)	(3.2)	9.2	21.3
EPS (HK\$ cent)	(1.7)	6.8	13.6
P/E (x)	-	31.6	13.6
P/B (x) pre-CB	-	-	3.4
EV/EBITDA (x)	-	14.0	7.0
Yield (%)	-	-	-
ROE (%)	-	5.9x	42
ROCE (%)	-	3.1x	58
N. Gear. (%)	N. Cash	7N. Cash	

Source: SBI E2-Capital

	12F	13F	14F
Consensus EPS (US\$)	-	-	-
Previous earnings (US\$m)	-	-	-
Previous EPS (US\$)	-	-	-

#### Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	28.1	32.5	(6.9)
Actual price changes (%)	34.7	45.9	4.6



Source: Bloomberg

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**What Welcome Inn offers at an economical price?** Welcome Inn offers quality hotels services at price around RMB180~RMB200/night, as compared to region average of RMB210 according to company prospectus. Services and facilities include internet booths, parking, laundry, breakfast, packing, meeting room, etc. With strategic location near key tourism, transportation hubs and business district (location details see Appendix). Welcome Inn's hotel suite design follows a cleanliness theme as shown in illustration 1, which designed by in-house interior design team. In terms of room types, LS provides comprehensive room type including standard rooms, executive rooms, executive suites, designated ladies' rooms, non-smoking rooms, etc fitting for different needs. In our view, LS delivers premium service at the given price, and possesses 3 key elements to become popular choices for boutique hotels 1) price 2) quality decoration and comprehensive services and 3) convenient location. Welcome Inn's hotels are ranked between 3 and 4 star with overall positive customer reviews.

**Illustration 1. Welcome Inn hotel layout**



Source: SBI E2-Capital, Booking.com

**Hotel consultancy services leveraged on management expertise.** Established since 2006, LS has denominated management capability of converting commercial building into good standard budget hotels at low cost with effective hotel management systems to sustain hotel business. With the successful track record, company diversified into hotels consultancy service in late 2009. Acting as business consultant, LS gives advice to budget hotel investors to establish low cost yet stylish hotels. The service consists of site section, feasibility study to hotel interior design, construction contractor selection and afterwards sales and marketing. With less than 2 years of development, consultancy services arm has become a major source of income to the group. Up to 1H 12A, LS has completed over 20 services at price around HK\$2.5m/job. Table 2 shows segment contribution over the last 2 years. Yet, consultancy services create cross-selling opportunity to promote hotel operation management services to investors, charging 5%~10% of hotel revenue while LS will provide key supports, training and personnel. Two successful cases are the Welcome Inn Dameisha and Welcome Inn Foshan.

**Table 2. Hotel consultancy services**

HK\$m	1H 10A	2H 10A	1H 11A	2H 11A	1H 12A
% of total revenue	17%	31%	0%	75%	59%
Segment turnover	2.4	7.2	0	42.2	19.1
Segment profit	1.4	6.0	0	31.2	12.4
Number of job during the period	2010: 4 jobs		2011: 14 jobs		Up to 1H 12: 7 jobs

Source: SBI E2-Capital

**Assets slight model, enable quick expansion with low set up costs.** The budget hotel industry is a competitive market with high number of players as a result of the low entry barriers, while top five players, namely Home Inns, 7 Days Inn, Jin Jiang, Hanting Inn and Motel 168, denote over 50% market share. LS-like small players might not have the capital strength to compete with Holiday Inn type international players and established domestic boutique hotels chain. Leased-and-operated business model allows LS to quickly penetrate into the market and to promote the brand 'Welcome Inn'. LS leases existing commercial units and refurbish them into hotel accommodations in around 3~5 months at low cost of roughly US\$10,000/ suite, enables quickly scaling up without substantial capital requirement and commitment. Pursuant to management, management is targeted to increase number of leased-and-operated hotels to 20 units by the end of 2015. Table 3 shows LS leased-and-operated hotels expansion plan from 2012F to 2015F:

**Table 3. Expansion & capex**

	11A	12F	13F	14F	15F
Number of leased-and-operated hotels	4	5	10	15	20

Source: SBI E2-Capital

**Leased-and-operated, fixed overhead, breakeven point analysis.** Resulted from leased-and-operated business models, company, in return, bears higher fixed operation costs due to the fixed lease payment. We performed breakeven point analysis base on occupancy rate. First of all, three key operation expense items are 1) operating leases expenses 2) depreciation expenses and 3) wages expenses, they accounted for 14%, 10% and 10% of 2011 sales revenue respectively. Operating leases expenses consists of lease payments for the 4 leased-and-operated hotels, reported expenses of HK\$10.0m in 2011 and HK\$5.2m in 1H 12 (roughly HK\$210k/hotel/m). In terms of depreciation, depreciation expenses refer mainly to capital expenditure raised from the initial refurbishment cost for hotel accommodations over the lease-term. In 2011, depreciation expense was HK\$7.1m, of which HK\$5.7m was attributable to hotel operations. Lastly, wages expense was around HK\$7.1m in 1H, we assume 60% resulted from hotel operation, i.e. HK\$4.3m. Other fixed overhead expenses include including audit & legal fee, marketing expense and others, adding up to HK\$3-4m, while consumable supply, sales commission etc, denotes approximately 8% of segment turnover. Hence, total fixed operating expenses for LS's hotel operation was around HK\$30m plus 8% of hotel operation income. Assuming room rate of HK\$225/suite, the hotel operation breakeven point based on occupancy rate for EBIT and EBITDA would be 77% and 57% respectively based on 2011 result, details shown in table 4 below:

**Table 4. breakeven analysis for leased-and-operated hotel business**

Assumption	
Rooms	418
Night	365
ASP (HK\$)	225
Total Available Room Night in a year	152,270
Annual franchise right income from Fujian Hotel (HK\$m)	2.4
Depreciation (HK\$m)	6.9
Operating Lease (HK\$m)	10
Wages/ employee benefit (HK\$m)	4.3
Other fixed expense (HK\$m)	3
Consumable & other suppliers (HK\$m)	8% of hotel revenue turnover
Breakeven Occupancy rate:	
- EBIT	70%
- EBITDA	50%

Source: SBI E2-Capital

We further examine hotel operation sensitivity to changes in occupancy rate based on the assumption above. The result shows earnings vary substantially to changes in occupancy rate, for example, EBIT increased by 96% when occupancy rate increases from 80% to 90%.

**Table 5. hotel operation sensitivity analysis**

Occupancy rate	EBIT (HK\$m)	EBITDA (HK\$m)
30%	(12.5)	(5.6)
50%	(6.2)	0.7
70%	0.1	7.0
90%	6.4	13.3

Source: SBI E2-Capital

**Return analysis of setting up a budget hotel.** LS is planning scale up operation in leased-and-operated hotels that targeted to add 5 additional hotels each year in the next three years. We examined the investment hypothesis on investing in a standard 100 suites hotel situated in the Shenzhen region. Pursuant to management, the refurbishment cost per suite is around RMB65,000, adding up decoration cost for lobby, elevator and fire safety systems of roughly RMB3.5m, the initial capital expenditure for a 100 suite hotel will be ~RMB10m. Fixed cash expenses item, as mentioned, include rental/lease payment and wages expense. Assuming, lease payment of RMB200,000 per month coupled with 26 employee at average rate of RMB4000 each per month, overall overhead expenses will be RMB3.6m per annum plus 8% of turnover for other consumable & sales related expenses. At average room rate of RMB200/night, cash profit is breakeven at around 55% occupancy rate, ROE 8%, 13% and 18% as occupancy rate increases in 70%, 80% and 90% respectively, details as shown in the table 6 below:

**Table 6. 100 suites budget hotel investment return analysis**

Assumption (RMB)					
Initial Investment	10,000,000		ARP	200	
Rent (20 years)	200,000		Available Room Nights	36,500	
Wages	104,000		Tax rate	25%	
Consumable expenses	8% of Revenue				
<b>Occupancy Rate</b>	<b>30%</b>	<b>50%</b>	<b>70%</b>	<b>80%</b>	<b>90%</b>
Turnover per month	182,500	304,167	425,833	486,667	547,500
Cash Income per month	-91,658	-7,708	76,242	118,217	160,192
Cash return to investment	-11%	-1%	9%	14%	19%

Source: SBI E2-Capital

**Historical financial result.** For the last three years, LS's turnover increased at CAGR of 89%. LS's sales can be divided into 1) hotels operation and 2) hotel consultancy services. Hotel operation denoted 39% of sales revenue, whereas hotels consultancy services represented 61% of 2011 sales income. Hotel operation result can be marginal due to the business nature, profit before depreciation for 2010 and 2011 were HK\$12.4m and HK\$9.5m with margin of 45% and 36% respectively. In terms of consultancy services, LS's input in the segment was mainly personnel, hence, segment recorded high segment margin of 77% in 2010 and 74% in 2011. Table 7 & 8 show company financial performance from 2009 to 2011:

**Table 7. Key financial result from 2009 to 2011**

HK\$m	09A	10A	11A
Revenue	19.55	37.32	69.59
Expenses			
Operating lease	(8.42)	(7.49)	(9.98)
Depreciation of PPE	(6.30)	(6.37)	(7.09)
Employee benefit	(3.48)	(4.04)	(7.09)
Utilities	(1.33)	(1.43)	(1.73)
Other operating	(3.32)	(4.38)	(12.18)
Operating loss/ profit	(3.31)	13.61	31.51
Finance income	0.05	0.05	0.06
Finance cost	(0.13)	(0.14)	(0.20)
Share of result of JV			(2.51)
Loss/ profit before income tax	(3.39)	13.52	28.85
Tax	(0.09)	(3.97)	(7.59)
Net profit	(3.48)	9.55	21.26
Net profit to holder	(3.19)	9.19	21.26

Source: SBI E2-Capital, LS

**Table 8. Result breakdown by segment**

HK\$m	09A	10A	11A
<b>Sales</b>			
Hotel Operations	19.55	27.69	27.39
Consultancy service		9.63	42.20
<b>Segment result</b>			
Hotel Operations	(3.31)	6.22	2.63
- Depreciation	(6.30)	(6.22)	(6.88)
Consultancy service		7.39	31.19
- Depreciation		(0.15)	(0.21)

Source: SBI E2-Capital, LS

**Our view and valuation.** LS is a young boutique hotels chain with focus in southern China. Since the commencement of hotel consultancy segment in late 2009, the segment has become major sources of income, while segmental performance is less predictable as compared to hotel operation business. Hence, there is a risk that consultancy performance can be fluctuated from time to time leading to high earning volatility of group's result. LS's 11A P/E and 11A P/B are currently trading at 13.6x and 3.4x respectively.

**Table 9. Shareholding**

Name of substantial shareholder	%
Fong Man Kelvin	56.1
Cheng Xiao Min	6.0
De Weyer Daniel Ludovicus Joannes	5.8
Public	32.1
Total	100

Source: SBI E2-Capital, HKEx

## Appendix:

**Welcome Inn hotels description:** LS is currently operating 4 leased-and-operated hotels under the brand of 'Welcome Inn', 2 leased-and-operated hotels via JV agreement and 1 granted franchise right to use Welcome Inn trademark in Foshan. Welcome Inn hotels are mainly located in Shenzhen city, near airport, border crossing centre, key shopping and business districts, and expanding to other key regions in Southern China area. Key leased-and-operated hotels information:

**Welcome Inn Caitian**, first budget hotel commenced operation in 2006, has total GFA of 2,000m<sup>2</sup> comprising 87 rooms. The hotel is ranked as 3 star and situated at a commercial area in the Futian district, which proximity of Shenzhen heat business district, surrounded by shopping park, market and near transportation hubs and Huanggang border. :

- Room Types: Economy Double Room, Business Double Room, Business Twin Room & Economy Single Room
- Transport: 3min drive from Shenzhen Convention Centre, 5min drive from CoCo Park and Huaqiangbei Street,
- Facilities: Air conditioning, heating facilities, flat-screen TV, personal safe and electric kettle, free wired internet and free private packing, meeting room, convenience store, business centre
- Location: No. 3030 Caitian North Road, Futian District, Shenzhen 518026, China

**Welcome Inn Nanshan** commenced operation since 2008, has GFA of 7,000m<sup>2</sup> comprising 192 rooms. The hotel is ranked as 3 star located at the commercial area in the Nanshan District and proximity to Guang Cai Xin Tiandi and theme park such as the Window of the World, and World at Sea, and near the Shekou Port

- Room Types: Business Double Room, Business Twin Room, One-Bedroom apartment, executive suite
- Transport: 10min drive from Shekou Pier, Sea World and the Window of the World (Shi Jie Zhi Chuang), 15min drive from Huanggang Crossing
- Facilities: Air conditioning, heating facilities, flat-screen TV, personal safe, tea making facilities, laundry service and electric kettle, free wired internet and free private packing, meeting room, convenience store, business centre, \* lady dedicated floor
- Location: No. 2009 Nanshan Avenue, Nanshan district, Shenzhen 518052, China

**Welcome Inn Baoan** commenced operation since 2008, has total GFA of 1,700m<sup>2</sup> comprising 59 rooms ranked as 3 star hotels. Welcome Baoan is located at a commercial area in the Baoan district and adjoining the Baoan Airport, Nan Tou custom, Baoan coach terminal and Xi Xiang Pier.

- Room Types: Business Double Room, Deluxe double Room, Business Twin Room
- Transport: 2min drive from Nantou Custrom and Bao'an Motor Station, 10min drive from Xixiang Wharf and 15min from Shenzhen Bao'an Airport
- Facilities: Air conditioning, heating facilities, flat-screen TV, personal safe, tea making facilities, laundry service and electric kettle, free wired internet and free private packing, daily breakfast, business centre, meeting faculties
- Location: building No. 23, Xin An 2<sup>nd</sup> Road, Bao'an district, 518001 Shenzhen

**Welcome Inn Luohu** commenced operation since 2008, has GFA of 2,000m<sup>2</sup> comprising 80 rooms. It is ranked as four star hotels. Welcome Luohu is located at the financial centre area in the Luohu District, near key business buildings and shopping malls, such as, the World Financial Centre, Shenzhen Book Store, the Mixc, the Citic City Plaza and Dongmen Commercial Pedestrian Street.

- Room Types: Economy Double Room, Business Double Room, Business Twin Room
- Transport: 5min drive of Dongmen business Street, Huaquangbei Business Street and the Luohu Railway Station, 10min drive from Huanggang Crossing
- Facilities: Air conditioning, heating facilities, flat-screen TV, personal safe, tea making facilities, laundry service and electric kettle, free wired internet and free private packing
- Location: No. 1050 Bao'an South Road, Luohu District, Shenzhen 518001, China

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**BUY** : absolute upside of >10% over the next six months

**HOLD** : absolute return of -10% to +10% over the next six months

**SELL** : absolute downside of >10% over the next six months

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