

Investing in the Business of Travel

Most people cannot remember what they had for dinner last night, but ask about their most recent vacation and you will likely get an enthusiastic and detailed response.

People love to travel, and this collective love fuels a massive industry. The industry's direct contribution to world GDP was \$2.1 trillion in 2012, which increases to more than \$6 trillion – or about 9% of global GDP – when incorporating indirect effects. The sector has been riding the tailwinds of the steadily improving economy, with spending on both leisure and business travel on the upswing. As the economy continues to strengthen, we expect more money to be spent on discretionary travel. We see plenty of upside for the selective investor.

Baron's investments in the travel sector includes hotels, casinos and gaming, cruise lines, and online travel sites. We will take a look at each one in turn.

Hotels and Resorts

There are many current industry trends to like in hotels and resorts. Demand is outpacing supply, with demand growth climbing steadily while supply growth remains at less than half of historic levels. Leisure and business travel are both on the rise, with growth in the former outpacing the latter. As a result, hotels have been able to increase room rates, which has boosted RevPAR (revenue per available room) and profit margins.

With the increased demand, many companies are looking to improve their balance sheets and diminish risk by reducing fixed costs through the strategic sales of assets. At the same time, hotel REITs and other buyers are looking to play the upswing in the cycle. This dynamic is resulting in more transactions, which should help boost public stock valuations of hotels that are trading at a discount to private market values.

In another positive, the increased willingness of banks to make loans is enabling hotel companies to recapitalize debt or issue new debt for remodels and additional units, which is helping improve balance sheets and generate cash flow.

The rise of the middle class in China, Brazil and other

developing countries bodes well for global travel, since a larger middle class means more people have discretionary income to spend. The trend dominating global travel in 2013 was the strong growth in emerging markets such as Asia, the Middle East and Latin America, driven by growing numbers of first-time trips among the new middle class.



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Baron's investments in hotels and resorts are benefiting from and leveraging these trends in different ways. For instance, **Starwood Hotels & Resorts Worldwide, Inc.**, a leading upscale hotel company, has been rapidly expanding in China in an effort to win a bigger share in one of the world's fastest growing travel markets. In its hotels worldwide, Starwood also offers specialized services aimed at Chinese travelers, such as translation services, in-room tea kettles, slippers, and Chinese menu items. Starwood has also been taking advantage of buyer interest to sell certain U.S. properties, thus reducing its exposure to the cyclical aspects of the lodging business. In lieu of owned properties, Starwood's current business plan favors management and franchise contracts, which generate more recurring revenue. Starwood enters into these contracts with the new owners of the properties it sells, as well as third-party hotel owners. We expect Starwood to sell the remainder of its owned hotels over the next few years, producing significant cash flow, which we anticipate will be returned to shareholders through increased dividends and share repurchases.

Hyatt Hotels Corp. has also been capitalizing on the under-supply of rooms in developing countries, select markets in the U.S. and elsewhere. Since its 2009 IPO, Hyatt has entered

Continued on page 2

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into more than 70 new markets, doubling its base of executed contracts for future growth. Its current backlog of signed deals to build new units over the next three-to-five years, both in the U.S. and internationally, gives Hyatt the largest pipeline of growth among its peers. Hyatt is also engaging in the strategic sale of certain assets to finance its expansion without incurring excessive tax liabilities. In addition to its impressively solid balance sheet, Hyatt has the least worldwide brand penetration of the large hotel chains, which we think should translate into both growth and margin improvement in the years ahead.

Casinos and Gaming

The expansion of the Chinese middle (and upper) class has also helped fuel an explosion in the casino and gaming industry in Macau, a Chinese territory located 40 miles from Hong Kong. In the 12 years since China opened Macau's doors to foreign operators, its GDP has increased on average by 14% a year, making Macau the fastest growing economy in the world. Macau now dominates the global gaming industry, with \$45.2 billion in gambling revenue in 2013, a 19% increase over the prior year, and more than seven times Las Vegas' 2013 total of \$6.4 billion. A bridge connecting Macau with Hong Kong and mainland China is scheduled for completion in 2016, which should drive even greater growth.

The growth in Macau is part of a surge in casino building across Asia, including Singapore and the Philippines. Rather than hurting Macau, the additional supply is creating additional demand in this underpenetrated market. Neither the worldwide recession nor the legalization of casinos in Singapore in 2006 had any discernible impact on Macau's casino-driven economy. This phenomenal growth has the governments of Taiwan, South Korea, and especially Japan looking closely at the legalization of casinos in their respective countries. We believe that Tokyo's new status as the host of the 2020 Summer Olympics could be a catalyst for legalization by early next year.

Wynn Resorts Ltd., one of a handful of U.S. casinos with a footprint in the territory, owes much of its recent growth to Macau. In the fourth quarter of 2013, Wynn's Macau revenue swelled by nearly 25% to \$1.12 billion, in contrast to its Vegas revenue, which grew just 2.4% to \$400 million. Wynn is building a second property in Macau to take advantage of escalating demand and expected infrastructure improvements, which should help improve access to the territory. Wynn has also said it will consider investing \$5-10 billion in casino resorts in Japan. Should Japan lift the ban on casinos, we believe it has the potential to become the second largest gaming market in Asia, after Macau.

In the U.S., the casino industry has been weighed down by weak post-recession demand as well as a supply glut as a result of certain states licensing new casinos that ended up cannibalizing existing casinos in these states. In the past few years, however, U.S. casinos have started to reap the benefit of a slow, steady uptick in consumer spending, as well as more rational promotional spending, which has helped profit margins despite intensified competition. In another positive trend, bookings in Las Vegas and across the

country for conventions and business travelers – who typically spend more than leisure travelers – are on the rise. Several states, including Texas, Massachusetts, New York and Florida, are contemplating the legalization of casino gaming as a way to reduce state budget deficits, which should also add to industry growth.

We anticipate that demand will continue to improve, although mergers and acquisitions are more likely to fuel growth in the more mature U.S. market. As cash flow improves and credit loosens, we are starting to see more transactional activity. In August 2013, in the first gaming industry merger in several years, **Pinnacle Entertainment, Inc.**, a Las Vegas based casino and racetrack owner, bought out Ameristar Casinos for \$2.8 billion. The acquisition gave Pinnacle 15 properties in nine states, doubling its size and anticipated cash flow. Management is expected to use this enhanced cash flow to pay down debt, resulting in cost savings conservatively projected at \$40 million annually, and we think the acquisition will be highly accretive for Pinnacle.

Cruise Lines

In the cruise line industry, pricing largely determines whether a business will sink or swim. For the past several years, oversupply has forced cruise lines to offer steep discounts to fill ships. (Cruise ships typically do not sail without full occupancy.) To add to the industry's woes, a series of mishaps in 2013 dampened demand.

Prospects are brighter looking forward, with the industry forecasting a resurgence in the number of cruisers in 2014. The market is significantly underpenetrated, with just 1% of Europeans and 3% of Americans taking a cruise in a given year. Cruise lines have been working

on ways to entice new younger passengers, such as more active vacations, exotic locales, improved technology, and luxury cruising.

Existing cruise lines enjoy the advantage of high barriers, due to the dominance of well-established brands, the large investments with long lead times needed to build new ships, and limited new-build shipyard capacity. Industry capacity is expected to slow from 7% annual growth over the past decade to a projected 3.6% through 2016, as a result of ships being retired or sold while relatively fewer are built.

Norwegian Cruise Line Holdings, Ltd., which is the smallest of the three big cruise lines, should benefit the most from this slowdown in supply. It has three new ships coming online over the next few years, which should drive growth, since it currently has only 12 ships in its fleet, compared to Carnival's 100 ships and Royal Caribbean's 40. New ships typically command higher prices, which should help boost net yields, which are already at peak levels for Norwegian. (None of the 2013 mishaps involved Norwegian.) We think this, in turn, should lead to stronger margins and higher cash flow, which can be invested in new ships or returned to investors through dividends and share buy backs.

Online Travel Sites

Although it may seem as if the Internet has killed the traditional travel agent, just a third of all global travel today is booked online, leaving considerable potential upside in the online travel sector. Growth in online travel is primarily driven by shifting market share from offline options, rather than overall growth in the travel industry. The growth rate typically slows down when online penetration of the travel market reaches about 35% in any given country, but only the U.S., the U.K. and Scandinavia have reached this level of penetration. Online travel agents continue to grow the

fastest of all booking options, with the online markets in China, Brazil, India, Mexico, and Italy increasing at the greatest rate.

Consumers like online travel agents because of the metasearch features they offer, which allow comparison shopping. In this regard, consumers want assurance that they are getting the best deal available on both price and quality. One-stop-shopping for lodging, air travel, and car rentals across multiple geographies is also a major draw for consumers. To meet these demands, breadth and depth of inventory, coupled with high quality information, is key. Because it tends to generate more consumer traffic, a larger inventory also appeals to hoteliers and other suppliers, creating an iterative network effect. In particular, independent hotels find that online travel agents can provide them with a marketing platform with far greater reach than they could attain on their own.

As the world's leading travel booking site, with almost \$40 billion in bookings and \$6.8 billion in revenue in 2013, **priceline.com, Inc.** is best positioned for growth among its competitors, in our opinion. The company's brands include priceline.com, Booking.com, CarRentals.com, Kayak.com and Agoda.com. The size of its inventory and the quality of information it offers is unrivaled and not easily duplicated, since both take years to build. To tap into the travel boom in the Asia Pacific region, priceline has partnered with China's leading travel website, Ctrip.com, making priceline the only global online travel agency with a meaningful toehold in the region. Financials of the company are strong, growing more than 30% on the topline. We believe that priceline will experience continued strong growth, given its dominant position in the online market and a penetration rate for international hotel bookings of well below 15%.

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The vacation rental segment is another promising market for online travel agents that can provide comparison and one-stop-shopping in this highly fragmented mom-and-pop category. With 700,000 paid rental listings representing a 12% market share, **HomeAway, Inc.** is the market leader in online vacation rentals. We believe HomeAway, which also own VRBO.com and Homelidays.com, has considerable room to add to total listings, as well as an opportunity to increase revenue per listing through tiered subscription pricing and attached products at checkout.

Conclusion

We believe the travel industry offers many attractive themes and businesses in which to invest. The gradual strengthening in the global economy is providing excellent opportunities for companies to take advantage of multi-year trends, such as the rise of the middle class in emerging markets and the ongoing shift from offline to online travel bookings. We think our portfolio of travel-related companies is well positioned for long-term growth and value creation, and we continue to find additional opportunities for investment in this ever-evolving sector.

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Portfolio holdings as a percentage of net assets as of March 31, 2014 for securities mentioned in this newsletter are as follows: **Starwood Hotels & Resorts Worldwide, Inc.** – Baron Real Estate Fund (4.8%); **Hyatt Hotels Corp.** – Baron Asset Fund (2.0%), Baron Partners Fund (7.1%*), Baron Focused Growth Fund (6.7%), Baron Real Estate Fund (3.8%); **Wynn Resorts Ltd.** – Baron Asset Fund (3.0%), Baron Small Cap Fund (1.2%), Baron Fifth Avenue Growth Fund (5.1%), Baron Real Estate Fund (3.3%); **Pinnacle Entertainment, Inc.** – Baron Growth Fund (0.8%), Baron Focused Growth Fund (4.5%), Baron Real Estate Fund (1.8%), Baron Discovery Fund (0.8%); **Norwegian Cruise Line Holdings, Ltd.** – Baron Asset Fund (0.6%), Baron Real Estate Fund (1.8%); **priceline.com, Inc.** – Baron Asset Fund (3.0%), Baron Opportunity Fund (1.8%), Baron Fifth Avenue Growth Fund (4.3%), Baron Global Advantage Fund (2.5%); **HomeAway, Inc.** – Baron Asset Fund (1.4%), Baron Small Cap Fund (1.5%), Baron Opportunity Fund (0.9%).

* % of Long Positions

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