An Undervalued Spinoff

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About: Park Hotels & Resorts Inc. (PK), Includes: AHT, CLDT, DRH, HGV, HLT, HPT, HST, PEB, SHO

Bottom Fisher Ideas

Summary

Park Hotels & Resorts and Hilton Grand Vacations are two spinoffs from Hilton Worldwide Holdings that began trading in January of 2017.

Since that time, HLT and HGV have both performed well, while PK has underperformed the market.

PK is undervalued. It trades at a significantly cheaper valuation than its peers.

There are notable market inefficiencies that explain the current underperformance of PK.

The inexpensive valuation, short-term market inefficiencies, the positive track record of spinoffs in the medium term, and the positive outlook for Hospitality REITs make it a buying opportunity.

Investment Thesis

Since its spinoff at the start of the year, Park Hotels & Resorts (NYSE:PK) has underperformed the market. PK is a high quality REIT that is undervalued compared to its peers and presents a great buying opportunity.

Overview

In December of 2016, Hilton's (NYSE:HLT) Board of Directors approved a plan to spin off Park Hotels & Resorts, a hospitality REIT holding the portfolio of hotels and resorts previously held by Hilton, and Hilton Grand Vacations (NYSE:HGV), Hilton's timeshare business.

From Hilton CEO Christopher J. Nassetta:

> *As three independent companies, Hilton, Park Hotels & Resorts, and Hilton Grand Vacations will be well-positioned to capture incremental growth opportunities and capital market efficiencies in their respective business. With the appropriate leadership, strategic vision, and capital structures now in place at both Park and HGV, I am confident that each business will enhance long-term value for its respective shareholders.*

These spinoffs began trading on January 4, 2017. HGV and its parent company, HLT, have both outperformed the market, while PK has lost value, both in absolute terms and relative to the broader market.

PK data by YCharts

Inexpensive Valuation

It is not a simple task to evaluate real estate investment trusts (REITs). The normal metric of price/earnings that works for many equities does a poor job of capturing the fundamentals of the industry, because assets often appreciate in value, whereas depreciation is the rule elsewhere. Most experts look at adjusted funds from operations (AFFO) because it is the most precise measure of residual cash flow available to shareholders.

AFFO does not appear on most stock screeners, but REITs often provide guidance in these terms. If we look at a company's quarterly statements, we can find their guidance for the upcoming full year. By using the midpoint of this guidance, we have a reasonable measure of its future AFFO.

After examining the 2017 guidance for Park Hotels & Resorts and some of its peers - Host Hotels and Resorts (NYSE:HST), DiamondRock Hospitality Company (NYSE: DRH), Pebblebrook Hotel Trust (NYSE: PEB), and Sunstone Hotel Investors (NYSE:SHO) - we can compare their AFFO. When we do this, we will find that PK looks inexpensive by comparison.

as of 5/24/17	PK	HST	DRH	PEB	SHO
Price per share	25.77	18.21	11.205	31.73	16
2017 Adjusted FFO per share (midpoint)	2.71	1.64	0.985	2.435	1.18
Price/AFFO	9.51	11.10	11.38	13.03	13.56

PK's price/AFFO is significantly lower than many of its peers. While this might make sense if Park Hotels & Resorts was not growing revenues and earnings, was overburdened by debt, or owned poor assets that were not expected to appreciate in value, none of these things are the case.

Another popular way of examining REITs is by looking at the dividend yield. PK's current dividend yield of 6.7%

places it near the top of the hospitality REIT category, and compares well with the four peers that were previously examined: PEB (4.8%), DRH (4.5%), HST (4.4%), and SHO (1.3%). The few hospitality REITs that edge PK out in the dividend yield department, like Ashford Hospitality Trust (NYSE:AHT), Hospitality Properties Trust (NYSE: HPT), and Chatham Lodging Trust (NYSE:CLDT), offer roughly comparable yields.

One additional way of examining PK is by looking at its intrinsic value in terms of (assets-liabilities)/outstanding shares. In theory, this should provide a number that is close to the share price. While it looks like a simple calculation on the surface, there is a subjective component to it, namely how to calculate the current value of the property and whether to include such things as good will and intangibles or subtract them out. Since we've already determined that PK offers an attractive price/AFFO and dividend yield, I'm going to take the total assets and liabilities from the accounting statements at face value, as a final check on value.

By taking the total assets of 9.84 billion and subtracting the total liabilities of 3.87 billion, then dividing by the outstanding shares of roughly 215 million, we arrive at an intrinsic value of $27.80 per share. With PK currently trading at an 8% discount to this, its inexpensive valuation appears to be confirmed. Meanwhile, other REITs in the same industry trade at a premium to their intrinsic values.

The question remains: Why is PK trading so cheaply compared to its peers? Does the market know something that we don't?

Short-Term Struggles of Spinoffs

With the majority of financial assets, the owners have made an intentional decision to own them. They know what they are purchasing and why. The criteria could be as simple as an index fund owning every large cap company in the US, or it could be as detailed as a careful examination of the financial statements and a forecasting of future earnings by an individual investor or an active manager.

Spinoffs, on the other hand, are a particularly inefficient method of distributing shares of a company. The initial owners of the stock made no active decision to own them, and many end up selling them in the first months of ownership. This puts short-term downward pressure on spinoffs.

Take the case of an index fund that owns a large cap company. On one day in January, this index fund suddenly owns shares in two new mid cap companies that may not fit into the fund's investing mandate. They may be required to sell the spinoffs, creating downward pressure. Similarly, individual investors who were attracted to the management of the parent company, the earnings track record, and the intangible value of the company name are now faced with owning a new company with new management and a limited track record.

In the particular case of Park Hotels & Resorts, there are two main factors that help explain its underperformance compared to Hilton Grand Vacations: sector classification and name.

Both HLT and HGV share the same sector classification, while PK is a real estate investment trust. The spinoff of PK could create an imbalance in sector weightings in a portfolio, or even expose the investor to an asset class that they had no interest in investing in. This creates additional selling pressure on PK that does not exist for HGV, both from individual investors and sector ETFs.

Additionally, Park Hotels & Resorts is notably lacking the Hilton name. While it might seem inconsequential, many individual investors are attracted to familiar names. An irrational bias for sure, but a pervasive one. It is not without some rationale, either, such as famed investor Peter Lynch's famous quote: "Invest in what you know."

These market inefficiencies help to explain the downward pressure on PK since its inception. Fortunately, academic literature also provides us with hope going forward.

Medium-Term Outperformance of Spinoffs

Numerous academic and sell-side studies exist that show an outperformance by spinoffs and, to a lesser extent, their parents in the first two to three years. The most famous study was titled "Restructuring through spinoffs: The stock market evidence", written by Cusatis, Miles, and Woolridge and published in The Journal of Financial Economics in 1993. Since then many others, including investment banks and academics, have replicated the findings and furthered the research on the subject.

The primary drivers for medium term outperformance appear to be increased incentives for management to perform, more freedom to cut costs and take risks, and the preference of investors for pure play investments.

Positive Outlook for Hospitality REITs

The common wisdom among many investors is that the so-called "bond proxies" are poor investments when rate hikes are on the horizon, with REITs being one of these along with MLPs and utilities. While this may hold true generally, there are exceptions.

Hospitality REITs have been one notable exception. While REITs can struggle in rising interest rate environments, REITs with short term leases can perform very well. Some research on this subject is available in the article titled "Rising Rates Environment Doesn't Hurt All REITs" by Qing Li on March 8, 2017.

In the article, this researcher examines 7 time periods with rising rates. In each of these 7 periods, short term REITs outperformed the overall REIT index by anywhere from 0.5% to 8%.

Conclusion

Park Hotels & Resorts trades at an inexpensive valuation compared to its peers and has been under short term pressure for non-fundamental reasons. Both spinoffs, generally, and the hospitality REIT industry, in particular, have a positive outlook going forward.

It seems unlikely that PK will continue trading at a discount to its peers for very long, so I consider it a strong buying opportunity.

Additional Sources

Park Hotels & Resorts 1st Q 2017 press release

Host Hotels & Resorts 1st Q 2017 press release

Sunstone Hotel Invests 1st Q 2017 press release

Pebblebrook Hotel Trust 1st Q 2017 press release

DiamondRock Hospitality 1st Q 2017 results

Disclosure: I am/we are long PK.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.