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Marriott Vacations Worldwide Corp. (VAC)

Q2 2014 Earnings Call

CORPORATE PARTICIPANTS

Jeff Hansen
Vice President-Investor Relations, Marriott Vacations Worldwide Corp.

Stephen P. Weisz
President, Chief Executive Officer & Director, Marriott Vacations Worldwide Corp.

John E. Geller
Chief Financial Officer & Executive Vice President, Marriott Vacations Worldwide Corp.

OTHER PARTICIPANTS

Steven E. Kent
Analyst, Goldman Sachs & Co.

Christopher James Wallace Agnew
Analyst, MKM Partners LLC

MANAGEMENT DISCUSSION SECTION

Operator: Greetings, and welcome to the Marriott Vacations Worldwide Second Quarter 2014 Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Jeff Hansen, Vice President, Investor Relations. Thank you. You may begin.

Jeff Hansen
Vice President-Investor Relations, Marriott Vacations Worldwide Corp.

Thank you, and welcome to the Marriott Vacations Worldwide Second Quarter 2014 Earnings Conference Call. I'm joined today by Steve Weisz, President and CEO; and John Geller, Executive Vice President and CFO.

I do need to remind everyone that many of our comments today are not historical facts and are considered forward-looking statements under federal securities laws. These statements are subject to numerous risks and uncertainties, as described in our SEC filings, which could cause future results to differ materially from those expressed in or implied by our comments. Forward-looking statements in the press release that we issued this morning, along with our comments on this call, are effective only today, July 24, 2014, and will not be updated as actual events unfold.

Throughout the call, we will make references to non-GAAP financial information. You can find a reconciliation of non-GAAP financial measures referred to in our remarks in the schedules attached to our press release, as well as the Investor Relations page on our website at ir.mvwc.com.

I will now turn the call over to Steve Weisz, President and CEO of Marriott Vacations Worldwide.

Stephen P. Weisz

President, Chief Executive Officer & Director, Marriott Vacations Worldwide Corp.

Thanks, Jeff. Good morning, everyone, and thank you for joining our second quarter earnings call. This morning, I'll begin with a walkthrough of our second quarter results and where we stand relative to our current initiatives and strategies. I'll then turn the call over to John to provide a more detailed view of our second quarter performance and our outlook for the rest of the year. We'll then open the call for your questions.

Our business in the second quarter performed exceptionally well, as demonstrated in virtually all of our key metrics and we continue to make progress on our strategic initiatives. Adjusted EBITDA improved almost 20% to $57 million, driven by roughly 7 percentage points of improvement in our adjusted development margin, a 5.3% improvement in our VPG, and a 33% improvement in the results of our resort management business.

In addition, we continue to generate strong cash flow, and as a result, are increasing the midpoint of our full year free cash flow guidance by $45 million. I'm also pleased to report that we have already returned nearly $110 million to our shareholders this year through our stock repurchase program.

Total company contract sales, excluding residential sales, increased $8 million to $164 million, 5% over the second quarter of 2013, driven by a $5 million increase in North America. In the quarter, VPG grew 5.3% to $3,383, reflecting higher pricing and a slight increase in closing efficiency. Tour flow in North America was down roughly 1%, but has begun to show the sequential improvement that we were expecting.

Let me take a moment to discuss our outlook for contract sales for the second half of the year. We expect to see some softness in the number of owner tours, as our owners are booking shorter stays within our portfolio of resorts, as well as enjoying the flexibility of our points product by taking advantage of exciting new options in our Explorer program.

We continue to focus on programs to increase the number of owner tours and are encouraged by the pipeline of new buyer tours that we are building. While bookings for new buyer tours are ahead of expectations, recall that it takes time, sometimes up to a year, for a booked tour to actually occur.

In addition, we remain focused on adding exciting new destinations in key markets that will bring meaningful new sales distribution. However, while we are actively pursuing opportunities, we do not believe that any new distribution announced this year will provide current year sales volume for us.

As we look at the second half of the year, we expect timeshare contract sales growth to be 3% to 5%, excluding the impact of the 53rd week in the prior year, as we build on the 2.7% growth we saw on the first half of the year.

Given our year-to-date performance and taking into account the negative impact of the 53rd week in the prior year, we are lowering our full year total company contract sales growth guidance to 1% to 3%. Factoring out the effects of the 53rd week in 2013, our full year contract sales growth would be 2% to 4%.

While the full year is below our expectations given slower tour ramp-up and the pace of new development activities, contract sales and tour growth trends in the second quarter were positive and we expect to build on this momentum as we move through the second half of the year.

Shifting to our resort management and other services business, results improved by $6 million over the second quarter of last year to $24 million. These results were driven by higher fees that we earned through our exchange company and from managing our portfolio of resorts in addition to continued improvements in our other services.

In our rental business, transient keys rented and transient rate improved over the second quarter of last year, yielding strong results in our core rental business. Rental results were down $2 million over the second quarter of last year as 2013 benefited from a $3 million of an expiring plus points.

As we discussed last year, results from our rental business can fluctuate quarter to quarter given seasonality and rental usage patterns. However, with the first half of the year completed, we are pleased with our rental performance and expect to exceed our 2013 full year results, contributing $16 million to $20 million to our result this year.

In our Asia-Pacific segment, the political unrest in Thailand that we saw on the first quarter continues, however, we are hopeful that the government will soon stabilize and tourism will return to more normalized levels in this region. It is important to note that our future growth in Asia does not hinge upon one market, but rather on us finding attractive new destinations in the region with strong on-site sales potential.

In Europe, we have seen very strong sales from our property in London this year, as well as from our sales locations in Dubai, which has had success selling our Europe inventory. Our strategy here has not changed and we anticipate sell-out of our remaining developer inventory over the next two years.

As it relates to our excess land and inventory, we've previously announced that we had completed the sale of a three-acre parcel on Singer Island, Florida for approximately $11 million. With the sale of this parcel, we have now disposed of approximately $50 million of excess land and inventory. We expect gross proceeds from our remaining excess land and inventory to total between $110 million to $150 million.

Additionally, as I mentioned last quarter, we signed an agreement to sell our Oceanfront property at Kaua'i Lagoons. The due diligence period for this agreement is six months with an anticipated closing date in the fourth quarter of this year. I must emphasize, however, that until the sales closed, there continues to be risk in completing these transactions.

With regards to our capital allocation strategy, during the second quarter, we've purchased an additional 930,000 shares for roughly $50 million. Through July 22, we have repurchased roughly 2.5 million shares of the 3.5 million shares authorized by our board, representing over $134 million return to our shareholders since the inception of the program in October of last year.

We continue to have discussions with our board regarding the next steps in our capital allocation strategy. Let me reiterate, however, that our strategy remains unchanged to first look for investment opportunities to grow our business and next to return excess capital to shareholders.

Now, before I turn things over to John, let me provide a quick summary of what I've discussed and update you on our adjusted EBITDA guidance for the year. We had another very solid quarter with VPG and development margins continuing to improve. Based on these trends in the first half of the year and our expectations for the second half, we are raising the lower end of our EBITDA guidance by $5 million to a new range of $190 million to $200 million.

With that, I'll turn the call over to John to provide a more detailed look at our second quarter results and the outlook for 2014. John?

John E. Geller

Chief Financial Officer & Executive Vice President, Marriott Vacations Worldwide Corp.

Thank you, Steve, and good morning, everyone. The second quarter continued the positive momentum we experienced in the first quarter of the year, with adjusted EBITDA improving to $57 million, up from $48 million in the second quarter of last year.

This was driven primarily by growth on our development margin, as well as improved results in our resort management business. Contract sales in North America, excluding residential sales, improved over 3%, due primarily to improved VPG, which was up 5.3%. While tour flow was down 1.4% compared to the second quarter of last year, this is an improvement to the first quarter when tour flow was down 5%. This trend is moving in the right direction, as our generation of tours focused on new buyers is beginning to offset the decrease in existing owner tours.

In North America, adjusted segment results improved $8 million over the second quarter of 2013 to $92 million. Adjusted development margin contributed $36 million, $11 million above the second quarter of last year, as our development margin improved 680 basis points. The primary driver was product cost, which improved 600 basis points. 200 basis points of that improvement came from a favorable mix of developer inventory being sold, while the bulk of the improvement approximately 400 basis points, stemmed from the success of our inventory repurchases.

Repurchasing existing inventory, which currently provides approximately one-third of our inventory for sale each year, allows us to secure inventory at a cost significantly less than replacement value. For the full year 2014, we expect product costs to be approximately 30%, a 1 percentage point improvement over our previous guidance.

The second quarter was another success story for our marketing and sales efficiency, as costs improved even while we made some investment in our programs to generate new buyer tours. Remember, once tours are sourced, they can take on average 9 to 12 months to occur. So when it comes to these new programs, we may not see the results in terms of revenue generated for several quarters.

Shifting to our rental business, keys rented and average transient rate each increased roughly 2 percentage points. Rental results in North America, however, were down quarter-over-quarter by $2 million. This was due to higher expiring plus points revenue in the second quarter of last year, as well as higher costs in the quarter from owners' increased utilization of the Explorer program.

For the full year however, we expect rental results to deliver meaningful improvement over last year and exceed the 2013 full year results by $5 million to $9 million. I should note that while redemption costs related to our Marriott Rewards pre-spin liability continued to trend in a positive direction, there is risk that these costs could come in higher than the liability we have accrued.

Turning to our resort management and other services business, results improved $5 million to $22 million in our North America segment. This was driven by an additional $1 million of management fees and $2 million of improved exchange company fees, as well as more efficient results from our other services.

In our financing business, as expected, revenue net of related expenses was down $1 million from the second quarter of last year, as our notes balance continues to decline faster than we're originating new notes. We expect to see our notes balance begin to stabilize in 2015, as our top line sales volume continues to grow.

Staying in our financing business, we were pleased to be able to complete a small securitization in June, providing net proceeds of $22.5 million. The purpose of this transaction was to securitize notes receivable, which, for a variety of reasons, we have not been able to include in our annual securitization process. However, due to the continued strength of the ABS market, we were able to securitize these notes albeit at a higher interest rate, as we continue to optimize our balance sheet.

In addition, we anticipate completing our traditional securitization later this year, which we expect to generate approximately $220 million of net proceeds.

Turning to our balance sheet and liquidity position. Since the beginning of the year, real estate inventory balances declined another $44 million to $820 million. The company's total debt outstanding decreased $108 million from the end of 2013 to $570 million, including $566 million in non-recourse debt associated with the securitized notes.

In addition, $40 million of mandatorily redeemable preferred stock remains outstanding. At the end of the second quarter, cash and cash equivalents totaled $170 million. We also had approximately $170 million of gross notes receivable eligible for securitization, and $197 million in available capacity under our revolving credit facility.

Shifting to guidance, Steve mentioned that we are increasing the lower end of our 2014 adjusted EBITDA guidance range by $5 million to a new range of $190 million to $200 million. We are also increasing our adjusted development margin by 1 percentage point to 21% to 22%, and increasing our adjusted North America development margin by 1 percentage point to 23% to 24%.

We have also increased our adjusted net income guidance accordingly, and updated our earnings per share guidance to reflect share repurchase activity through July 22.

Taking into account our recent securitization, additional proceeds expected from our fourth quarter securitization, and other improvements in our operational activities, we are also increasing the midpoint of our 2014 adjusted free cash flow guidance by $45 million, resulting in a new range of $190 million to $205 million. As a reminder, our adjusted free cash flow guidance does not include proceeds from dispositions.

In addition, as Steve touched on earlier, we have not secured inventory at new resort destinations yet. If we do not complete any acquisitions in the second half of the year or to the extent we're able to acquire inventory in an asset-light manner, there's additional upside to our free cash flow this year of $40 million to $50 million. Keep in mind, some of this potential upside could negatively impact cash flow next year, depending on the timing of the acquisitions and whether they are completed on an asset-light basis.

We've had another solid quarter. Through the first half of the year, we have seen VPG improve nearly 6%, and we have continued to improve our development margin. We are also seeing a positive trend in our new buyer tours, as the programs we started last year continue to gain traction. And we are poised to generate continued growth in contract sales in the second half of the year. We have disposed of two parcels of excess land in the first half of 2014. And our free cash flow projections remain very positive.

I am pleased with our progress and I look forward to reporting on our successes throughout the remainder of the year. As always, we appreciate your interest in Marriott Vacations Worldwide. And with that, we will now open the call up for Q&A. Jessie?

QUESTION AND ANSWER SECTION

Operator: Thank you. Ladies and gentlemen, at this time, we'll be conducting a question-and-answer session. [Operator Instructions] Our first question is coming from the line of Steven Kent with Goldman Sachs. Please proceed with your question.

Stephen P. Weisz
President, Chief Executive Officer & Director, Marriott Vacations Worldwide Corp.
A

Good morning, Steve.

Steven E. Kent
Analyst, Goldman Sachs & Co.
Q

Good morning. Can you hear me?

Stephen P. Weisz
President, Chief Executive Officer & Director, Marriott Vacations Worldwide Corp.
A

Yes. Absolutely.

Steven E. Kent
Analyst, Goldman Sachs & Co.
Q

So a couple of things, just broadly, what seems to be driving the sales momentum? Is it new targeting techniques? Is it better middle upper income consumer trends? I know we've been seeing very good resort travel trends. So I wanted to understand that. And then also, cost controls were just strong across all items, but maybe you could just give us some more color on lower development costs and lower marketing sales expense in the quarter and looking forward.

Stephen P. Weisz
President, Chief Executive Officer & Director, Marriott Vacations Worldwide Corp.
A

Yeah. I'll start and maybe John can jump in here as well. I mean, when you look at the VPG increase of, call it, 5.3%, that was a little bit of improvement in closing efficiency, plus some better pricing as we've increased prices. Obviously, as we see demand in the marketplace and the kind of macroeconomic conditions, we'll opportunistically increase our prices. So that's some of that.

The other thing is that we continue to – as we've said before, we're trying to kind of pivot from the ratio of order reloads and – to more first-time buyers and we've got some of that. Typically, an owner reload will in fact be topping off the tank of [indiscernible] (19:07) points, not necessarily a full week's equivalent points versus a first-time buyer buys generally at least a full week of points. So there is some of that.

The other thing I'd say on the sales and marketing cost efficiency side, when you get a 5.3% increase in VPG, you're able to leverage your fixed cost a little bit more which cause you to have some better sales and marketing volume. Maybe John can touch on the product cost.

John E. Geller
Chief Financial Officer & Executive Vice President, Marriott Vacations Worldwide Corp.
A

Sure. Yeah. On the product cost side, Steve, it's a little bit of mix here in the quarter. I think if you look at our product cost for the quarter, it's probably in that 27% to 28% versus the full year, which, as I said, should be more in the 30% range. And so, what you have is some timing issues. You've got the repurchased inventory that we've talked about that we're buying on the secondary market. The volume, that hasn't really increased, but in terms of what's in the trust to sell, it's a little bit more in the second quarter.

But recall, we've finished a couple of phases, one in Palm Springs and one in Las Vegas, that inventory will come into the trust and then that blend – that comes and obviously developer inventory has a higher product cost than the repurchase, so that'll blend that cost back up towards the second half of the year. So that's where you get to the kind of the full year 30%.

Steven E. Kent
Analyst, Goldman Sachs & Co.
Q

And then, some of the general customer trends?

Stephen P. Weisz
President, Chief Executive Officer & Director, Marriott Vacations Worldwide Corp.
A

I'm sorry, I completely skipped over that piece. We are seeing a little bit more of a positive environment from the tours that come through. I mean, again, you know as well as we do that on any given month, the economic news sometimes it's better, sometimes it's worse. I mean, I think you probably saw that new jobless claims this morning came out to be materially better than what had been predicted and probably the best in a number of years. And so, all of that has a read through to consumer confidence. And as consumer confidence winds its way northward, it certainly helps us in terms of, A, attracting people to actually take a tour; and B, it helps us in our closing efficiency. So there's certainly some influence there.

Steven E. Kent
Analyst, Goldman Sachs & Co.
Q

Okay. Thank you.

Stephen P. Weisz
President, Chief Executive Officer & Director, Marriott Vacations Worldwide Corp.
A

Thank you.

Operator: Thank you. Our next question is coming from the line of Chris Agnew with MKM Partners. Please proceed with your question.

Stephen P. Weisz
President, Chief Executive Officer & Director, Marriott Vacations Worldwide Corp.
A

Good morning, Chris.

John E. Geller
Chief Financial Officer & Executive Vice President, Marriott Vacations Worldwide Corp.
A

Chris?

Stephen P. Weisz
President, Chief Executive Officer & Director, Marriott Vacations Worldwide Corp.
A

Chris?

Operator: Mr. Agnew, your line is live. You may proceed with your questions.

Christopher James Wallace Agnew
Analyst, MKM Partners LLC

Q

Thanks very much. Sorry, I was on mute there.

Stephen P. Weisz
President, Chief Executive Officer & Director, Marriott Vacations Worldwide Corp.

A

Okay.

Christopher James Wallace Agnew
Analyst, MKM Partners LLC

Q

First of all, I want to ask about cash on the balance sheet. What do you think the right amount of cash is? And maybe just what's the minimum amount of cash you need for working capital, et cetera? And tied to that, what are your thoughts on adding some non-receivable supported that actually putting on a little bit of leverage like some of your peers? Thank you.

John E. Geller
Chief Financial Officer & Executive Vice President, Marriott Vacations Worldwide Corp.

A

Sure. Yeah. I mean, I think those two questions really go hand-in-hand, Chris, in terms of the optimal capital structure. And as we've talked about in the past, cash on hand and the amount of debt that you have, we obviously have flexibility with our revolver for working capital needs, things like that. So that said, with no additional debt, I would expect that you probably have, call it, $75 million to $100 million of cash that's somewhat permanently invested in the business.

And then on top of that, as we've talked about longer term, we will continue to look at our capital structure. We're not afraid to put some additional leverage on the balance sheet for the right reasons, and clearly some dry powder, if there is a good acquisition opportunity or something that might come down the path. So we do have some dry powder there and we'll continue to look at that going forward.

Christopher James Wallace Agnew
Analyst, MKM Partners LLC

Q

Got you. Thanks. And a question on product cost. Sorry, can you recap, and I don't know if you can break out the split between why product costs benefited this quarter between developer inventory and then inventory repurchases?

John E. Geller
Chief Financial Officer & Executive Vice President, Marriott Vacations Worldwide Corp.

A

Yeah.

Christopher James Wallace Agnew
Analyst, MKM Partners LLC

Q

And on the inventory repurchases, is there any particular pacing to that that we need to be aware of? I mean, not only thinking the rest of this year, but also into next year, and that how that comes in affects product cost maybe quarter-to-quarter or year-to-year? Thanks.

John E. Geller
Chief Financial Officer & Executive Vice President, Marriott Vacations Worldwide Corp.

A

Yeah. In terms of – I'll start with the pace. We're buying back – we've been into this program now probably almost two years. We're buying back on a cost basis, call it, $45 million to $50 million of our CapEx or inventory spend is what we're buying back. And as we've said, that's about – couldn't support based on our current year sales, call it, a third of our sales.

So you're getting it out of a good product cost. For the foreseeable future, there's always going to be that churn of people reselling their inventory, having a life event, something that they just decide that they want out. So I think given the size of our system, we don't see any issues in terms of that pace.

In terms of the mix, remember, we sell a points-based product. So all of our inventory in North America is being sold through a Florida-based land trust. So the product cost that we recognize in any quarter is a blend of the cost of the inventory that's in the trust.

And so, from a timing, what I was talking about, you're always putting inventory and we typically put inventory in the trust, call it, twice a year. And so, you're depleting it down and putting more inventory in.

I think the blend over the course of the year on the repurchase inventory should be about what we've seen over the last year. It's just some of the timing of the developer inventory, as I mentioned, when you put in our Palm Springs and our Vegas, the developer inventory is going to have that higher product cost.

So you'll put it into the trust and that will re-blend the cost that you recognize in the quarter. So full year, we're about a, call it, percentage point better than where we were in the first quarter. But we think that 30% product cost is a good target.

Christopher James Wallace Agnew
Analyst, MKM Partners LLC

Q

Excellent. Thank you very much.

Stephen P. Weisz
President, Chief Executive Officer & Director, Marriott Vacations Worldwide Corp.

A

Thank you.

Operator: Thank you. There are no further questions at this time. I would now like to move the floor back to Mr. Weisz for any additional concluding comments.

Stephen P. Weisz
President, Chief Executive Officer & Director, Marriott Vacations Worldwide Corp.

Thank you. Thank you, Jessie. At the midpoint of the year, I am very pleased with our performance and with the outlook for 2014. We remain focused on our key strategies, and intend to build on the momentum of contract sales growth that we saw on the second quarter, and expect to continue in the second half of the year.

Thank you for your participation on our call today and your continued interest in Marriott Vacations Worldwide. And finally, to everyone on the call and your families, enjoy your next vacation. Thank you.

Operator: Thank you. Ladies and gentlemen, this does conclude today's teleconference. We thank you for your participation and you may disconnect your lines at this time.