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HOTELS: SUITE NOTHINGS, OR SLEEP EASIES?

The local hotel industry is finally showing signs of life again after a few difficult years, with trends in occupancy and rates moving up with increasing momentum.

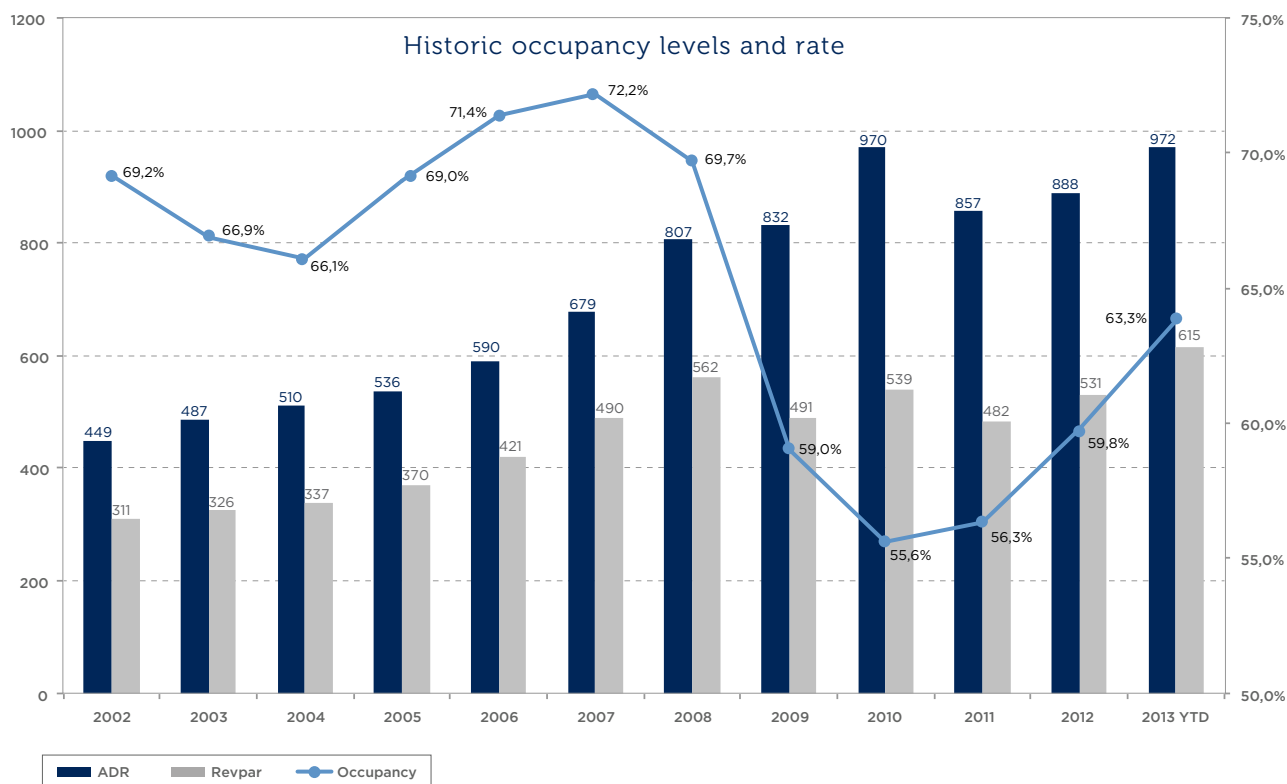
Although the major listed hotel operators, including City Lodge Holdings and Tsogo Sun Holdings, have shown marked improvements in hotel profitability in recent earnings announcements, we are yet to see significant new supply hitting the market. We question whether it is still too early.

Between 2008 and 2010, the number of hotel rooms available in South Africa increased from around 55,000 to 67,000 rooms; this was driven by a building frenzy as a result of consistent growth in demand from 2002 to 2008 and the anticipated jackpot that would be the 2010 FIFA Soccer World Cup. At a 60% occupancy level these additional rooms could provide accommodation for over 2.6 million guests per annum.

As a result of this expansion South Africa was faced with a glut of new supply, some of which was not even ready for the Soccer World Cup. This, combined with the global financial crisis and its effect on local business and consumer

confidence, resulted in the twin effect of increased supply and reduced demand that has hampered the industry since 2008. National hotel occupancy rates dropped from 70% in 2008 to 56% in 2011 with rates going backwards in real terms, as illustrated in the graph overleaf. In challenging times many hotels run at losses due to the large operating and financial (for some) leverage inherent in running a fixed-cost heavy operation.

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Occupancy and rates are linked to GDP growth and, more directly, to corporate spend on business travel, and thus a large portion of demand is cyclical in nature. We do, however, feel that there have been structural changes to demand. The Gautrain has changed the business travel dynamic, and made it easier for businesspeople to visit Johannesburg for a day trip; corporate entertainment and conferencing has taken on a less gratuitous nature in this current age of austerity, and we do not see this abating any time soon; and finally, improvements in technology have reduced the need to travel locally for business meetings.

Structural changes notwithstanding, the industry is firmly in recovery mode, driven by increased demand from big business and parastatals. We expect the next leg of growth to be driven by SMME's and the leisure market, which are still relatively subdued, with the latter being adversely effected by a strained consumer and events such as the 1time airlines bankruptcy and the resultant surge in domestic air ticket prices. Interestingly, demand is now back to all-time highs, albeit not on a GDP adjusted basis, while the increased supply still constrains occupancy levels and rate increases.

August 2011 was the first month showing a year on year

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increase in occupancy, and was the start of what is now considered a continued recovery in the industry, with every month since showing a year on year improvement. From January 2013, the data shows that hotel operators are now passing on rate increases well ahead of inflation, a key milestone and evidence that the recovery has gathered momentum. Although industry sources, including CEO's of the listed operators and property consultants, consider the recovery sustainable, is the strong recent data sufficient to start planning new hotels?

The cost of building a new hotel varies dramatically, as shown below. To illustrate the depressed state from which the industry is emerging, in April 2012 Tsogo Sun acquired "The Grace", a 5 star hotel in Rosebank which has been refurbished and reopened as "54 on Bath", at a cost per key of under R1m, less than half the estimated build cost. A newly built hotel can take up to two years to reach normalised occupancy levels; clearly there is an advantage to picking up distressed assets from over-burdened operators if they are in attractive locations.

Cost per key - new build	R'000
1 star	400-650
2 star	600-850
3 star	700-1100
4 star	1200-1500
5 star	2200+

For the lone operator relying on bank credit, it is still too early to start moving earth, as year to date national average occupancies of 63% are still too low for banks to consider lending again. Occupancy levels will have to revert to the key 68-70% level, with commensurate rate increases, for the credit taps to open. To run at these levels a business hotel such as a City Lodge, which is very quiet during the weekend, needs to run at close to full capacity from Monday to Thursday; this is no easy feat. We are still around 18 months away from these occupancy levels if the steady improvements since the latter half of 2011 are to continue and market participants are to be believed.

A basic industry heuristic is that to earn a "reasonable" return, a hotel that costs R1m per room to build would need to earn an average daily rate (ADR) of R1,000 and run at a 50% occupancy level. To determine whether the time is right to open more hotels, it is necessary to analyse the returns that could be expected at current occupancy and ADR levels. The table below illustrates a quick and easy calculation of returns on invested capital (ROIC) for a 3 star hotel such as a City Lodge or Garden Court, using current data and reasonable assumptions.

While Cape Town 3 star hotels have achieved very strong occupancy levels year to date, the room rate lags the national average, resulting in RevPar being insufficient to generate adequate returns. RevPar, or revenue per available room, is simply the average daily rate multiplied by the occupancy level, and is a proxy for hotel revenue. The returns delivered

	3 Star - Economy National average	3 Star - Economy Cape Town
Cost of build (R')	800 000	800 000
Average daily rate (R')	756	725
Occupancy (%)	61,4%	71,9%
RevPar (R')	464	521
Annual Room Revenue (R')	169 427	190 265
EBITDA margin	60%	60%
EBITDA (R')	101 656	114 159
Depreciation (R')	26 667	26 667
Operating profit (R')	74 990	87 493
Operating profit after tax (R')	53 993	62 995
ROIC	6,7%	7,9%

are clearly not attractive assuming a cost of capital around 12%. However listed hotel groups, with the bulk of their properties paid off and many hotels built years ago, are demonstrating their ability to generate rapidly improving profitability at these levels.

Inadequate potential returns are perhaps why the listed operators have, up to now, been focussing more on expansion into the rest of the continent. The growing African consumer story has been well documented, with local food and clothing retailers, brewers, logistics companies and fast-food operators all pushing aggressively north of our border. It seems reasonable then, that as companies further entrench their presence in these markets, the need for quality, affordable accommodation increases.

Our allocation to Tsogo Sun Holdings has been a core position in our equity funds and continues to add positively to performance.

In 2012 City Lodge Holdings made their first foray into the continent with the acquisition of a 50% share of two hotels in Nairobi. This was followed by the development of a Town Lodge in Gabarone and the announcement of a potential R2bn of spend in East and West Africa over the next five years. Tsogo Sun Holdings, who have for years operated five Southern Sun hotels on the continent, have also been active, announcing the purchase of their hotel in Lagos (previously managed), an expansion of their Maputo property and, most importantly, the opening of their first economy hotel in Africa, the StayEasy in Lusaka. A quality, recognisable budget offering is so far lacking in Africa, and we are bullish on the Group's potential to roll out more StayEasys across the continent.

Turning our attention back to South Africa, higher occupancy and room rates are clearly needed to drive new investment, and as a result timing remains uncertain. Industry whispers suggest that we are getting closer to seeing some announcements ahead of an anticipated normalised level of occupancy being reached over the next 18 months. The challenge may, however, become apparent if new hotels are announced as the industry reaches the top of the cycle, as these properties can take 2 to 3 years to build. The risk thus exists that we are faced with another flood of supply arriving ahead of the next mild cyclical downturn, the twin effects of which would once more be adverse for occupancies and rates.

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Tantalum MNC Fund						
Strategy	Multi-strategy, hedge					
Fund Objective	The fund is targeting above average real returns (8% to 12%) over the medium term at lower volatility than the market. Returns come from equity alpha on the long and short side, with yield enhancement from fixed interest, preference shares, hybrid instruments and listed property.					
Launch date	Jun-05					
AUM	R803m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	-1.82%	2.29%	6.28%	10.41%	12.09%	151.50%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	3.78%	3.52%	7.42%			
Tantalum Focus Fund						
Strategy	Multi-strategy, hedge					
Fund Objective	The fund is targeting above average real returns (10% to 15%) over the medium term at lower volatility than the market. Returns come from equity alpha on the long and short side, with yield enhancement from fixed interest, preference shares, hybrid instruments and listed property.					
Launch date	Nov-10					
AUM	R265m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	-1.96%	2.36%	6.00%	N/A	11.33%	33.13%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	4.53%	N/A	5.45%			
Tantalum Fusion Fund						
Strategy	Fixed Income, hedge					
Fund Objective	The fund is targeting cash + 2% returns over the medium term at lower volatility than the market. Returns come from fixed income alpha on the long and short side, with yield enhancement from preference shares, hybrid instruments and listed property.					
Launch date	Mar-06					
AUM	R57m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	0.93%	2.69%	7.72%	8.74%	8.81%	85.74%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	1.41%	1.77%	3.33%			
Tantalum Resources Fund (ZAR)						
Strategy	Resources, hedge					
Fund Objective	The fund is targeting 15%-25% over the medium term at lower volatility than the resources and commodity markets. The fund invests in a global portfolio of mining and energy equities, commodities and associated derivatives trading on the LSE, JSE, ASX, TSX and NYSE.					
Launch date	Mar-13					
AUM	R41m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	-7.28%	-8.33%	N/A	N/A	N/A	-8.33%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	N/A	N/A	22.59%			
Tantalum Global Resources Fund (USD)						
Strategy	Resources, hedge					
Fund Objective	The fund is targeting 10%-20% over the medium term at lower volatility than the resources and commodity markets. The fund invests in a global portfolio of mining and energy equities, commodities and associated derivatives trading on the LSE, JSE, ASX, TSX and NYSE.					
Launch date	May-12					
AUM	\$4.7m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	-10.66%	-13.04%	-10.90%	N/A	-10.12%	-11.71%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	10.47%	N/A	9.77%			
Tantalum Enhanced Cash Fund						
Strategy	Fixed Income, long only					
Fund Objective	The fund is targeting cash plus returns over the medium term. Returns come from fixed income alpha, with yield enhancement from preference shares, hybrid instruments and listed property.					
Launch date	Aug-10					
AUM	R302m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	1.05%	2.84%	7.78%	8.67%	8.93%	28.35%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	1.37%	1.58%	1.58%			
Tantalum Balanced Fund						
Strategy	Fixed Income, long only					
Fund Objective	A Reg 28 compliant fund which invests in a mix of domestic equities, bonds, property, commodities and cash where the asset allocation is tactically managed. Maximum net equity exposure is 75% and index derivatives may be used to reduce net equity exposure.					
Launch date	May-13					
AUM	R1m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	N/A	1.75%	N/A	N/A	10.96%	1.75%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	N/A	N/A	6.86%			