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Great Eagle Holdings: Misunderstood Hotel Operator And Prime Property Owner Trading At A Bargain Valuation

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Summary

- Great Eagle's stock has been unfairly hit by the Hong Kong protests.
- At the current stock market valuation, investors are getting over HKD 8 billion of prime property assets for zero.
- Great Eagle is also a case of low bankruptcy risk and is not a value trap - which together makes the risk of permanent loss here to be negligible.
- All in all, the stock today appears to be a case of 'heads I win big, tails I don't lose much.'
- We are not alone with this opinion. Chairman Ka-shui Lo agrees with us and has been voting with his money in the last 3 months in the stock market.

Several months of ongoing political protests in Hong Kong appears to have served up an outstanding investment opportunity in the form of Great Eagle Holdings (OTCPK:GEAHF) (41:HK).

For an investor with a 3-5 year horizon, I am convinced that this investment has overwhelming odds of doubling in value - which would be a fantastic result, even if partially achieved in that timeframe. I also think that the stock today represents a situation with nearly zero chance of permanent capital loss - a classic 'heads I win, tails I don't lose much' situation.

The 2019 Hong Kong political protests have tipped the city into recession and disrupted everyday life. These events have caused a 70% drop in tourism and adversely affected retail businesses. Hence, it is no surprise that stocks of Hong Kong property landlords have hit multi-year lows.

Source: Yahoo Finance

Stocks in the above chart:

- Great Eagle Holdings Limited (OTCPK:GEAHF) (41:HK)
- Swire Properties Limited (OTCPK:SWPFF) (OTCPK:SWROY) (1972:HK)
- Hang Lung Properties Limited (OTCPK:HLPPF) (OTCPK:HLPPY) (101:HK)
- Hang Lung Group Limited (OTCPK:HNLGY) (OTCPK:HNLGF) (10:HK)
- Wheelock and Company Limited (OTCPK:WHLKF) (OTCPK:WHLKY) (20:HK)
- Hysan Development Company Limited (OTC:HYSNF) (OTCPK:HYSNY) (14:HK)
- Hongkong Land Holdings Limited (OTCPK:HKHGF) (OTCPK:HNGKY) (H78:SI)

In the chart is also Great Eagle, a well-established property owner and hotel operator controlled by Ka-shui Lo and family. The stock is down 35% in the last 2 years.

This table from the 2018 annual report provides a good overview of the underlying business: mainly hotel operations and commercial property ownership. Dividend income represents the upstreaming of income from property subsidiaries into the holdco.

	2018 HK$'000	2017 HK$'000
Hotel income	**5,950,684**	5,421,744
Rental income from investment properties	**2,943,531**	2,686,664
Building management service income	**313,521**	294,392
Sales of properties	**578,156**	107,224
Sales of goods	**197,478**	167,753
Dividend income	**26,247**	99,604
Others	**146,563**	170,723

	10,156,180	8,948,104

Source: 2018 Annual Report

Two notable observations concerning its earnings:

1. The bulk of Great Eagle's revenues come from hotels (59% of 2018 revenues, 30% of EBITDA). Most of the Langham branded hotels are located *outside* Hong Kong and hence insulated from the protests.
2. Rent and management fee income from its property management business is a safe 5-year bet given the super-prime property it manages in Hong Kong (65% of 2018 EBITDA).

Hence this is a steady income-generating company as long as Hong Kong is a prominent world city and luxury hotels don't become obsolete. These are safe assumptions in my opinion.

A Compelling Bargain

Great Eagle is a holding company. It owns and controls other property entities from which it derives its earnings and net worth. Interestingly, its key property subsidiaries are listed and hence we can independently observe their market value.

By comparing the value of this holding company and its listed subsidiaries, the extreme undervaluation of this stock becomes clear as night and day. Consider the facts:

1. Great Eagle (OTCPK:GEAHF) (41:HK) has a market cap of HKD 19 billion today.
2. Champion REIT (2778:HK) is valued at HKD 30 billion. Great Eagle owns 66.10% of Champion REIT, which means Great Eagle's stake is worth HKD 19.8 billion in the stock market today.
3. Langham Hospitality Investments (OTC:LMMHF) (1270:HK) is valued at HKD 5 billion today. Great Eagle owns 63.14% of Langham, which means that its stake is worth HKD 3.2 billion.

Theoretically, if I bought up all the stock of Great Eagle and sold off its stakes in Champion REIT and Langham in the stock market today, I would end up with HKD 4 billion cash in my pocket along with ownership of the remaining assets owned by Great Eagle.

These remaining assets are:

- 50% ownership and a stream of management fee of the US Real Estate Fund (mainly

US commercial property), which generated HKD 35 million in earnings and GE's ownership is worth HKD 440 million at 1x NAV.
- Contracts to operate various hotels and manage several buildings. Champion REIT, just one asset under its management, bought in HKD 400 million in management fee in 2018. At a 5% cap rate, this is worth around HKD 8 billion!

Alternative approaches also show the stock valuation being absurdly low:

- A P/E of 4x vs. 11x for the Hang Seng.
- A P/B of 0.3x which is like saying that the stockholder can expect to only monetize 30 cents for a dollar in book value if the company liquidates today. This is absurd for anyone familiar with the high-quality properties here, or even when compared to other HK landlords whose book values are inflated with Level 3 fair value gains.
- A P/CF of 7x which is less than half of the stock's 5-year average.

Risk Factors & Catalysts

The two main risks to this thesis are that:

1. **The market may remain irrational longer than we can remain solvent:** There are no hard catalysts in this situation and hence it may take years of patience and a strong stomach for MTM drawdowns to cash out rich from this position. We suspect that this is why the opportunity exists in the first place. For leveraged or shorter-term investors, there is an alternative stub trade that I have described below.
2. **Earnings may worsen before they get better:** It is possible that earnings deteriorate from current levels before improving to support a re-rating higher. The main arguments here are the 'late cycle' exposure to hotel earnings, prolonged softness in Hong Kong retail from the ongoing situation and new supply of cheaper office space pressuring rental income.

In addition, the usual dangers of being a minority shareholder in a family-controlled company in Hong Kong also apply at Great Eagle: Earnings inflation from 'fair value gains' that plague other HK property names is also here. Accounting opacity from subsidiaries, associates, SPVs and complex debt structures are also present with Great Eagle. We have done our homework and are comfortable going in at current levels, but other investors should do their own DD and channel checks.

We also see a soft catalyst here that the incumbent owner-operator may execute a financial engineering move to unlock value if the current undervaluation stays prolonged.

A recent example of this was seen with Wheelock (OTCPK:WHLKF) (OTCPK:WHLKY) (20:HK) listing their mature assets as Wharf REIC (OTCPK:WRFRF) (1997:HK) to spotlight the fundamentals there and surface value.

Two trade setups are available to execute this long thesis (using the liquid HK listed stocks):

1. We are simply going long 41:HK and staying invested unless proven wrong or until the thesis is realized. We expect to stay invested for years are likely to scale the position up/down as our conviction changes over time - a classic value investing approach.
2. For other 'hedge fund' style investors, a simple 3-legged stub trade to exploit the current mispricing may be more attractive. As described earlier, the setup below would add up to a negative HKD 3 billion in net market cap, which makes no sense, unless this company *deserves* a gigantic conglomerate discount for some reason not known to us. The stub can be created as follows:

    1. Long 1 share of Great Eagle Holdings (41:HK)
    2. Short 5.5 shares of Champion REIT (2778:HK)
    3. Short 1.9 shares of Langham Hospitality Investments (1270:HK)

Note: For the latter two stocks, the number of shares to short is calculated as the ratio of the company's outstanding shares divided by Great Eagle's outstanding shares times Great Eagle's ownership of that company. Shares traded by an investor will be rounded to an integer after determining the position size.

Conclusion

For a company with nearly no debt at the holding company level (debt on the books is non-recourse at the individual asset level), the current situation appears to be an outstanding investment opportunity.

Chairman Ka-shui Lo has bought shares in the open market 28 times since September 2019, as have other members of his family. He has bought over 3 million shares (1.3% of outstanding shares) at an average price of HKD 26.66. The closing price as of today, the 31st of December 2019, is HKD 26.25.

In conclusion, Great Eagle is a compelling investment where the stock market is offering us prime property for zero, in a world when people are paying top dollar for off-plan apartments in Phuket.

Patient investors who can see the bargain valuation and appreciate the high quality of the underlying property assets should take a suitable long position and wait for the geopolitical and macro worries to play themselves out.

Disclosure: I am/we are long 0041:HK. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

Editor's Note: This article discusses one or more securities that do not trade on a major U.S. exchange. Please be aware of the risks associated with these stocks.