

Sell Recommendation

March 18th, 2003

Checking out of FS & Hotel Industry

- Low margins and costs increasing:**
 Motion to sell due to earnings and growth decline, a problem compounded by increasing costs due to expenses that are not controllable by FS. Company increasing supply of hotels and resorts worldwide, which will dramatically increase costs while adding little to the bottom line due to low demand.
- The Lodging industry is a bad investment altogether:**
 Right now and for the foreseeable future the lodging, tourism, and travel industries are not expected to make rapid recoveries; the decade low occupancy rates have especially affected higher-end properties.
- Decrease and achieve desired portfolio weights:**
 FS is a prime candidate to sell in order to decrease the portfolio equity exposure and maintain the forecasted consumer discretionary sector weights; freeing up cash to invest in stocks with less cyclical risk
- Valuation results conclude insufficient Free Cash Flows:**
 Last year FS posted positive FCF's through the sale of PP&E. This year, without such revenue, the firm has negative FCF and would need approx. \$133 million to achieve it's current share price of \$27.

COMPANY SNAPSHOT:

Four Seasons Hotels Inc. manages 54 luxury hotel and resort properties and two Residence Clubs containing approximately 15,184 guest rooms and fractional units. These properties are operated primarily under the Four Seasons and Regent brand names, in principal cities and resort destinations in 25 countries in North America, Europe, Asia, the Middle East, Australia, the Caribbean and South America. In addition, 24 hotel and resort properties to be operated under the Four Seasons brand name are under construction or development in a further nine countries around the world. Thirteen of these new hotels and resorts include a Residence Club or other residential component. The Company's goal is to offer business and leisure travelers the finest accommodation in each destination it serves.

Source: WSJ.com



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Share Price (03/14/03) \$27.00
 52 week range \$25.26 - \$57.50

Key Numbers & Ratios:

		Industry
Shares Outstanding	35.20	
Market Cap. (mill)	921.89	
Beta	1.33	

Earnings:

EPS	\$0.68	
EPS (fully diluted)	\$0.44	
1yr growth rate (%)	(57.00)	
5yr growth rate (%)	17.90	

Valuation:

Price/Book	1.91	1.53
Price/Sales	5.27	1.32
P/E Ratio	69.10	12.90
PEG	3.86	

Operations:

ROA	2.40	3.48
ROE	2.90	10.34

Financial Strength:

Current Ratio	6.09	0.78
Debt/Equity	0.16	1.54
Dividends yield	0.27	1.64

Sources: Yahoo!, WSJ.com, Multex

Industry Evaluation

In a post 9/11 era, the travel industry is still recovering and will continue an attempt to recover in 2003. With much fear of uncertainty as war looms in the future and possible future terrorist attacks, travel is down. The decrease in travel is more apparent with the business traveler rather than the leisure traveler. This slow down has led to a predicted occupancy rate of 59.5%, the lowest in over a decade. More expensive, higher-end properties have not held up to the challenge as well as limited service hotels have. Since air travel is down, it is the travelers by other forms of transportation that have kept the lower end hotels in a better position. Now travelers are much more price sensitive and expectant of deeper discounts. As a result the industry will have a difficult time recovering from these discounts in the future. A slow down in capital expenditure is expected as lenders are more reluctant to give out loans to hotel chains after a large building boom between 1986 - 2001.

Source: Standards and Poor

2002 in Review

Profits down across the board, major asset impairment charges, increasing litigation and terrorism.

In 2002, Four Seasons as a company only made C\$.61 a share as compared to C\$2.48 a share in 2001. Total Revenues in 2002 were C\$285 million versus 2001 revenues of C\$303 million. Total net earnings were only C\$21 million in 2002 down from C\$86 million in 2001. Worldwide, "average room revenue per available room" was down 1.9% and gross profits were down 7.7%. Four Seasons generates revenues from two main operating activities of management and ownership operations. In management operations Four Seasons does not have any equity or ownership in the hotel but staffs and runs the hotel for its owner and receives fee revenues in exchange. In 2002, fee revenues were down 8% to C\$147.9 million and incentive fees were down 16.5% to C\$25.1 million. The profit margin in management operations dropped from 59.3% in 2001 to 55.4% in 2002. As the name suggests, in ownership operations Four Seasons actually owns part of the hotel in addition to managing it. In 2002, Four Seasons lost C\$19.6 million from ownership operations, which was an increase from the 2001 loss from ownership operations of C\$10.2 million. The company tries to maintain only minority positions of ownership of less than 20% to mitigate its exposure to hotel ownership. Its greatest losses in hotel ownership in 2002 were related to its hotels in New York, Berlin and Toronto where Four Seasons has 100% ownership.

Due to a lack of improvement in tourism in Australia, Four Seasons does not expect to recover its full C\$45.5 million investment in its hotel in Sydney and therefore took a C\$7 million asset impairment charge in 2002 relating to this investment. Four Seasons also took a C\$16.1 million asset impairment charge relating to the Four Seasons hotel in Caracas due to the owner's default on a loan and his inability to complete construction and generate enough working capital to run the hotel. This reduced Four Seasons' investment in the hotel to zero and currently the hotel is closed until the litigation is settled. Four Seasons is also in litigation with the owner of the Four Seasons Hotel in Seattle who claims he can sell the hotel without Four Seasons consent. In 2002, Four Seasons spent C\$1.8 million in legal fees related to these two issues and expects to incur another C\$4 to 5 million in 2003.

Four Seasons' two hotels in Bali had severe decreases in business after a terrorist bombing occurred there in October. Travel is expected to continue to be light in this area due to the number of posted travel warnings.

2003 and the Future

Four Seasons future profitability dependent on factors it cannot control.

Four Seasons expects business and leisure travel to increase when the world economy turns around. The only problem is that no one knows when this will be. Demand is expected to remain flat for 2003 and Four Seasons expects losses in ownership operations to be higher in 2003 than they were in 2002. Costs such as employee benefits, energy and insurance will continue to increase and the war in Iraq and the threat of terrorism will negatively impact Four Seasons earnings for 2003. In other words, Four Season profitability is basically dependent on factors which it cannot control. It is also not possible to accurately forecast or predict the financial impact of these factors on Four Seasons.

In light of all of this Four Seasons can only hope for the best and continue to follow its long-term plan, which basically centers on maintaining room rates. Four Seasons claims that it has generally been able to maintain room rates established in 2000, which were the highest ever established by the company, over the past two years without sacrificing market share to competitors. Additionally, Four Seasons is expanding the number of hotels it runs and owns all over the world. In the past two years it has opened 10 new hotels and resorts worldwide and expects to open an additional six this year and another 15 by 2006. That is a total of 31 new hotels and resorts over a six-year period.

From an outsider's point of view we find it very doubtful that Four Seasons can maintain its high room rates in the current economic conditions. The addition of 31 new properties seems very excessive given the current low demand for luxury hotels and resorts. These new additions were probably planned during the buoyant and excessive years of the 1990's and therefore may have been based on the 1990's demand for luxury hotels and/or are the by product of that time periods' over exuberance by firms for capital investments. These new properties will probably add very little to the bottom line in the coming years will increase costs dramatically. In addition, Four Seasons return to higher profitability is basically dependent on factors beyond its control. In the short we see costs for Four Seasons to continue to rise while demand will remain relatively flat.

Source: Four Seasons Hotel 2002 un-audited annual report

Competitors and Comparables

Four Seasons Comparables Evaluation:

Ratio Comparison		Four Seasons	Fairmont Hotels	Starwood	Marriot Int'l	Industry	S&P500
Earnings Per Share	2001	\$1.49	\$11.49	\$0.73	\$0.92		
	2002	\$0.61	\$1.17	\$1.16	\$1.10		
	2003 est.	\$0.68	\$1.04	\$0.94	\$1.85		
Valuation Ratios							
P/E Ratio	2001	36.1	n/a	39.7	42.3		
	2002	41.3	n/a	24.6	20.9		
	TTM	69.1	17.19	19.94	17.35	18.1	17.5
Beta		1.28	n/a	0.73	0.83	1.19	1.00
Growth Rates							
EPS 5yr. Growth Rate (est.)		17.90%	14.60%	14.50%	14.40%	14.40%	8.00%
Cap-Ex 5yr. Growth (avg.)		48.34%	nm	-2.01%	-10.90%	-1.07%	-11.86%
Management Effectiveness							
ROI (ttm)		2.31%	5.22%	2.41%	6.57%	4.22%	10.18%
ROI 5yr. Avg		12.48%	n/a	-0.04%	7.10%	3.60%	12.28%
Financial Strength							
Debt / Equity		0.16	0.24	1.11	0.43	1.54	0.97
Dividend Yield		0.30	0.20	3.40	0.90	1.64	2.34

Source: Multex Investor

Four Seasons is a comparatively good company in some aspects but the main argument here is that FS and the Lodging industry altogether are bad investments, mostly due to high cyclical risk. There are other good stocks in the consumer sector that can spare us exposure to such high cyclical risk. When examining the numbers, one of the more conspicuous deficiencies of Four Seasons comes in the category of return on investment (ROI). ROI measures the performance of the overall business, apart from variations on how an individual company chooses to work with long-term liabilities (which influence return on equity) or short-term liabilities (which influence return on assets). The time series trend (ttm vs. 5yr. average) on ROI for FS shows weakened demand and a poor economy have impacted investment returns, and with our negative outlook on the market for the relevant time horizon there isn't a good opportunity for rapid improvement. Furthermore, FS dividend yield is below average, which negatively impacts the earning potential for the portfolio as a whole. FS also has an unusually low debt-to-equity number, which could signal that the firm isn't utilizing the tax advantage of funding projects with debt. Four Seasons beta is high when compared against its top competitors, but near average for the industry – which tells us that FS and the industry might contain too much cyclical risk. When looking at the average capital expenditures over the last 5 years we see that Four Seasons has made tremendous investments – most likely as a part of the large building boom the many hotel chains experienced from 1986-2001. This spending may be impacting the company now that travelers are staying home; resulting in low occupancy rates at the many new properties. This factor combined with a reduction in base management fees, which is the contributing factor in the decline in management fee revenues, along with other earnings difficulties are affecting the Price-to-Earnings ratio of Four Seasons – which is obviously deficient when compared across the board. Finally, as the chart at right shows, other analysts following the stock have all recommended a hold or sell, with some moving from hold to strong sell in recent months.

Recommendations	Current	1 Month Ago	2 Months Ago	3 Months Ago
Strong Buy	0	0	0	0
Moderate Buy	0	0	0	0
Hold	5	5	6	6
Moderate Sell	2	2	2	2
Strong Sell	4	4	3	3
Mean Rec.	3.91	3.91	3.66	3.66

Source: CNBC

Valuation | DCF & Method of Comparables

Discounted Free Cash Flow Valuation:

Free Cash Flows	2002	2001
BIT	\$16,549	\$66,653
Times (1-T)	\$12,577	\$50,656
Plus depreciation	\$9,940	\$10,882
Minus capital expenditures	(\$20,827)	(\$6,458)
Minus change in NWC	(\$12,926)	(\$4,143)
CF	(\$11,236)	\$50,937

Assumptions			
Risk-Free Rate	1.5%	Debt	86.466
Market Risk Premium	6.5%	Equity	921.888
Beta	1.33	W _d	0.09
R _e	10.15%	W _e	0.91
R _d	4.0%	WACC	9.54%
5yr. Growth Rate	17.9%		
Long-Term Growth	5%		

Cash Flows:	0	1	2	3	4	5
FCF Est.	133	156.807	184.9	218.0	257.0	303.0
Total of Cash Flows	133.0	143.2	154.2	166.0	178.7	4676.6

Valuation Computations	
Firm value 12/31/02	5319
Existing Debt	86.466
Implied Equity	5232.2
No. of Shares	197.7
Value/share	26.47
three months FV	27.07

Four Seasons has negative free cash flows during the year 2002 due to lower than normal cash from operation and higher than normal capital expenditures. During the 2001 year the firm had higher free cash flows due to a fairly large disposal of hotel properties. In order for Four Seasons to have achieve a free cash flow valuation of its \$27.00 stock price, the valuation requires them to have approximately 133 million dollars in free cash flows for the year 2002. This number would be impossible for Four Seasons to achieved even without the unusual low cash from operations and high capital expenditures. We have used the quoted five year growth of 17.9% (CNBC) which we also feel is too generous given current industry outlooks. We do not feel that Four Seasons will be able to produce free cash flow numbers within the next two or three years and therefore feel that the company is overvalued.

Method of Comparables Valuation:

P/E Ratio Valuation -

Four Seasons EPS x Industry P/E Ratio:

$$\$0.68 \times 12.90 = \$8.77$$

Price/Sales Valuation -

Four Seasons Revenue/Share x Industry Price/Sales Ratio:

$$\$5.12 \times 1.32 = \$6.76$$

Price/Cash Flow Valuation -

Four Seasons CF/Share x Industry Price/CF Ratio:

$$\$0.70 \times 7.50 = \$5.25$$

Four Seasons Hotels, Inc. | Financial Statements

note: These Financial Statements were originally presented in Canadian Dollars. We have listed the values in U.S. Dollars to allow ease of viewing and analysis. The numbers were converted at an exchange rate of $S^{C/\$} = 0.67$.

Balance Sheet

	2002		2001	
	Canadian	U.S.	Canadian	U.S.
Assets				
Current Assets				
Cash & cash equivalents	\$165,036	\$110,574	\$210,421	\$140,982
Receivables	\$85,594	\$57,348	\$78,450	\$52,562
Inventory	\$2,609	\$1,748	\$3,074	\$2,060
Prepaid Expenses	\$4,718	\$3,161	\$2,492	\$1,670
Total	\$257,957	\$172,831	\$294,437	\$197,273
Long-Term Assets				
Long-Term Receivables	\$207,106	\$138,761	\$201,453	\$134,974
Investments in hotel partnerships	\$146,362	\$98,063	\$141,005	\$94,473
Fixed Assets	\$74,593	\$49,977	\$50,715	\$33,979
Investment in management contracts	\$222,835	\$149,299	\$201,460	\$134,978
Investment in trademarks	\$6,329	\$4,240	\$33,784	\$22,635
Future income tax assets	\$17,460	\$11,698	\$17,745	\$11,889
Other assets	\$37,982	\$25,448	\$39,782	\$26,654
Total	\$970,624	\$650,318	\$980,381	\$656,855
Liabilities & Shareholders Equity				
Current Liabilities:				
Accounts Payable & Accrued Liabilities	\$40,362	\$27,043	\$50,813	\$34,045
Long-term obligations due within one year	\$2,668	\$1,788	\$1,188	\$796
Total	\$43,030	\$28,830	\$52,001	\$34,841
Long-Term Obligations				
	\$126,386	\$84,679	\$118,244	\$79,223
Shareholders Equity				
Capital Stock	\$321,601	\$215,473	\$319,460	\$214,038
Convertible Notes	\$178,543	\$119,624	\$178,543	\$119,624
Contributed Surplus	\$4,636	\$3,106	\$4,784	\$3,205
Retained Earnings	\$264,016	\$176,891	\$285,619	\$191,365
Equity adjustment from foreign currency	\$32,412	\$21,716	\$21,730	\$14,559
Total Shareholders Equity	\$801,208	\$536,809	\$810,136	\$542,791
Total	\$970,624	\$650,318	\$980,381	\$656,855

Income Statement

	2002		2001	
	Canadian	U.S.	Canadian	U.S.
Consolidated Revenues	\$284,674.00	\$190,731.58	\$303,106.00	\$203,081.02
<u>Management Operations</u>				
Revenues	\$147,894.00	\$99,088.98	\$160,672.00	\$107,650.24
General & Admin. Expenses	(\$65,903.00)	(\$44,155.01)	(\$65,416.00)	(\$43,828.72)
<u>Ownership Operations</u>				
Revenues	\$141,290.00	\$94,664.30	\$147,500.00	\$98,825.00
Distributions from hotel inv.	\$1,321.00	\$885.07	\$1,510.00	\$1,011.70
Expenses:				
Costs of sales and expenses	(\$156,374.00)	(\$104,770.58)	(\$152,663.00)	(\$102,284.21)
Fees to Management Op.	(\$5,831.00)	(\$3,906.77)	(\$6,576.00)	(\$4,405.92)
	(\$19,594.00)	(\$13,127.98)	(\$10,229.00)	(\$6,853.43)
Earnings before other op. items	\$62,397.00	\$41,805.99	\$85,027.00	\$56,968.09
Depreciation & Amortization	(\$14,837.00)	(\$9,940.79)	(\$16,242.00)	(\$10,882.14)
Other Income (net)	(\$22,860.00)	(\$15,316.20)	\$30,698.00	\$20,567.66
EBIT	\$24,700.00	\$16,549.00	\$99,483.00	\$66,653.61
Interest Income	\$3,235.00	\$2,167.45	\$6,740.00	\$4,515.80
Earnings before taxes	\$27,935.00	\$18,716.45	\$106,223.00	\$71,169.41
Income Tax Recovery				
Current	(\$5,743.00)	(\$3,847.81)	(\$15,711.00)	(\$10,526.37)
Future	(\$1,118.00)	(\$749.06)	(\$3,087.00)	(\$2,068.29)
Reduction of future tax assets	\$157.00	\$105.19	(\$939.00)	(\$629.13)
Net Earnings	\$21,231.00	\$14,224.77	\$86,486.00	\$57,945.62
Basic earnings per share	\$0.61	\$0.41	\$2.48	\$1.66
Dilluted earnings per share	\$0.59	\$0.40	\$2.27	\$1.52

Cash Flow

	2002		2001	
	Canadian	U.S.	Canadian	U.S.
Operations				
Management Operations				
Earnings before other operating items	\$81,991	\$54,934	\$95,256	\$63,822
Items not requiring an outlay of funds	\$1,805	\$1,209	\$1,430	\$958
Working Capital Provided	\$83,796	\$56,143	\$96,686	\$64,780
Ownership Operations				
Earnings before other operating items	(\$19,594)	(\$13,128)	(\$10,229)	(\$6,853)
Items not requiring an outlay of funds	\$0	\$0	\$2,604	\$1,745
Working Capital Provided	(\$19,594)	(\$13,128)	(\$7,625)	(\$5,109)
Total	\$64,202	\$43,015	\$89,061	\$59,671
Interest received	\$12,373	\$8,290	\$17,898	\$11,992
Interest paid	(\$791)	(\$530)	(\$9,939)	(\$6,659)
Current Income tax paid	(\$10,374)	(\$6,951)	(\$17,784)	(\$11,915)
Change in non-cash working capital	(\$19,293)	(\$12,926)	(\$6,183)	(\$4,143)
Other	(\$4,354)	(\$2,917)	\$2,457	\$1,646
Cash Provided by Operations	\$41,763	\$27,981	\$75,510	\$50,592
Investments				
Long-term receivables	(\$28,893)	(\$19,358)	(\$23,348)	(\$15,643)
Hotel Investments	(\$9,451)	(\$6,332)	(\$22,088)	(\$14,799)
Disposal of Hotel Investments	\$4,566	\$3,059	\$88,629	\$59,381
Purchase of Fixed Assets	(\$31,085)	(\$20,827)	(\$9,639)	(\$6,458)
Investments in trademarks, etc.	(\$1,598)	(\$1,071)	(\$8,212)	(\$5,502)
Other assets	(\$7,809)	(\$5,232)	(\$6,319)	(\$4,234)
Cash used by investments	(\$74,270)	(\$49,761)	\$19,023	\$12,745
Financing				
Long-Term Obligations	\$1,139	\$763	(\$102,858)	(\$68,915)
Issuance of shares	\$5,653	\$3,788	\$2,820	\$1,889
Repurchase of shares	(\$16,495)	(\$11,052)	\$0	\$0
Dividends Paid	(\$3,639)	(\$2,438)	(\$3,625)	(\$2,429)
Cash used in financing	(\$13,342)	(\$8,939)	(\$103,663)	(\$69,454)
Decrease in cash	(\$45,849)	(\$30,719)	(\$9,130)	(\$6,117)
Increase due to unrealized foreign exchange gain (loss)	\$464	\$311	\$1,451	\$972
Cash beginning of period	\$210,421	\$140,982	\$281,100	\$188,337
Cash end of period	\$165,036	\$110,574	\$210,421	\$140,982