To: The McIntire Investment Institute Managers
From: Tian Zeng, CLAS, 2nd year
Subject: Short Proposal – Orient-Express Hotels Ltd. (OEH)
DATE: April 27th, 2008

Financial Statistics

Price:	**$46.07**
52 week high	**$65.36**
52 week low	**$39.19**
Market Cap:	**1.96B**
P/E	**59.1**
PEG	**1.63**
Short Interest	**5.03%**
Net Sales (2007)	$**578.41 Million**
Net Income (2007)	**$33.64 Million**
EPS (diluted)	**$0.78**
Total debt/equity	**1.03**

Introduction

The objective of this memo is to introduce Orient-Express Hotels Ltd (OEH) as possible short investment for the McIntire Investment Institute, as well to be a criterion for evaluating my candidacy for Short Fund Manager.

Business/Management Overview

Orient-Express Hotels Ltd is a hotel and leisure company that operates high-end hotels, cruises and train services around the world, and is incorporated in Bermuda. In 2007 it had 41 individual deluxe hotels, two restaurants, six tourist trains and two river cruise businesses in 25 countries. Hotels and restaurants represent the largest segment of OEH's business, contributing 80% of revenue at the end of 2007. Tourist trains and cruises accounted for 12% of revenue during 2007. Property development activities accounted for the remaining revenue 8%. The Company's worldwide portfolio of hotels consists of a total of 3,900 individual guest rooms that make up the many of its suites. Approximately 70% of Orient Express's customers are leisure travelers, the other 30% being business travelers. It has approximately 50% of customers in 2007 originating from the United States, 40% from Europe and the remaining 10% from elsewhere in the world. OEH focuses its business on providing quality concierge service. Most customers book in advance through phone calls, its website, as well as travel agencies. OEH exerts a lot of

efforts in retaining its very wealthy customers, but is moving toward serving the middle-upper class as well as the middle class.

# of hotels in Europe – 914 suites total
# of hotels in North American – 706 suites total
# of hotels in rest of the world – 919 suites total
2 restaurants in Manhattan
3 trains in England
1 cruise ship in Burma

Management

Name, Age	Position
Paul M. White, 43	President and Chief Executive Officer since August 2007
Filip J.M. Boyen, 49	Vice President–Operations since September 2007
Roger V. Collins, 61	Vice President–Design and Technical Services since 2001

Mr. White served as Vice President–Finance and Chief Financial Officer from September 2005 until appointed CEO in 2007. Previously, he was Vice President–Hotels, Africa, Australia and South America from 2000 to 2005, and was Director of Hotel Operations for the same geographical region from 1998 to 2000. He joined the Company's predecessor, Orient-Express Hotels Inc., in 1991 from Forte Hotels as Financial Controller.

Industry and Competitors

Sector: Services **Industry**: Lodging/Hospitality

Industry Statistics	
Market Capitalization:	30B
P/E:	17.8
Price / Book:	366.6
Net Profit Margin:	8.1%
Price To Free Cash Flow:	-26.0
ROE:	26.0%
Total Debt / Equity:	1.8
Dividend Yield:	1.2%

Lodging industry can be very dependent on the health of the economy. The top 5 firms include Marriot International (11.6B), Starwood Hotels (9.3B), Wyndham Worldwide (3.6B), Choice Hotels (2.1B), and Orient Express Hotels (1.8B), in order of market capitalization, totaling 28.5 billion in market cap. Aside from the hotel competitors, OEH also faces competitors in the restaurant, train & cruise industries.

Some of OEH's properties are located in areas where there are numerous competitors, some of which have greater resources than OEH has.

Competition for guests in the hospitality industry is based generally on the convenience of location, the quality of the property, room rates and menu prices, the range and quality of food services and amenities offered, types of cuisine, and name recognition. OEH's strategy is to acquire only hotels which have special locations or uniqueness. OEH tries to build its competitive advantage by offering high quality service and cuisine, usually with a local flavor.

Thesis Points for Shorting

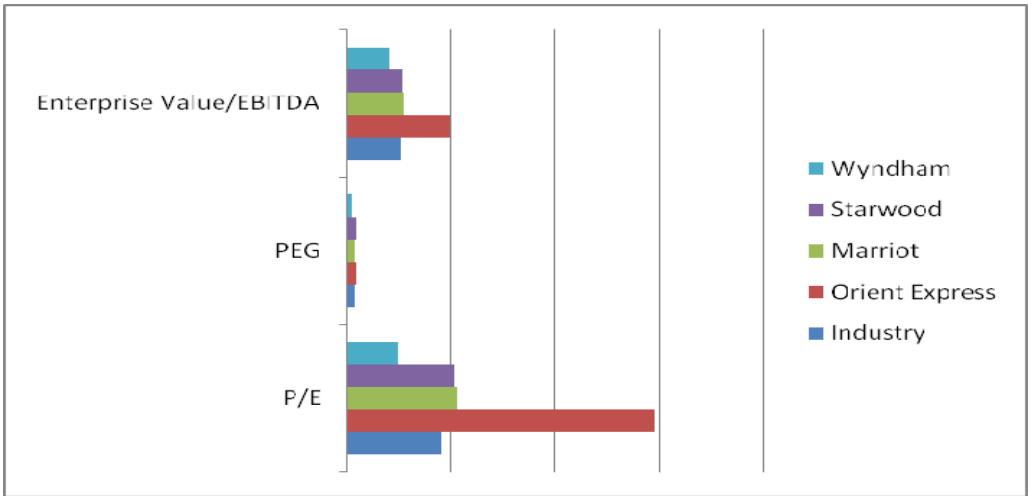
*Unwarranted Buyout Speculation

Buyout speculation has circled Orient Express since the past year, though the management has always stated that they have absolutely no interest in selling the company. The structure of the class shares gives management 80% voting rights. There was a failed buyout after management rejected an offer of $60/share from the Dubai holdings, as well an offer from Taj Hotels, part of the Tata Group for a 10% stake. Given the voting structure and the stubborn management, a buyout is almost impossible. In February, D.E Shaw obtained a 5.6% stake in with the goal to change the voting class structure and hopefully move toward a buyout for a bigger payday. SAC Capital group also holds a 22.5% stake, so does BlackRock with a 5.2% stake. These three hedge funds, making out 1/3 of the shares outstanding, are courting DLF group and Tata group as potential buyers for their stakes. The move by the hedge funds indicates that their previous motivation for buying the stake originally to change the thinking of the management failed, and has given up on further friendly buyout. There is a complicated shareholder structure in OEH in which it has two classes of shares: Class B shares are not traded, Class A shares are listed on stock exchanges, and these 2 different types of class shares have different voting rights. Orient-Express Holdings, an OEH subsidiary, holds the entire Class B shares, and therefore according to the company policies, enjoy an 81% voting power in OEH. Indian Hotels for example, holds 11.5% equity of Class A shares, but only has 2% voting rights. Also in the 10-k report, the manager specifically stated "OEH management plans to continue owning or part-owning and managing most OEH properties."

*Stock Valuation

OEH trades at a ridiculously high P/E (59.1x), and EV/Ebitda of over 20x. It is valued at over twice comparable companies based on common valuation methods. Industry P/E is about 20x while EV/Ebitda is around 10x. These valuations way too high compared to the OEH's growth rate. The valuations are too high at this point due to the continuing speculation of buyout.

	Industry	Orient Express	Marriot	Starwood	Wyndham
P/E	17.8	59.1	21	20.6	9.61
PEG	1.21	1.63	1.26	1.46	0.71
EV/EBITDA	10.14	19.72	10.72	10.5	7.79



Short interest rate is currently at 5.3% of the float. The short interest ratio which is the number of days it takes to cover the short position is at 3.2. This is very attractive considering that there are a decent number of people betting against OEH, but not too many to the point where the short interest ratio is too high and we can't cover short positions in time.

***Economic downturn and poor business model**

Despite the common perception that the stocks from high end & geographically diversified companies can hold up during an economic slowdown, I think OEH is actually more prone to be affected by the economic trends than its competitors. The majority of OEH's revenue comes from high-end leisure travelers, about 2/3 vs. business travelers, about 1/3. 50% of its customers come from the US, 35% from Europe, and 15% from the rest of the world. This shows that OEH still relies largely on the US for a big bulk of its business. Eventually, these fears should begin to be priced into the stock, and eventually begin to show in the operating results. The economic slowdown will hit the consumers on business travel significantly, and it makes up 1/3 of OEH's business. The wealthy class holds many of their assets in the equity markets as well, which has been hammered in the past 6 months. The very weak dollar makes the U.S customers much worse-off than previous years when the dollar was strong and when OEH had positive income. Therefore, even the wealthy can be affected by an economic downturn, even the managers acknowledged that that is the case. The following is pulled straight from the **10-k:**

"OEH benefits from trends and developments favorably impacting the global hotel, travel and leisure markets, including strong demand growth trends over the long term in the luxury hotel market in many parts of the world, increased travel and leisure spending by consumers, favorable demographic trends in relevant age and income brackets of U.S., European and other populations, and increased online travel bookings. **These trends suffered a setback beginning in 2001** ***due to slowing national economies***, the shock of

terrorist attacks, the build-up and aftermath of the wars in Afghanistan and Iraq and the SARS epidemic."

- For the fourth quarter, Orient-Express realized a net loss of $4.9 million compared with net earnings of $6.7 million in the prior year period. OEH attributed this to the conflicts in Burma that deterred tourists, and the poor performance of the hotel in New Orleans. This indicates that even with a geographically diverse business, if the performance of just a few of its many regions is not up to par, the earnings can be dramatically affected by it. OEH also has spent a decent amount of money on building more villas, resorts and condos for its real estate development venture. This was a trend or fad in the lodging industry, before the housing crisis hit the U.S as well as some of the other countries that OEH has invested in. Many lodging companies are stuck with condo and timeshares they can't sell. OEH has overbuilt in many markets, for example, condos in the St. Martin's. OEH has several existing properties could not sell, and for the upcoming years it will be hard for OEH to recoup its losses if it can't find a buyer for these properties. Though this has not been taken by the analysts, its competitor such as Starwood Hotels has suffered because its failed real estate endeavors. Although the real estate development accounts only 8% of total revenue, this part of the business will harm OEH more than it will contribute for many years to come.

When describing the competition and its competitive advantage in the 10-k, OEH has exposed some its weaknesses. The following is pulled straight from the **<u>10-k</u>:**

"**Some of OEH's properties are located in areas where there are numerous competitors, some of which have greater resources than OEH has**. Competition for guests in the hospitality industry is based generally on the convenience of location, the quality of the property, room rates and menu prices, the range and quality of food services and amenities offered, types of cuisine, and name recognition. **OEH builds its competitive advantage by offering high quality service and cuisine, usually with a local flavor**."

- The competitive advantage strategy doesn't make sense, since its competitors can do the exact same thing by offering high quality food, and local restaurants have better advantage in offering local food than OEH. Since the hospitality industry is one of the most competitive industries, this competitive advantage isn't very sound or at least sustainable in the long run because competitors can recreate this experience at their own hotels, especially if they have greater resources than OEH.

Also from the 10-k

"Described below are only the risks OEH management considers to be the most significant. There may be additional risks that are deemed less material or not presently known to management. If any of these risks occurs, OEH's business, prospects, financial

condition, results of operations or cash flows could be materially adversely affected. A risk that might have a material adverse effect means that the risk may have one or more of these effects. **In that case, the market price of the Class A common shares could decline**. Some of these factors include:

1. cyclical downturns arising from changes in general and local economic conditions and business activities, which impact levels of travel and demand for travel products,

2. political instability of the governments of some countries where OEH properties are located, resulting in depressed hotel demand,

3. less disposable income of consumers and the travelling public,

4. increases in operating costs at OEH properties due to inflation and other factors which may not be offset by increased revenues, and changes in costs of materials,

5. foreign exchange rate movements impacting OEH's revenues and costs,

6. seasonality, in that many of OEH's hotels and tourist trains are located in the northern hemisphere where they operate at low revenue or close during the winter months."

- Every one of these potential risks listed by OEH's own management has happened, cyclical downturns, political instability because many of its foreign hotels, safaris, villas are in developing countries, less disposable income due to the downward stock market, increase in food prices that could cost its restaurant business, weak dollar, and the trains can't even run in the winter because they are all in the northern hemisphere.

Risks to Shorting

Management's change of heart

Even though it is most likely that the management will reject any buyout offer since it has 80% voting rights even after the hedge funds decided to make a friendly approach through obtaining percentage of the OEH, the management can use the company policies and Bermudan laws protecting it to fight off any hostile takeover. The main concern for me would be that somehow the management had a change of heart, and decided that OEH is unsustainable in the long run without a buyout, then the stock price will increase dramatically on the buyout. Though I still think this is highly unlikely.

Short interest percentage decrease

The newest published short interest rate, which is usually published mid month each month, shows that the short interest has decreased over 20% from 2.06 million shares on short to 1.66 million, mostly due to investors pulling out in the speculation of a

buyout. The stock price went up 8% on Thursday the 24th due to the speculation and the average daily volume Thursday increased 60%.

Value Added Research

For my VAR, I focused on these following questions:
(1). How does the economic downtrend affect the high-end hotel hospitality industry, specifically OEH?
(2). What is OEH's competitive advantage and is it sustainable against its competitors?
(3). What is are some major factors that would induce a drop in the OEH's stock price in the near future?

My VAR contacts include senior research analyst Dr. Gary Wu at Legg Mason Capital Management; Commerce School graduate/former long-fund manager of MII Edmond Darmawan who currently works for JPMorgan; Mr. Mesiah Smith, manager at Keswick Hall located in Charlottesville, one of the hotels of Orient Express; last but not least Mr. Kevin Lo of entertainment division at Russell Investments.

Dr. Gary Wu holds his PHD from Columbia University and has worked at Legg Mason Capital Management for many years. He has graciously taken time out of his busy schedule to discuss OEH over lunch when I drove to Baltimore to tour the LMCM building and its business operations. Dr. Wu believes when it come to shorting stocks, other than the valuation metrics, one key thing is a "catalyst".

He said: "There needs to be near term catalyst events to trigger a down turn in stock price. These events could include an **earning miss**, **a rejection by some regulatory authority**, or other types of events. As shorting a stock has unlimited theoretical downside, and only 100% maximum gain, you often can't afford to wait long for the stock to work in your favor. Many bubbles can keep going for a long time even with high valuations and your short can get killed in the process. So for all the short sellers, having high conviction that multiple catalyst events could turn the stock downward is the key."

OEH's earning miss has already happened in the 4th quarter of 2007, attributed to Burma and New Orleans, which at the same time reveals the vulnerability of OEH's hotels in developing countries that are prone to political unrest. The rejection of multiple buyouts before by the management indicates that the management will do the same this time around, as hedge funds have given up their hope for payday on the buyout. The research on OEH has shown that recent events have convinced me that these "catalyst" events will turn the stock downward.

Mr. Edmond Darmawan graduated UVA's Commerce School last year and was a long-fund manager/Chief Information Officer of MII who now works at JPMorgan. He emphasized on the concerns about the weakness of the dollar as well as the political instability in many countries where OEH operates hotels and resorts. He said given 50% of OEH's customers are from the U.S, the weakness of the dollar definitely discourages U.S travelers to take leisure vacations abroad in countries where the exchange rates have hammered U.S tourists. He also believed that one of the biggest threats of the OEH business as a whole is that, even though OEH has diversified its business geographically,

many of its hotel resorts are in countries in South East Asian and Africa, where many political unrests can put an end to OEH's business there.

Mr. Mesiah Smith is a manager at Keswick Hall, which is located about 10 miles from UVA in Louisa County. Keswick hall is one of the OEH's hotels and has 48 suites and 400 acres, though some are being sold to private land developers. I first drove there, but the manager was not in and I talked to a girl in the front desk for a little bit. I called a couple of days later to the phone number provided and finally had the chance to ask Mr. Mesiah Smith a few questions. Mr. Smith mentioned about the business model of expanding its business to middle-upper class and middle-class to fill the rooms, especially on Mondays and Tuesday where the business is very slow and the rooms are empty. He believes that the competitive advantage of OEH is its personalized service such as concierge. He also believes that the size of OEH over its competitors is advantageous.

I'm very thankful for Mr. Smith for providing the information. If OEH (at least OEH's Keswick Hall) is to expand its business toward middle-upper and middle class customers, it has a tremendous negative effect on OEH, since these customers have more disposable income and are more prone to economic downtrends than upper-class customers, decreasing some important statistics in hotel industries such as revenue/room. This would be a move away from its original business model, and I see this change to have a negative effect on OEH in the near future. I also became a bit skeptical when he mentioned about rooms not being filled very much on Mondays and Tuesdays.

Finally, based in Seattle, Mr. Kevin Lo is a recent graduate of Wharton and is currently a portfolio manager at Russell Investments that provides data such as the Russell 3000 index. He said: "wealthy people do get hurt from the overall downturn of the markets as you've mentioned that wealthier people tend to have a lot of stock. A more legitimate concern is what is happening to the wealthy's short term investments which may be more correlated with the amount of short term disposable income they have. For example, hedge funds have been predominately closed to wealthy individuals and they have been hit quite hard lately. This may be a good reason for why one can expect more frugal spending patterns. The weak dollar also affects tourism outside the US in general."

Mr. Lo's point about the disposable income of the wealthy is one of the very important points that affect high-end markets. Although the wealthy do have long term retirement fund, they are not as disposable as the money they put into hedge funds that have been hit pretty hard lately, thus decreasing the average disposable income of the high-end customers. Mr. Smith mentioned earlier that OEH tend to target people with a median income of **$120k**, which I think many of OEH's less-wealthy (but still well-off) customers are affected by the current economic downtrend.

Conclusion & entry/exit points

Orient-Express represents an over-valued company that lacks good business model. The thesis on the speculation, valuation, economic downturn and the business model will all contribute to the falling of the share prices in the future. Since the stock is way overvalued compared to the industry and its competitors, we can even overlook many of the economic, business factors and play market neutral similar to the 3 furniture pair plays that MII has made very good returns in the past few weeks, if we can find a

undervalued stock in the lodging/hospitality industry to go long with. I think a good entry point would be now at $46.07, and although I did not do a DCF, I think $35 is a good price to exit at.

Ideas for MII

- Update the website more often, such as the YTD portfolio in PDF format (last time this file was updated was March 6th as indicated on the file).
- After the managers evaluate the presentations from analysts, it would be better if the managers can announce to the members before each meeting whether the stock was selected into the portfolio or not and the reason for it (especially if it was not selected), so that we can learn some of the factors that make stocks attractive or unattractive to MII portfolio. (for example, the market neutral pair trade with Hooker Furniture and Stanley Furniture)
- Provide brief market news that is relevant to the MII portfolio, such as news that impacted stocks in MII portfolio.
- I feel that we should be a little bit more conservative in closing out long positions to make realized gains as opposed to many of our longs that are unrealized paper gains.