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RLH - Q4 2017 Red Lion Hotels Corp Earnings Call

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PRESENTATION

Operator

Greetings, and welcome to the RLHC Corporation (sic) [RLH Corporation] Fourth Quarter 2017 Earnings Conference Call. (Operator Instructions) It is now my pleasure to introduce your host, Amy Koch, Manager, Investor Relations.

Amy Koch

Thank you. Welcome to RLH Corporation's earnings call. With us today are President and Chief Executive Officer, Greg Mount; and Executive Vice President and Chief Financial Officer, Doug Ludwig. Also joining the call for the question-and-answer period is Aaron Howard, Senior Vice President of Financial Planning and Analysis.

Before we get started, I want to remind you that the company's remarks today contain forward-looking information as defined by the SEC that is subject to a number of risk factors that may cause actual results to differ materially from those expressed or implied. These risks will be disclosed in our annual report filed with the SEC on Form 10-K on April 2, 2018. The report will also be available on our website, rlhco.com, in the Investor Relations section, or through the SEC website at sec.gov.

The company will also be referring to a number of non-GAAP measures. The reconciliation of these measures to their comparable GAAP measure is provided in the table to the press release issued today. That release is also available on the Investor Relations section of our website. For purpose of the discussion today, the company will be referencing fourth quarter 2017 results on a comparable basis for all periods presented.

I will now turn the call over to Greg Mount.

Gregory T. Mount - *Red Lion Hotels Corporation - CEO, President & Director*

Welcome. 2017 was a year of strategic evolution, financial execution and the proliferation of exceptional executive talent. Our executive team delivered 4 strong quarters of financial execution and exceeded the business plans for the year. The development team achieved 144 executed franchise agreements, surpassing our new contract goal initially set for 2017 of 90 to 120.

In 2017, we attracted great executive talents, future industry leaders to fill out our team that will lead and execute on creating our future and to drive aggressive franchise growth plans. We also took a significant step to improve our asset-light business model by announcing a plan to sell most of our ownership interest in hotel properties and retain franchise contracts on those hotels. These asset disposals will significantly reduce our long-term debt and increase our cash reserves, providing the liquidity to fund our technology platform and significant growth of our franchise contract base.

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During the first quarter of 2018, we closed in the sales of 5 of 11 hotels identified for sale, reducing long-term debt by over $38 million. Our 2017 consolidated debt net of cash reserves was $34 million, and the 5 assets sold in the first quarter of 2018 dramatically reduced our net debt position. It was truly a tremendous year.

As a reminder, we began on this path to becoming an asset-light hotel franchise company less than 4 years ago when we were 55 hotels in 8 states to approaching 1,100 hotels in 48 states by the end of 2017. We have clearly demonstrated our ability to execute an asset-light business model for the future, enabling us to minimize the capital required for growth and maximize our operational profit margins.

As part of our move from hotel ownership to franchising, we have realigned our team to emphasize those skills and experiences that can maximize the franchise profit potential of RLH. We have carefully considered the executive talent needed to execute our strategies and have added talent in general management, digital presence, loyalty programs and brand development for each of our primary growth brands. We have one of the most diverse, innovative and talented executive teams in the lodging industry.

We have also focused on the use of innovative technology relevant to our franchisees and our guests and our employees to maximize the impact of this talent and increase returns to our owners. This realignment has allowed us to initially reduce our operating cost by more than $2.5 million on an annualized basis.

As we continue to sell hotels, we will execute additional cost reductions throughout 2018 to improve our profit margins and productivity even further. We strongly believe that one of our key competitive advantages is our leadership in technology for both our customers and our hotel owners.

As an example, we recently completed the last important milestone toward deploying Apple TV in all of our Hotel RL properties. With Apple TV, RLH Corporation connects the in-room experience to the complete guest journey offered to its customers. That journey begins prearrival with SMS messaging between the hotel and the guest and then prompts the user to download the Hello Rewards application. Once the guests have arrived on-site, this enhanced journey continues with self-service check-in options, digital mobile keys, communication and requests from guests to staff.

Additional on-site lobby touch points includes digital signage displaying local recommendations and travel information.

Within 6 months of our brand acquisition, we completed a brand realignment to ensure that each of the 9 brands had a unique and meaningful position in the market while also providing our hotel owners with the freedom to move efficiently between brands as their business needs or their markets change with the objective of maximizing their returns on invested capital.

We also took the brand realignment process to rejuvenate certain brands and to ensure that all of our brand standards are current and relevant to our customer base. We also focused great attention to the relevant cost-effectiveness of our property improvement programs related to each brand.

Our development strategy will continue to focus more on the mid and upscale segments, which cover most key markets. Franchise agreements in the mid and upscale segments are typically longer term, approximately 20-year agreements, and fees are typically a percentage of revenues, which makes them more valuable in contributing to our growth in RLH Corporation's value for our shareholders.

An important example of this mid and upscale emphasis was achieved in the first quarter of 2018 when we reached agreement with Inner Circle to enter 10 franchise agreements for mid and upscale properties in markets such as St. Louis, Baltimore and Hartford. These new 20-year franchise agreements are on 9 Red Lion Hotels and 1 Hotel RL, representing nearly 2,600 rooms and/or more than 10% to our mid and upscale segments. We are targeting a further 20 to 25 mid and upscale properties in our 2018 organic growth objectives.

As we free up capital base from our hotel ownership assets, we have established internal growth targets for 2018 to include franchise contract acquisitions. Our senior executive team is focusing its attention on acquisition candidates that can be acquired at reasonable values and integrated into RLH with modest incremental costs as well as to benefit from our RevPak platform. It is also a key objective that our acquisitions are immediately accretive to our earnings and cash flows.

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I would like to now turn the call over to Doug to discuss the financial performance and outlook for the company.

Douglas L. Ludwig - *Red Lion Hotels Corporation - CFO, EVP and Treasurer*

We have continued to focus great detail on the consistent execution of our business plan and strategic initiatives throughout 2017 to significantly improve our asset-light business model.

The company's net income for the year ended December 31, 2017, was $581,000 as compared to a loss of $4.7 million in 2016. As the company realizes its asset sale objectives, it will achieve reductions in depreciation, amortization and related interest costs, which should contribute to additional net earnings in future years. The sale of these assets will also reduce the inclusion of variable interest entities income, those are the earnings associated with our joint venture partners, bringing greater clarity to our consolidated earnings in future years.

Our adjusted EBITDA from continuing operations and for our entertainment business through the date of sale increased $3.6 million on a year-over-year basis to $23.1 million. Franchise segment revenues rose to $48.6 million, representing a year-over-year improvement of 97%. The significant improvement resulted from the brand acquisitions in late 2016 as well as the organic unit growth realized throughout 2017.

The company executed 144 franchise license agreements in 2017, exceeding our increased guidance for the year. The new franchise license agreements included 29 midscale and 115 economy properties. Divisional profit from the franchise segment increased from $5.3 million in 2016 to $13.8 million in 2017, representing an increase of 159%. The divisional profit margin in the franchise segment increased 675 basis points to 28.3% for the 2017 fiscal year.

Giving a better indication of the franchise division's future profit margins, the margin achieved in the fourth quarter of 2017 was 32.1%, which represented a 670 basis point improvement as compared to the fourth quarter of 2016. The systemwide midscale RevPAR increased by 2% in the fourth quarter of 2017 and 2.5% for the 2017 fiscal year.

In October of 2017, the company announced its intention to market for sale 11 of its hotels to significantly improve its balance sheet, increase its cash reserves and reduce the economic and business risks associated with hotel ownership. This asset sale program will allow the company to focus its future growth on its high profit margin and less capital-intensive franchise business. We have made significant progress towards our goal of selling these assets.

In the first quarter of 2018, we closed 5 hotel sales, generating gross proceeds to the joint venture of $47 million for the repayment of long-term debt and to distribute to the joint venture partners. We maintained the franchise rights to each of the 5 hotels. We have also signed agreements to sell an additional 2 hotels in the upcoming months, and we expect to maintain the franchise rights for those 2 hotels.

The financial impact of these hotel sales will begin to lower our adjusted EBITDA in the first quarter of 2018. Companies expect to realize a net loss of approximately $500,000 in the first quarter. The performance is expected to be down from the same period in 2017 by $1.5 million. A large portion of the decrease is due to the sale of 5 hotels in February of this year.

Additionally, we increased our investment in our franchise development team. This investment in personnel has already increased the flow of new deals. We are also expecting to record a gain on sale of the assets in the first quarter of 2018 of $14 million. The debt reduction and increase in cash reserves resulting from the hotel sales will help us improve our cost of capital in the future. 2018 will be a year of significant changes in our earnings base due to the sales of the hotel assets and the related reductions of our hotel ownership division earnings, the repositioning of our cost base as we exit hotel ownership and focus on franchise operations, the reduction expected in our interest, depreciation and amortization costs relating to the hotels being sold, the expected organic growth of our franchise business, the addition of the Inner Circle franchise agreements and the potential of acquisition activity relating to our franchise business.

As the hotels are sold, we will disclose the terms of each transaction in our 8-K filings, including the historical divisional earnings from each asset.

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Due to the inability to predict the timing of the asset sales, our initial guidance for 2018 will concentrate on our franchise business and our 4 leasehold interests, being Seattle, Anaheim, Spokane and Kalispell, combined with 3 hotel assets not being marketed for sale, being Washington, D.C., Baltimore and Atlanta.

So our initial guidance for 2018 is as follows. 2018 systemwide midscale RevPAR growth of 1% to 3%. We expect our franchise divisional profit to be between $16 million and $17 million, representing a potential increase of 16% to 23%. The franchise division profit margin is expected to increase from 28.3% in 2017 to between 30% and 32% in 2018. This profit margin should improve further as the hotels the company sells enter new franchise agreements with the company.

The 5 new franchise agreements relating to the hotels sold in the first quarter are expected to generate franchise fee revenues of $400,000 to $600,000 over the remainder of 2018. General and administration costs are expected to be $16.2 million to $16.5 million. These costs include our public company costs, our bonus and equity incentive program costs, Board of Directors, executive and management and general corporate overhead. Our cost reduction efforts will improve the divisional profits of the franchise and hotel ownership segments.

The initial cost reductions are expected to be $4 million to $5 million. Cost reduction efforts will be ongoing, and the impact will depend on the ultimate timing of the additional hotel sales in 2018.

The company expects to execute 150 to 200 license agreements in 2018. Our leasehold interest in the 3 hotels not being currently marketed for sale contributed EBITDA of $5.9 million in 2017. We anticipate modest growth in these properties due to generally favorable market conditions and the continued work to stabilize the joint venture properties to hire occupancies and achieve room rates. The 2018 adjusted EBITDA contribution for the 5 hotels sold in the seasonally slow first quarter of 2018 was $150,000 through the dates of their respective sales. The adjusted EBITDA for the 5 hotels was $4.7 million for fiscal 2017. The adjusted EBITDA contribution for the 6 hotels currently being marketed for sale was $12.1 million for fiscal 2017. Our adjusted EBITDA for the 6 hotels will be for the period in 2018 through the dates of each of the hotel sales.

Lastly, in 2017, we expanded our Investor Relations activities by simplifying our communications and spending significantly more time meeting with shareholders, analysts, potential shareholders and by participating in investor conferences. These IR efforts resulted in the significant improvement in trading volumes of our stock and an improvement in the market valuation of our stock to historical highs. We have much more work to do, but the movement to the asset-light model should result in continued improvement in the market valuation of our shares.

This concludes our comments, and we'd now be pleased to respond to any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Alex Fuhrman from Craig-Hallum.

Alex Joseph Fuhrman - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

I wanted to ask about a couple things, was particularly interested in the franchise targets that you threw out for 2018. Certainly looking for some nice growth there. Wanted to get a little bit more color on the deal that was recently announced with Circle management. It sounds like that's going to be 10 of your mid and upscale hotels. And just trying to understand a little bit about how your franchise development has been evolving. It seems like for the most part over the last 5, 10 years, a lot of your franchise deals have been sort of one and two-off kind of deals. So was nice to see such a large expansion, particularly on your higher-end properties. Is that how a lot of your conversations has been going? And as we think about the volume of deals that you're looking to close in 2018, do you suspect that they'll be weighted a little bit more towards large, multiunit deals than we've seen in the past?

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Gregory T. Mount - *Red Lion Hotels Corporation - CEO, President & Director*

Alex, it's great to hear from you, and thanks for asking a question. We're really excited with the Inner Circle deal. It really is a great example of the type of deals that we've been talking about as we reposition the company and look to really accelerate our growth on the franchising side. And as we've talked about in past calls and meetings that we've had, these deals can be worth anywhere between 5 to 10 of our economy scale deals depending upon the size and location in the market. So a deal like this is significant. We believe that there are more. We are also seeing a much higher level of activity this year as it relates to the midscale and upscale deals, which has really been an evolution for us, as you know, and a big area of focus. And while we'll continue to focus on our economy segment and see continued improvement there, we're very, very excited about what's happening in the midscale and upscale side of it.

Alex Joseph Fuhrman - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Thanks, Greg. And then as you think about the franchise sale process, it seems like there's a lot of really interesting things that you've been doing with Signature Inn and how that has been positioned sort of uniquely in the marketplace. Looks like there was one deal that was just recently signed for Signature Inn. Beyond that one deal, would you say that's a brand that factors significantly into your growth plans for 2018? I'd be curious how the reception has been from hotel owners about that more unique concept.

Gregory T. Mount - *Red Lion Hotels Corporation - CEO, President & Director*

Yes. Getting the first deals done in San Francisco and kind of in the South market area has been really transformational for us. The activity level on this brand is really inspiring and really kind of eclipsing what we had anticipated early on. The brand really speaks to the ability to take a 25, 30-year-old box that may have exterior corridors but then a great location and really bring it back and provide some -- make it relevant again and make it interesting and create an opportunity for an owner to really create a good return on their invested capital. And so currently right now, I in fact had a report from our guys who are at -- currently at the AAHOA conference in Washington, D.C. where about 6,000, 7,000 people in attendance. And they say that you literally can't set foot in the booth as it relates to Signature. There's just a phenomenal amount of excitement going on. And so I think you'll see that brand continue to grow. I think it's really the right evolution, particularly in the economy and midscale segments because it provides the owner as well as the guest an opportunity to stay in a hotel that meets their budget but at the same time provides them kind of a sensibility that they don't typically get in our industry, in the economy brands and some of the midscale brands. So for us, we're really excited about it, and the content and the collateral is then just phenomenal. Our designers are having just a great time. And as you know, we work very hard to allow the franchisees to actually go out and order their key FF&E through a joint venture that we have with [Wayfair] as an example. So we're doing the things correctly that I think are going to resonate with owners. We're going to provide them more accessibility. We're going to reduce their cost of conversion through programs like Wayfair and provide them, I think, really an exciting opportunity for an asset that's probably has been forgotten many, many years ago.

Alex Joseph Fuhrman - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

That's great. And then, lastly, if I could just ask about the ongoing sale process. Do you still feel good about that range that the company had talked about last year, $165 million to $175 million of gross proceeds for all 11 properties and is that still something that you feel is a good range to think about? And so far, it looks like you guys are 5 for 5 in terms of signing the new owners on to franchise agreements. Do you anticipate that you would be able to secure franchise deals on most of the remaining hotels to be sold as well?

Douglas L. Ludwig - *Red Lion Hotels Corporation - CFO, EVP and Treasurer*

Yes. I'll deal with the last question first, which is, yes, we feel very confident about our ability to maintain the franchise rights relating to the 11 properties. So it's something that we're also fortunate that CBRE as our broker has really helped convince the future owners that we are the right franchise, we're the right brand, we've got the right systems, we've got the right ability to maximize profitability in of each of their hotels. So we're feeling good about that side of it. On the original estimate of proceeds, again, we're very confident. We're there or better than there on those. A

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lot of activity is going on. We've got 2 more signed up that will be closing in the next month or so. So we feel really good about accomplishing what we set out to do, which is not just refining our business model further, but the key being the debt reductions, the freeing up of our balance sheet, the freeing up of our capital base for future franchise activities, including acquisitions. So, so far, a lot of blood, sweat and tears, but we're achieving what we set out to achieve.

Operator

(Operator Instructions) Our next question comes from the line of Eric Wold from B. Riley & Co.

Eric Christian Wold - *B. Riley FBR, Inc., Research Division - Senior Equity Analyst*

A couple of questions just on kind of the next phase. It sounds you're doing great with the -- kind of the franchise trends as well as the sales -- kind of taking the next step of using the proceeds from a cleaner balance sheet to start looking for M&A targets. Can you talk about the M&A environment out there, for targets you're considering? And kind of address the gap between what you would want to pay as a multiple to EBITDA or cash flow versus some of the recent public transactions you've seen out there be announced? And would you expect to kind of go forward with any transactions prior to selling all 11 of the hotels being marketed? Or would you want to wait until that process is completed before going for on any M&A?

Gregory T. Mount - *Red Lion Hotels Corporation - CEO, President & Director*

Hey, Eric, it's great to hear from you. Thanks for the question. We have always been very clear on this, is that as we sell these assets and create opportunities, we're going to reinvest that capital in what we think high returns are going to be for the organization. And whether that's through our organic growth, where we may be using key money for strategic assets or acquisitions, we're going to continue to do that, we're going to redeploy it and really grow that business. As it relates to the activity, we've continued to be very active. There have been some bigger transactions that occurred out there that have set some pretty lofty benchmarks when you think about the multiples that were paid. I think that those situations are specific and kind of inherent to those acquisitions. We do feel that there are a number of other good opportunities out there. We continue to filter those. We continue to dialogue. And we remain confident that we're going to be able to continue to execute on that part of our strategy as well. So I think you'll see us be active, diligent. We're not going to overpay. That is important. I don't think that there's a need to. We also feel that the consolidation that's going on in the industry is really creating an opportunity for companies like ours to acquire. I will also say to you, even as recently as this morning, I was speaking with the Chief Operating Officer of a rather large management company, and they were talking about the fact that as these companies, like Marriott and others, are really becoming so large and so ubiquitous, that their ability to be flexible is really starting -- their inability to be flexible is really starting to create issues and opportunities. And so we also see that as something that we'll continue to focus on. And I think when you look at the Inner Circle deal that we executed this first quarter, now that's a great example of a very large deal that will create a significant amount of EBITDA over the next 20 years for the organization. Got a great net present value. And if you kind of convert it, how we looked at that acquisition from a multiple is very, very attractive. So for all of those reasons, I think that we feel very good about it and are very focused on them.

Eric Christian Wold - *B. Riley FBR, Inc., Research Division - Senior Equity Analyst*

Okay. And then can you refresh how many brands you currently have? I know you've done some retooling of the brand portfolio post the Vantage acquisition. How many brands are currently in-house now? Where would you want to kind of exit '18? What do you think is the optimal number of brands for you to have in your portfolio? And if you were to make additional acquisitions, would you be comfortable adding brands? Would you want anything that kind of convert to one of the ones you have? And I guess, how large of an acquisition of a portfolio would that need to be for you think that, that brand is relevant to kind of stay on its own?

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Gregory T. Mount - *Red Lion Hotels Corporation - CEO, President & Director*

Yes. We're continuing to be opportunistic. We're still servicing about 13 brands. As we noted in the fourth quarter of last year, we're working to get that down to 9. And that process is moving and going along smoothly, and we're seeing a fair amount of transition. We're also seeing a number of hotels that were in some of those brands that we inherited that had just a few hotels eagerly moving over and finding a good home in 1 of the core 9 brands that we're going to go forward with. And so I think you'll see us drop that up here over the course of the next quarter or 2 as we wind that down. And then if you remember, we also rolled out Franchiseasy, which is another opportunity for owners that may want to be -- more on the independent side can do that and particularly in the economy segment. As it relates to adding brands, we're going to continue to be opportunistic. We have said that our focus would be in the midscale and upscale. That doesn't mean that's the only place where we're going to make those types of acquisitions. We feel that the multiple is good. We see it as accretive. We feel that there's enough ubiquity in the brand. And as I've talked about on other calls, you feel -- we feel we fairly need to be 100 to 125 hotels to really even really kind of be in the brand description. So I think from all of those standpoints, you'll see us focused more directly and look at all of the opportunities that are there and continue to evaluate them. But again, we've got a great platform. It's a successful one. It's one that has really created additional return on invested capital for our owners. It's very much on the cutting edge, and owners are seeking us out. And so that's all a good sign.

Eric Christian Wold - *B. Riley FBR, Inc., Research Division - Senior Equity Analyst*

One more question, if I may. Just clarity on the 150 to 200 franchise agreements guidance for this year, what would you expect kind of the net number to be in there? How many would be renewals of existing franchisees? And how many would be net additions? And then you mentioned Franchiseasy. Have you signed anyone up under the Franchiseasy program? And do those signings that are Franchiseasy count towards that 150 to 200?

Gregory T. Mount - *Red Lion Hotels Corporation - CEO, President & Director*

Yes. We have executed the Franchiseasy deals, and they're continuing to move as we have anticipated. Any deal that we compete with our competitors on, whether that's -- as we've talked about before, whether that's an existing deal that has reached its term and we execute a new agreement, it's something that we look at as a new execution. And I know that that's always a difficult thing to kind of interpret as you're looking at numbers. What I will tell you, though, is that both the acquisitions we've done, we've seen what we've expected to see in turnover. I will also tell you this year, we're focused on moving through our current franchise deals and making sure that we're eliminating any bad actors or any franchises that are not accretive or not supporting the brand. And so you'll see some of that, but I don't think you'll see anything out of the norm. But we are very focused on our quality, and we're very focused on ensuring that we're delivering the expectation for that particular segment. That being said, I would suggest that the better way to really kind of evaluate us particularly going into this year and where we've position the company by the sales of our core assets has been really the total revenue. Because I think what you're starting to see and what you saw in the Inner Circle deal and you'll see in future deals, both in the economy and the midscale and the upscale segments, is we're securing and signing much more valuable, much longer-term deals. And so the revenue really, while the number of hotels is always an interesting benchmark and a good topic of conversation and it does give you some idea into what's going on, ultimately, it's the revenue. And as we've talked about in our guidance, we feel very good about the franchise revenue growth. And that's really where I think the best barometer is going to be as we go forward.

Operator

With no more questions, I will pass the call to Mr. Mount for his final words.

Gregory T. Mount - *Red Lion Hotels Corporation - CEO, President & Director*

Thank you. Thank you for joining us today. 2017 was an extraordinary year for RLH Corporation. We are confident and excited about the strategic changes that will enhance the future profit potential of the company. We believe that our brand have significant growth potential, and we have the management team to effectively execute our growth strategy. So with that, thank you again and have a great week.

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Operator

Thank you, ladies and gentlemen. This does conclude today's teleconference. A replay to the conference will be available until April 11, 2018. You may access the replay by dialing (877) 660-6853 and entering ID 13674846. And with that, you may disconnect your lines at this time and have a wonderful day.

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