10TH ANNUAL NEW YORK VALUE INVESTING CONGRESS

September 8, 2014 • New York, NY

Off the Radar: More Underfollowed Gems

Guy Gottfried, Rational Investment Group

Off the Radar:
More Underfollowed Gems

Guy Gottfried, Rational Investment Group
(647) 346-0464 guygottfried@rationalig.com

Investment Idea: Holloway Lodging Corp. (TSX: HLC)

Hotel Owner and Operator

Snapshot

Recent Price	Shares
$5.00*	19.8 million

Market Cap	Dividend
$99 million*	$0.16* (2.8% yield)

- **All financial figures pertaining to Holloway are in Canadian dollars*

Background

- Historically mismanaged company whose stock collapsed following dividend suspension, dilutive debt recapitalization
  - Shares now trade at $5 compared to $150 range (split-adjusted) prior to financial crisis
- Activist investor took control of Holloway in 2012 – replaced management, significantly improved operations
  - Holloway portfolio performing solidly
- Just completed transformative acquisition of another hotel company, Royal Host Inc. (RYL), thereby doubling its size

Why is Holloway Worth Your Attention?

- Combined Holloway-Royal Host business valued at 7.7 times unadjusted free cash flow (FCF)
  - Compares to average of 11.7x for publicly-traded comparables
- On normalized basis trades for just 5.0x FCF
  - Abnormally cheap for well-run, growing business
- Stock undervalued based on existing Holloway portfolio alone; investors get Royal Host for less than zero

Why is Holloway Worth Your Attention?

- Substantial insider ownership and widespread buying
- Several near-term catalysts
- Considerable runway for continued growth
  - Operational improvements, asset sales and redevelopments at Royal Host; further acquisitions in highly fragmented industry

Why is It So Cheap?

- Small, closely held company
- Underfollowed: no quarterly conference calls, only covered by one boutique sell-side firm
- Still stigmatized by the market
  - Many investors burned by debt recap

Royal Host: A Decade of Mismanagement

- Paid little attention to costs
- Underinvested in key assets
- Major leadership vacuum
  - From 2006 to 2013, Royal Host had three presidents/CEOs lasting an average of just 13 months
  - During rest of time, company run "by committee" with no leader at the helm prior to current chairman Michael Rapps

It should be no surprise that such a neglected and poorly-run business would be dramatically under-earning

Royal Host Mismanagement: Some Telling Anecdotes

- At recently sold Chatham, Ontario hotel, Royal Host was paying nearly double the property taxes paid by competitor with same size and location
  - Never bothered to check rival's tax records and initiate appeal with tax authority

- London Hilton property was paying $60,000 annually for terrorism insurance; this isn't London, England but London, Ontario!

- Royal Host's 129-room Yellowknife Inn only generated around 30% more NOI than Holloway's 66-room Super 8 Yellowknife
  - This despite being double the size, having meaningful food and beverage business (restaurant, banquet hall) and being just a couple of kilometers apart

Royal Host: Tremendous Cost-Cutting Opportunity

- Addressing just about every noteworthy cost item
  - Insurance, property taxes, food, chemicals, energy, benefits among others
- Exited costly external property management contracts
- Major cost savings already achieved but have not yet been reflected in financial statements
- Significant additional cuts to come in near future both on Royal Host's standalone portfolio and via synergies created by acquisition

Holloway stands to generate millions in annual cost savings – sizeable amount for company with $12mm in trailing FCF

Hidden Assets: Under-Earning Hotels

- Royal Host owns several hotels that make little or no money yet can be sold for meaningful proceeds
- Can deploy proceeds into debt repayment, share repurchases or hotel acquisitions at high teens levered returns
- Will likely realize $20mm to $25mm from dispositions in near term

Reinvestment of proceeds into above-mentioned uses will result in several million dollars in incremental FCF

Case Study: Travelodge Dixon Road

- Only produces an estimated $300,000 to $400,000 in annual cash flow (NOI less capex) but possesses considerable real estate value
  - 17-storey building, attractively located near Toronto's Pearson Airport
- Can likely be sold for $15mm pre-selling costs
- If deployed proceeds into acquisitions at 10% cap rate with 55% LTV mortgages at 6% interest, would see $2mm in FCF accretion
  - Such opportunities are available – e.g. Holloway bought hotel at 11% cap rate last quarter

Other Hidden Assets and “Low-Hanging Fruit”

- Master franchise rights for Travelodge and Thriftlodge brands in Canada
  - $2mm per year in FCF, highly profitable, minimal capital requirements

- Renovations: e.g. London Hilton, combined company’s most valuable hotel, was under-invested for years as part of Royal Host
  - Aiming to boost NOI from approx. $2.5mm to $4mm with $5.5mm to $6mm investment; at 9% cap rate, would lead to $17mm increase in property value

- Redevelopments: hotels sitting on valuable real estate that can accommodate additional buildings or whose highest and best use is not a hotel
  - Hired dedicated VP Development last year to pursue such projects

Case Study: Chimo Hotel

- Across street from St. Laurent Centre, largest mall in Ottawa and National Capital Region
  - Mall will be connected to Confederation Line light rail system under construction – one of largest infrastructure projects in Canada, expected to bring increased traffic and accessibility
- Hotel itself occupies less than half the property's six-acre lot
  - Footprint can be further reduced by replacing street-level parking with parkade
- Can accommodate existing hotel plus two mid-to-high rise apartments and two mid-rise office buildings
  - Company envisions partnering with larger real estate firm to minimize development risk

Insider Buying

Six insiders have purchased nearly 10% of Holloway on the open market since May; strong signal from those "in the know"

Insider purchases since May	1,887
Percent of shares outstanding	9.5%

Unadjusted FCF Multiple: Holloway vs. Public Peers (Temple Hotels and InnVest REIT)

	HLC	TPH	INN
Price	$5.00	$5.60	$5.65
Unadjusted FCF	$12.8	$20.7	$43.5
Shares	19.8	40.8	94.9
FCF per share	$0.65	$0.51	$0.46
P/FCF	7.7	11.0	12.3

Trades at one-third discount to peer average despite materially greater FCF upside given magnitude of opportunity at Royal Host

**Based on trailing reported AFFO (Canadian real estate companies' equivalent of FCF). For Holloway, only adjustment is inclusion of Royal Host's trailing AFFO. FCF and shares are in millions.*

Normalized FCF Multiple

Reported AFFO: HLC and RYL	$12.8
RYL synergies and standalone savings	3.0
Interest on acquisition debt	(1.0)
Acquisition transaction costs	0.6
CF of near-term RYL dispositions	(0.5)
FCF	$14.9
Per share	$0.75
Price	$5.00
Value of near-term RYL dispositions	(1.21)
Adjusted share price	$3.79
P/FCF	5.0

Calculation ignores opportunity for continued value creation (e.g. London Hilton reno, redevelopments) and for more shrewd acquisitions like Royal Host over time;
at its current price, Holloway will ultimately trade at low single digit FCF multiple

**Amounts in millions. Adjustments not tax-effected as Holloway does not pay taxes and will not do so for foreseeable future.*

FCF Multiple: Holloway Only

Trailing FCF (millions)	$11.8
Per share	$0.60
P/FCF	8.4

Ignoring Royal Host altogether, Holloway still undervalued at 11.9% FCF yield and 28% discount to peer multiples; market giving you Royal Host for less than nothing

Catalysts

- Inclusion of Royal Host results – takeover just closed in July
  - FCF will likely be much stronger than investors anticipate
  - Combination of cost cuts already achieved but not yet reflected in Royal Host's financials and additional standalone savings and synergies
- Divestiture of under-earning hotels
  - Should see several deals over next six months
  - Will unlock latent asset value, produce material FCF growth as proceeds are reinvested

Other Long-Term Opportunities

- Huge opportunity for continued acquisitions
  - Management targets expanding hotel portfolio from approx. 33 (post-dispositions) to 50 over time – would send FCF soaring
  - Hotel industry highly fragmented and management has proven its acquisition acumen
- Opportunistic share repurchases
  - E.g. bought back 4% of shares last year at average price of $3.57

Conclusion

Bargain valuation on absolute basis and relative to industry peers

Market missing enormous FCF growth and value creation potential stemming from Royal Host takeover

Incremental acquisitions beyond Royal Host will result in continued material growth for years to come

Investment Idea: Perpetual Energy Inc. (TSX: PMT)

Snapshot

Recent Price	Shares
$1.95*	162 million

Market Cap	Enterprise Value
$316 million*	$664 million*

All financial figures pertaining to Perpetual are in Canadian dollars

Background

- Heavily natural gas-weighted exploration and production (E&P) company – gas accounts for around 85% of production
- Stock has plummeted since 2011 due to gas price collapse and resulting dividend suspension
- Continues to trade more than 50% below 2011 levels
  - Even further below pre-crisis levels (priced over $20 at its highs)

Why is Perpetual Worth Your Attention?

- Valued at 3.7x and 2.6x estimated 2014 and 2015 funds flow, respectively*
  - Peer group median: 8.1x and 6.7x; Perpetual at 54%/61% discount
  - June asset sale executed at 8.0x

- Trades at enterprise value to flowing barrels of production of just $34,000
  - Compares to $84,000 peer group median (stock at 59% discount), $105,000 for aforementioned asset sale (68% discount)

- Reserve-based net asset value of $4.80 at 8% discount rate and $4.35 at 10%; both well over double current stock price

**Funds flow: commonly-used metric in Canadian E&P space approximating operating cash flow before changes in working capital*

Why is Perpetual Worth Your Attention?

- Cheap valuation despite expected funds flow growth of 45% this year and 40% in 2015
- Strong management and excellent capital allocation
- Multiple near-term catalysts that will address market's concerns about Perpetual and unlock significant value

Why is It So Cheap?

- Mistakenly perceived as being overleveraged
  - Several recent and upcoming near-term developments will alleviate any lingering doubts about balance sheet
- Small size: e.g. median market cap of coverage universe for BMO: $2.3bn, RBC: $1.4bn, TD: $2.9bn vs. Perpetual at $0.3bn
- Hidden assets: company has several assets producing no cash flow that are nonetheless highly valuable

Management and Capital Allocation

- Company controlled by Riddell family
  - Patriarch Clay Riddell is legendary in Canadian oil patch
  - Insider buying: CEO Susan Riddell Rose bought 2.2mm shares at average of $2.86 from 2008 to 2013

- Allocated capital exceptionally well amid difficult environment for gas prices and shares of gas-weighted Canadian E&Ps

- No equity offerings after stock price tanked despite difficulties raising capital through natural gas downturn*
  - In industry where share offerings are practically an afterthought, Perpetual did not dilute shareholders by issuing undervalued equity
  - Instead was willing to sell assets and shrink the company

**Last held equity offering in 2010 at $4.75 per share (close to 150% above current stock price)*

Capital Allocation Case Study: Edson

- Invested $120mm in 2010 and 2011 to acquire position in Wilrich liquids-rich gas play in Edson, Alberta
- Edson now accounts for vast majority of Perpetual's reserves
- Recently sold 50% interest in East Edson property in joint venture transaction for $120 million
  - Leaves company with half of East Edson, whose development and value will be greatly accelerated by the JV, plus existing stake in West Edson

Other Capital Allocation Examples

- Elmworth Montney (shale gas play)
  - Acquired in 2008, sold in 2013 primarily to raise capital to deploy into core Wilrich and Mannville (oil) assets
  - Bought for $19mm, minimal additional capital in ensuing years
  - Sold for $78mm – approximately 300% gain in five years
- Warwick (gas storage facility)
  - Began developing in 2009/2010; capital cost of $40mm*
  - Sold partial stake for $62mm net, remaining interest likely worth $40mm to $50mm
  - Also earning $1.5mm in annual management fees

*Net of forward gas sale arrangement executed to help fund Warwick's construction

Balance Sheet: Debt Fears Overdone

- Perceived overleverage a serious drag on stock price
- Leverage ratios swelled to excessive levels when gas prices collapsed, reducing cash flow while debt stayed constant
- Company had two classes of debentures maturing in 2015, raising concerns of equity dilution

Balance Sheet: Debt Fears Overdone

- Perpetual has dramatically reduced leverage ratios via combination of asset sales, investment in its high-return Wilrich and Mannville plays and rebound in gas prices
- Repaid one of its two 2015 debentures in July; additional asset sales in next few quarters will enable it to retire the other
    - Well over 90% of total debt will then have term into 2018 or later
- Secured first borrowing base increase in five years from its lenders earlier this year

Net Debt to Trailing Funds Flow

Cut key leverage ratio by 39% in past six quarters with another 44% expected in next six; 66% cumulative decline

	Actual				Estimated	
	2011	**2012**	**2013**	**Q2 2014**	**2014**	**2015**
Net debt	527	388	377	360	325	323
Funds flow	73	49	58	75	85	120
Debt/funds flow	7.2	7.9	6.4	4.8	3.8	2.7

Actual reduction will likely be even greater due to dispositions not incorporated into management's projections

**Amounts in millions. Net debt not adjusted for future proceeds on exercise of in-the-money stock options.*

Price to Funds Flow and EV per Flowing BOE: Perpetual vs. Peer Group (Gas-Weighted Junior and Intermediate Producers)

	Price to Funds Flow		**EV per Flowing BOE**	
	2014	**2015**	**2014**	**2015**
Perpetual	3.7	2.6	34	28
Peer group median	8.1	6.7	84	59
Discount	54%	61%	59%	52%

Peer metrics imply upside to current stock price ranging from 108% to 154%; in addition to being far below group median, Perpetual is also cheapest overall in both metrics for both years

**Peer group figures based on broker estimates. EV per flowing BOE (barrels of oil and oil equivalents) is in thousands.*

Cash Flow and Flowing BOE Multiples: Perpetual Stock vs. East Edson JV (Executed in June)

	Cash Flow Multiple	Flowing BOE Multiple
Stock price	3.7	34
East Edson JV	8.0	105
Discount	53%	68%

Edson JV transaction multiples imply upside to stock price of 115% and 209%, respectively

- **Flowing BOE multiple is in thousands*

Price to Proved and Probable (2P) Reserve-Based Net Asset Value Per Share

	Discount Rate	
	10%	8%
Price	1.95	1.95
2P reserve NAV	4.35	4.80
Discount	55%	59%

Implied upside based on proved and probable reserves of 123% and 146% at 10% and 8% discount rates, respectively

**2P reserve value determined by Perpetual's independent reserve evaluator*

Catalysts

- Significant additional asset sales this year and next at hefty premiums to consolidated valuation metrics
  - Will highlight stock's undervaluation, enable continued debt repayment
- Retirement of remaining class of 2015 debentures well ahead of maturity (December 31, 2015)
- Sizeable reserve growth will lead to material increase in borrowing base by early next year
  - Will allow Perpetual to pursue acquisitions and enter growth phase after multi-year preoccupation with balance sheet

Conclusion

Extremely cheap

Management with substantial ownership and record of strong capital allocation

Upcoming catalysts will highlight valuation discount and eliminate doubts about balance sheet