Stock Market Review

Hotel San Antonio bond provides good case study

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On May 30, the 7.5 per cent Hotel San Antonio bond was redeemed and all bondholders received the nominal amount originally invested together with the final interest payment. Hotel San Antonio was one of the few bond issuers that regularly organised briefings for the financial community, and last week's annual meeting coincided with the recent successful bond redemption.

Management and representatives of the two shareholders delivered a presentation and provided a detailed analysis of the hotel's 2011 financial performance and also gave updated figures on the trends during the first few months of 2012.

The positive performance experienced by the company especially since 2007 continued during 2011 with an increase in turnover and operating profits supported by a combination of a slight increase in occupancy, improved room rates and also a reduction in costs.

When analysing the performance of the company over the past 10 years (that is during the lifetime of the bond), 2011 was a record year reflecting positive tourism figures across the Maltese Islands. Hotel San Antonio is expecting this positive financial performance to carry on this year too, on the basis of a further improvement in room rates as the shift away from the traditional tour operator business is allowing more flexibility on rates with visitors now opting for direct bookings.

Hotel San Antonio had originally launched the bond issue in May 2002 to finance the repayment of capital creditors for the construction and completion of the hotel.

The interest rate was set at 7.5 per cent per annum reflecting the high leverage at the time (3.3 times) and the fact that the company was still to commence operations and dependent on a single hotel to honour its commitments. It also reflected the different interest rate scenario in 2002 compared to the historically low interest rates of today.

As the bond market was still in its early stages of development in 2002 and some may have been skeptical on this particular issue given the rate of interest attached to the bond, the company performed very positively over the years. The overall level of indebtedness of the company was reduced by €8 million since the launch of the bond issue in 2002 through further capital injections by the two shareholders in the early years of the bond and through the consistent positive cash flow which was retained by the company annually to reduce its borrowings.

The increase in cash flow was especially evident once the day-to-day management of the hotel was taken over from Accor in 2006. A lower level of borrowings implies a decreased credit risk for investors. The gearing ratio improved from a level of 3.3 times in 2002 to 1.16 times in 2011 reflecting total equity of €8.8 million and borrowings of circa €11 million. At last week's meeting it was reported that the company's leverage is anticipated to improve further by the end of 2012 to a level of one through further debt reduction and higher reserves following expectations of another profitable year.

The improved hotel performance also led to a significant increase in the interest cover from a low of 1.2 times in 2006 to a very comfortable 2.8 times in 2011 despite the high rate of interest on the bonds. This consistent improvement in the interest cover coupled with reduced leverage was comforting for bondholders. This presumably also supported the company's endeavors in 2010 to obtain bank refinancing for the eventual bond redemption that took place three weeks ago.

The successful financial performance of Hotel San Antonio and the company's ability to regularly honour its commitments to the banks and to bondholders, reducing bank borrowings and also successfully redeeming the bond provides a good case study on the mechanics and ultimate scope of companies using the bond market as a method of financing.

The ability of a company like San Antonio to obtain funding from the bond market in 2002 as opposed to seeking additional borrowings from the bank provided the company with the financial flexibility to operate positively, even at the initial difficult phase of the launch of a new hotel. While the structure of a bank loan normally requires the repayment of interest and capital to be done periodically during the entire term of the loan, by its nature a bond is serviced solely through the semi-annual or annual interest payments and the full repayment of the sum borrowed will only be made upon maturity.

Some critics may argue that companies very often approach the market again shortly before the bond matures to issue a further bond and obtain the re-financing necessary to effect the final repayment. While such 'roll-overs' may be looked upon negatively by some observers, one cannot generalise that this is a bad signal as a certain level of borrowings will always be required by companies to optimise their financial models and obtain a fair return for shareholders.

In essence, 'roll-overs' take place regularly by many governments and corporates locally and internationally. New bonds are launched to finance their working capital requirements and also to repay their maturing bonds.

The success story of the Hotel San Antonio bond should be viewed positively also by the regulators of the local financial market and this should encourage similar financing arrangements from other local companies, providing the much-needed investment opportunities that issuers provide to the local investing community.

> **The success story of the Hotel San Antonio bond should be viewed positively also by the regulators**

However, the amendments made to the listing requirements in Malta in August 2010 which necessitate the build-up of a sinking fund have provided additional burdens on a company and reduced the attractiveness of a company to tap the bond market.

This argument was also raised by Anthony Zahra at last week's presentation. Mr Zahra, one of the two shareholders of Hotel San Antonio plc, explained that the company wanted to approach the bond market again this year to offer investors the ability to maintain an exposure to the company given its positive track record. However, the 2010 listing policies prohibited the company from using the bond market again for the continued financing required for such a hotel operation.

While it was evident in recent months that some changes were being contemplated by the authorities to address such concerns raised by industry players, no final solution seems to have been achieved so far.

Other than bonds from banks and the government which are both exempt from these policies, no other company has since tapped the bond market with the exception of a partial 'roll-over' of a Corinthia Finance plc bond. This new bond has been rendered almost completely illiquid by certain characteristics which had to be introduced to counter-effect the requirements of the new listing policies of 2010.

The more stringent regulations which are inhibiting local companies from using the bond market are providing fewer opportunities for investors. While this is proving beneficial for the government which is seeing very strong demand from the general public for the periodic Malta Government Stock issues, the lack of corporate bond issuance is not helping investors who are finding it increasingly difficult to build up a varied fixed income portfolio.

This is further exacerbated by the lack of corporate bonds available for sale on the secondary market since most investors generally buy and hold bonds to generate sufficient income to supplement their pension or other sources of income. Apart from the government, the main beneficiaries of the status quo are some of the newly set-up banks operating locally offering rates of interest significantly above those of the more traditional retail banks. Although a liquid and dynamic banking system is healthy for the market's development, investors should be aware that high interest rates come with higher levels of risk.

The complete inexistence of new local corporate bond issuance is forcing many more local investors to invest overseas without realising the higher levels of risk they are taking on. This is reversing the trend that was evident shortly after the start of the international financial crisis in September 2008 where many investors preferred local investments in view of the better understanding and visibility of companies managed by well-known Maltese families.

It is becoming increasingly evident that the business dynamics and risks associated with certain types of overseas investments are not well understood by investors. This is not only exposing investors to additional risk but also leading to an outflow of funds to the detriment of the local economy.

This should be a cause for concern for all especially the regulators, the authorities, market participants, local companies and retail investors. A well-functioning and liquid local bond market is imperative for a successful financial market to assist local economic development.