Stock Market Review

The AX Investments bond issue

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The AX Group is tapping the financial market again through its finance vehicle AX Investments plc. This is the fourth time that the group is using the capital market to finance its ongoing expansion. Initially, the AX Group launched an equity and bond offering for Suncrest Hotels plc in 1997 and, four years later, it raised €5.4 million to partly fund the construction of the Verdala Mansions in Rabat.

In 2006, AX Investments plc issued two bonds – one of only €2.3 million to fund the buy-back of the Suncrest Hotels plc shares held by the public. The other bond issue totalling €11.6 million was mainly raised to fund the redemption of the €7 million Suncrest Hotels plc bonds and to fund the development of other Group activities.

The new €40 million issue officially announced yesterday at a rate of six per cent will be used to fund the bond exchange programme of the €11.6 million 6.7 per cent bonds which will be redeemed on the earliest possible date of December 15. Similar to the previous issues of AX Investments plc, this new bond is also guaranteed by AX Holdings Ltd. A larger amount totalling €21 million is being raised to fund the development of a retirement village and care home in Naxxar.

The existing AX Investments bondholders (totalling around 2,000) may exchange the maturing bonds at par value for the new six per cent issue. Such existing bondholders are being given a guaranteed allocation for the amount of existing bonds currently held, rounded up to the nearest €100 nominal or to the minimum of €1,000 (if applicable). However, bondholders wishing to apply for more than their existing holding must complete a separate application and this will rank with all other retail and institutional investors. Since the new bonds are priced at six per cent as opposed to the 6.7 per cent coupon of the maturing bonds, existing bondholders will be compensated for the interest differential of 0.7 per cent. As such, on December 15, existing bondholders opting to exchange their bonds will receive interest of 6.7 per cent for the period from December 16, 2013 to March 7, 2014 (being the date of commencement of interest on the new bonds) together with the 0.7 per cent compensation from March 8 to December 15. Other existing bondholders who do not accept the bond exchange programme will receive the capital and interest back on December 15.

The AX Group aims to diversify its business operations by tapping into the healthcare sector with the development of the Hilltop Gardens Residences & Care Home comprising 143 residential units for independent living as well as a separate nursing home for those persons requiring long-term medical care.

The retirement village in Naxxar is expected to be constructed over the next two years and commence operations as from the financial year ending October 31, 2016. During a recent meeting with the financial community, Angelo Xuereb announced that the group recently appointed Jackie Camilleri as CEO of Hilltop Gardens to oversee the project from its early stages.

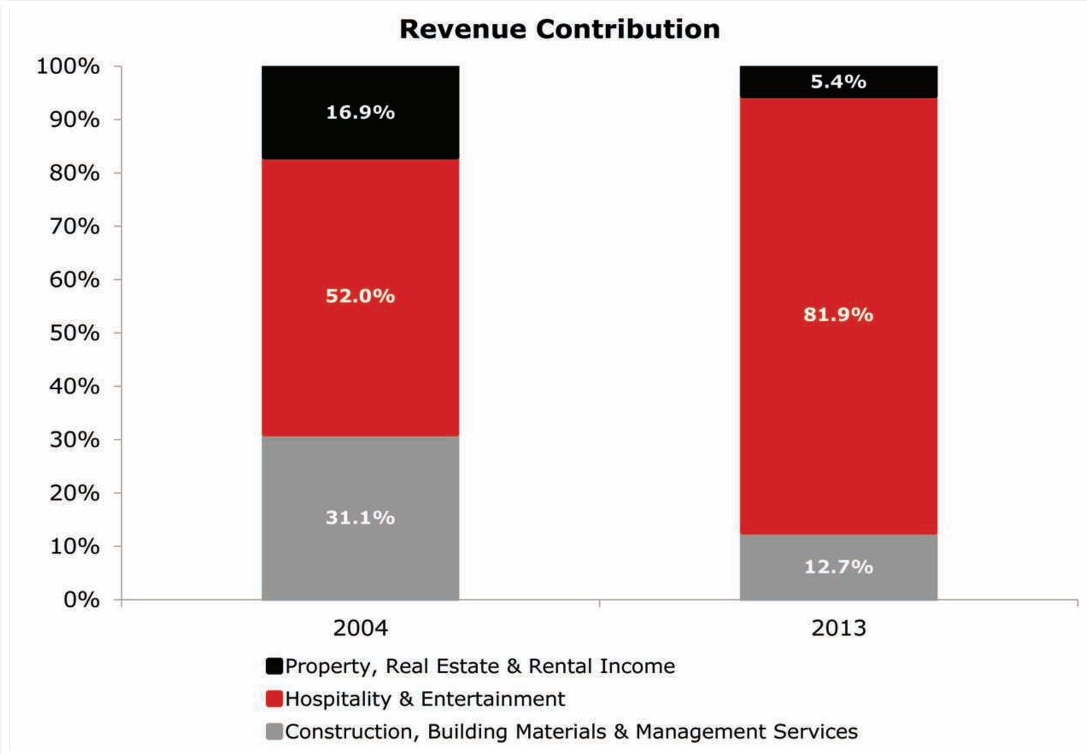
The residential units will be available for lease for periods ranging between one and 30 years. Additionally, the AX Group is also anticipating to generate income from the sale of consumables, maintenance fees and the provision of services such as cleaning. Given the innovative concept of the retirement village, the AX Group is conservatively projecting that initially it will lease the units for short-term periods of up to five years.

Based on this assumption, the AX Group is expecting to generate €1.7 million in annual revenues by the financial year ending October 31, 2019. On the other hand, residents at the nursing home will be charged a daily room rate apart from other charges for additional services required. Occupancy is expected to reach 90 per cent by the financial year ending October 31, 2019 at which point the nursing home is anticipated to generate annual revenue of circa €2.6 million.

As the 2006 bond issue was also guaranteed by the group parent company, i.e AX Holdings Ltd, investors had access to the financial statements of AX Holdings Ltd on an annual basis since then. This enabled financial analysts to follow the financial performance and developments of the AX Group throughout the years.

Contrary to popular belief, the AX Group today is not mainly dependent on the construction industry. The AX Group was founded in 1977 and although the group was mainly focused on construction in its early years, this division accounted for less than 13 per cent of overall Group revenue during 2013.

The group is now mainly focused on hospitality through the AX Hotels portfolio comprising four properties, namely the Palace and the Victoria hotels in Sliema and the Suncrest and the Sunny Coast in Qawra, as well as the two Tal-Kaptan restaurants. The dependence on the hospitality division accelerated in recent years following the development of the five-star Palace hotel in Sliema. Revenue from the four hotel properties contributed over 80 per cent of group turnover in 2013 up from 52 per cent in 2005 just before the last bond issue.



During the last financial year, ended October 31 2013, the Palace was again the largest contributor to the hospitality division accounting for 35 per cent of revenue and 36 per cent of gross operating profit which amounted to €2.4 million. A comparison to other competing five-star hotels indicates that the Palace outperformed in terms of occupancy level which averaged 82 per cnet during 2013 but was below competition in terms of room rate at an average of €90 per night.

> **“Gross operating profit could more than double to €4 million following this upcoming investment”**

During a presentation on the bond issue, the finance director of the AX Group, Michael Warrington, remarked that using another important indicator, i.e the gross operating profit per available room, the Palace ranks third in the five-star sector with only Hilton and Westin ranking ahead.

The second largest contributor to the hospitality division is the Suncrest. After a number of years with very disappointing performances, the hotel offering was changed to an all-inclusive concept which helped gross operating profit rise from €1.2 million in both 2011 and 2012 to €1.8 million in 2013. Although this is undoubtedly a weak performance given the size of the property with 452 rooms, Mr Warrington is confident that significantly better results can be achieved once the €7 million refurbishment programme is completed. This investment is being funded through bank borrowings and the property will be closed for some months as from November for a complete overhaul of the rooms and the main areas.

The AX finance director claims that gross operating profit could more than double to €4 million following this upcoming investment.

While the financial performance of AX Holdings has been positively impacted in recent years by property revaluations, it is worth pointing out that earnings before interest, tax, depreciation and amortisation (EBITDA) climbed from a low of €3 million in 2009 to €7.3 million in 2013. The significant improvement in the financial performance was due to the increased contribution of the hospitality sector reflecting the record tourism numbers in each of the last four years and coinciding with the launch of the five-star Palace Hotel in Sliema in August 2007.

Mr Warrington also explained that during the same period, costs remained largely flat as management was highly focused on being as efficient as possible across the various business units.

The strong growth in the financial performance led to an increase in the interest cover ratio, a very important indicator for bondholders since it shows the amount of times that profits cover interest obligations on all borrowings. This increased to 2.9 times in 2013 which compares well with other local debt issuers.

Another important indicator is the gearing ratio which measures the level of borrowings at €46.3 million compared to the total shareholder equity of €88 million. The ratio of 0.5 times also compares well with other debt issuers and this possibly comes as a surprise to many followers of the local bond market.

The new funding required by the group which is mainly for the development of the retirement village will increase borrowings to €68 million during the current financial year. This will lead to a deterioration in the gearing ratio to 0.76 times.

Based on the financial projections for the current financial year to October 31, 2014, the interest cover will decrease to two times. Warrington highlighted in the meeting that the performance during the first quarter of their current financial year (from November 2013 to January 20-14) is already well ahead of the budgets and he is very confident that the end result will be superior to that projected. The prospectus indicates that the directors are aiming for a seven per cent growth in EBITDA to €7.8 million. The finance director also argued that the AX Group, primarily from the hospitality division, is generating sufficient profits to support the increased borrowings independently of the expected future profits being generated from the Hilltop development.

The AX Group also owns other properties for eventual development and these include an office centre in Marsa as part of a large area identified by the government for a business park; the ex-Verdala hotel site earmarked for residential units; and two parcels of land in Mosta also awaiting appropriate permits to be issued by the Malta Environment and Planning Authority for development into residences and commercial units.

The AX bond is the first corporate bond on offer in the market in 2014. After three years of very low levels of new bond offerings, retail and institutional investors will have a wide choice available from issuers operating in various sectors of the economy. There are indications of a further six new bond issues by July, pointing to a very busy period for the bond market.

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