COMMENTARY

June 8, 2018

Dear clients and colleagues,

"A week is a long time in politics." A quote attributed to British Prime Minister Harold Wilson in the 1960s but as true today as when it was first allegedly uttered.

Let's see what has happened over the last ten days or so: Italy and Spain, the Euro region's third and fourth largest economies respectively, got themselves new leaders; the trade tariff war escalated as the G7 is seemingly degenerating into the "G6 plus one"; and the on-off US and North Korea summit is back on again until further notice. But this week, Global Alpha is going to concentrate on Spain and suggests that not all political uncertainty is equal.

As you all know, last week Mariano Rajoy, Spain's conservative prime minister, lost a vote of no confidence to his Socialist counterpart Pedro Sanchez. A corruption scandal led to Rajoy's downfall.

With just 84 seats in the 350-seat Congress, Sanchez had to secure the help of other minority parties to win the no-confidence vote, and it remains to be seen how the coalition will function. In exchange for its support, the Podemos party could seek a change in the spending cuts suggested by the EU and implemented by the Rajoy government. Sanchez also received backing from the Catalan and Basque separatist groups for the no-confidence vote, even though he opposed the Catalan independence referendum last year. For their part, the Catalans said they voted more against Rajoy than with Sanchez, but it remains to be seen how Sanchez will deal with these groups long term. He has previously recognized Catalonia and the Basque Country as nations, and not regions, in Spain.

Spain is steadfastly pro-European, and there is no talk of a clampdown on immigration. The nature of the new government's make-up should render any big policy changes difficult, and Sanchez has said that he will continue with Rajoy's budget for 2018.

Spain's economy has performed well after structural reforms implemented by Rajoy's government, though high debt levels and unemployment remain a problem. According to the European Commission, Spain has enjoyed GDP growth of more than 3% over each of the last three years, with a forecast of 2.9% for 2018 – a deceleration but still above the eurozone average of 2.3%. For those who are pro-EU, the new Spanish government will prove to be less of a concern than the new populist government in Italy. The markets were spooked by the uncertainty in the week leading up to Rajoy's defeat, losing 5% before gaining 2% on the day the change in government was confirmed.

With all of this in mind, we feel comfortable continuing to hold Spanish hotel operator Melia Hotels, which is more of an international than pure-Spanish play. Melia, which we have owned since 2016, is the number one hotel chain in Spain, number three in Europe, and sixteenth in the world. To give you an idea of the international make-up of Melia, if we include its current portfolio as well as properties in the development pipeline, the company has a presence in 43 countries with 384 hotels and around 97,000 hotel rooms. In 2017, Spain accounted for 41% of the company's operating profit, the Americas 40%, EMEA 15% and Asia and Africa 2% each. Operating profit is split 70/30 between resorts and cities.

In terms of the tourism industry as a whole, the Mediterranean region saw an 8% increase in international arrivals in 2017. Growth in Spain's tourism GDP outpaced the overall economy for the eighth straight year at 4.4%. In 2017 Spain received 82 million foreign tourists, which translates to €134 billion of activity. Forecasts indicate we can expect similar growth in 2018 as European tourism is expected to grow by 3.5% to 4.5% in that year. The two main drivers behind the growth in tourism and hospitality are a growing middle class and changing lifestyles. The global middle class is currently estimated to be over 3 billion people and growing faster than global GDP. Asia accounts for most of the increase in the middle class. This demographic is also more interested than ever in experiencing new cultures. Other geographic areas that Melia is exposed to should also benefit from positive market dynamics, with tourism in 2018 expected to grow by 3.5%-4.5% in the Americas, 5%-6% in the Asia-Pacific region, 5%-7% in Africa and 4%-6% in the Middle East.

Melia operates in the Premium, Upscale and Midscale segments of the hotel industry with eight dedicated brands, each targeting a specific customer group. The Premium offerings include Paradisus, Gran Melia and ME by Melia and compete with other luxury resorts and hotels such as Sandals, Secrets, Four Seasons and W Hotels. The Upscale offerings are Melia and Innside, and they compete with the likes of Hilton, Marriott, Hyatt and Pullman. The Midscale offerings are Tryp by Wyndham and Sol and compete with NH Hotels, Novotel, Barcelo, etc.

Melia earns revenues from properties in one of four categories: owned, leased, management and franchised. Owned is where Melia owns and operates the hotel. In Leased, Melia operates a hotel which it leases. In Management, Melia provides management services for a Melia brand hotel on behalf of the owner and receives a management fee in return. Franchised is where the owners of the hotels operate under one of the Melia brands and contract sales and marketing services from Melia.

Melia's growth strategy is to focus on expansion in key growth regions. Asia is one of these regions, and 34% of the 63 hotels and 16,000 rooms in the company's development pipeline are located in Asia. Ninety-three percent of properties in its development pipeline are located outside Spain. Melia is also increasing its emphasis on the upscale segment. In 2017, 93% of the hotels it signed up were either premium or upscale. Additionally, the company is moving towards an "asset light" model with 81% of the properties in its development pipeline falling under the Management umbrella. Melia benefits from a strong brand reputation and also scores highly in our proprietary ESG scoring system due to its history of winning ESG awards, record as a top employer and stance on numerous social issues, among other things.

Extreme weather phenomenon, such as the hurricanes in the Caribbean last year, had a negative impact on Melia, and the company continues to feel the effects of lost revenues in Cuba. Political uncertainty in the Mediterranean could impact lodging companies operating in the region, but Melia has resilient in the past.

Melia produced solid numbers in 2017, increasing revenues by 5%, EBITDA by 11% and RevPAR by 6% (the sixth consecutive year of RevPAR growth). The good performance continued into the beginning of 2018 with year-on-year constant currency improvement of 4% in revenues, 14% in EBITDA and 7% in RevPAR. With the Spanish economy progressing nicely despite the political sideshow, and Melia executing on its selective international growth strategy, we believe the company continues to possess significant upside.

Have a great weekend.

The Global Alpha team