Hilton Grand Vacations Inc.

Q2 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

Robert LaFleur – *Head of Investor Relations*

Mark Wang – *President and Chief Executive Officer*

Jim Mikolaichik – *Executive Vice President and Chief Financial Officer*

PRESENTATION

Operator
Good morning and welcome to the Hilton Grand Vacations' Second Quarter 2018 Earnings Conference Call. Today's call is being recorded and will be available for replay beginning at 2:00 p.m. Eastern today. The dial-in number is 888-203-1112 and enter the pin number 656130. At this time, all participants have been placed in a listen-only mode. The floor will be open for your questions following the presentation.

If you would like to ask a question, please press star, one on your touchtone phone to enter the queue. If at any point your question has been answered, you may remove yourself from the queue by pressing star, two. If you should require operator assistance, please press star, zero. Also, if you are using a speakerphone, please lift your handset to allow the signal to reach our equipment.

I would like to turn the call over to Robert LaFleur, Vice President of Investor Relations. Please go ahead, sir.

Robert LaFleur
Thank you, Ebony. Welcome to Hilton Grand Vacations Second Quarter 2018 Earnings Call. Before we get started, I'd like to remind you that the discussion this morning will include forward-looking statements. Actual results could differ materially than those indicated by these forward-looking statements, and the formal statements made today are effective as of today. We undertake no obligation to publish an update or revise these statements. For a discussion of the factors that could cause actual results to differ, please see the risk factor section of our previously filed 10-K or our 10-Q, which we expect to file later today.

In addition, we will refer to certain non-GAAP financial measures in our call this morning. You can find definitions and components of such non-GAAP numbers, reconciliations of non-GAAP and GAAP financials measures discussed today in our earnings press release and on our website at investors.hgv.com.

This morning, Mark Wang, our President and Chief Executive Officer, will provide highlights from the second quarter 2018, in addition to an overview of current operations and company strategy. Jim Mikolaichik, our Executive Vice President and Chief Financial Officer, will then provide more details on our second quarter and expectations for the balance of the year. Following their remarks, we will open the line for questions.

Before I turn the call over to Mark, you may have noticed we filed a revision to our earnings release this morning. This corrects a transposition error on our guidance table in the high end of our ratings for license fees and segment EBITDA. It affected no other areas of the release or guidance.

With that, let me turn the call over to Mark.

Mark Wang
Well thank you, Bob, and good morning. It's great to be with you today. The strong trends we saw earlier in the year carried over into the quarter, as our teams continue to execute and deliver exceptional growth with contract sales increasing 10.5% in the quarter, with capital efficient inventory making up 78% of these sales.

Our resort and club segment also had another great quarter with expanding margins and double-digit EBITDA growth. With this continued momentum, we are raising our full-year contract sales guidance to 9% to 11% from 8% to 10%, as well as increasing our adjusted EBITDA and adjusted free cash flow guidance. Jim will provide additional details during his overview.

Other highlights for the company were: we opened The Residences in New York and announced the Quin and Cabo acquisitions, started sales at our new fee-for-service property Ocean Enclave in Myrtle Beach, and began presales in Odawara.

I'm especially pleased to announce that HGV is entering the Chicago market with a partial conversion of the DoubleTree Chicago - Magnificent Mile. I'll provide more details on this exciting opportunity later in my remarks.

In our real estate business, first-time buyers and owners showed continued confidence in our brand as each segment posted impressive results for the quarter.

We continue to lead the industry in engaging new customers, with first-time buyers generating half of our second quarter contract sales. Double-digit tour growth and higher conversation rates in this segment helped drive over 7% NOG.

In fact, just last week HGV hit a major milestone when our club membership surpassed 300,000. In ten years, we've more than doubled our member base and no one has come close to the organic growth that we've achieved in the past decade. And we know that today's new buyers become tomorrow's highly engaged owners.

But it's our selling efficiency with owners, that's the great force multiplier behind our successful story. If you take our $690 million of contract sales to existing owners over the last 12 months and divide it by our owner base a year ago, we generated approximately $2,500 of owner sales for each owner in our system. We believe that's at least one and a half times the industry average. Said another way, our owner base is 50% more efficient at generating owner sales than the competition.

This premium demonstrates the level of embedded real estate value and potential financial profit that exists in our owner base. When you combine this with the growing stream of recurring club and management fees, I believe the value of our NOG strategy will be fully appreciated over time.

Shifting gears, I'd like to spend a few minutes talking about Hawaii, particularly the big island. I joined in HGV in '99, specifically to launch our Hawaii business, so I lived and worked there until 2008 and I know this area very well.

We're having a great year in Hawaii, led by continued enthusiasm for our new Ocean Tower property on the Big Island in Waikoloa.

We're pleased to report this because, since the increased activity at the Kilauea Volcano started making headlines in May, there's been some confusion about its effect on tourism and our business.

For those unfamiliar, the Big Island is larger than all seven of the other Hawaiian Islands put together and are properties are 100 miles away from Kilauea, essentially the distance between New York and Philadelphia, so the volcano poses no direct threat.

Local tourism and air traffic had been resilient and our Waikoloa sales center had a record second quarter. Our result and club side, owner usage and rental volumes were strong and occupancy at our

Waikoloa properties was up year-over-year.

As for Ocean Tower specifically, it's been one of our most successful resort launches ever and sales for the first six months of the year topped $125 million and our tour pipeline continues to build. So the headlines don't match reality for us.

Moving on, I'd like to spend a few minutes updating you on the progress we're making on our growth and investment strategy.

The goal of separating from Hilton was to put us in a better position to allocate capital and pursue sales strategies that would maximize earnings growth, return on invested capital, and ultimately free cash flow in order to drive long-term value to our shareholders.

Earlier this year we made plans to invest approximately $500 million in inventory in new and existing markets. The reason for this are: We're executing at a faster pace than we anticipated at time of spin; we came into 2018 in a strong financial position; and we had compelling deals that shifted form '17 into this year.

While we're investing in new and existing markets, were taking distinct approaches and adopting different risk profiles in each.

For example, the lion's share of our current spending is going into proven and established markets, like New York and Hawaii, markets we've been in for over 15 years. These are high-barrier-to-entry markets with long lead-times that make inventory continuity vital.

In new markets, we're making smaller, more tactical investments. New markets allow us to tap into new customer segments while increasing the value proposition of our Club.

A good example is our new opportunity in Cabo. Hilton's property there is one of its premiere resorts in North America. We now have direct access to some of Hilton's best customers who have a demonstrated affinity for the Cabo market. This compliments a base of HGV owners with the same affinity for Cabo that today is using club points to book into non-HGV-affiliated resorts in the market. So this new project in a new market will drive sales to new owners and improve the customer experience of existing owners, which stimulates additional owner sales.

Over the first half of this year, we've articulated our increased investment fairly well. With that said, we could've done a better job of explaining how these investments would benefit our future growth and free cash flow. So today I'd like to put some numbers around our strategy. For each dollar of contract sales we shift from fee to owned, we should produce $0.10 to $0.12 of incremental real estate margin and, given current portfolio averages, $0.37 of incremental financing revenue over 7 years following the sale.

This should help accelerate our Adjusted EBITDA growth over the next several years. At our Analyst Day in December '16, we laid out a base case 3-year Adjusted EBITDA growth scenario of 6% to 8% and said that additional inventory investments could accelerate those growth rates.

We're already starting to see that with our investment in Ocean Tower. So in the near term, 2018 and '19, we expect to add 100 to 200 basis points to the base case growth scenario, which is consistent with our current guidance. Beyond '19, we think we can accelerate to 300 to 400 basis points above the base case for several more years as our investments gain momentum.

As EBITDA grows and inventory spending stabilizes, we should see a nice ramp up in adjusted free

cash flow, starting at approximately 100 million next year and heading for $300 million by 2021. After that we should stabilize around $300 to $400 million.

But as I mentioned earlier, our strategy isn't just about accelerating growth. It's also about maximizing returns. By making capital efficient inventory investments and de-risking those investments wherever possible, we can accelerate our earnings and still generate sector-leading returns on invested capital. When we combine our capital efficient approach to inventory investment with our ongoing fee program, our ROIC should remain in the mid-to-high twenties for the foreseeable future.

So let me walk you through some of the ways we approach de-risking and capital efficiency in our inventory investment strategy.

First, we tend to limit big ticket projects to established markets and then target new markets with more bite-size investments.

Then, we focus mostly on conversions, third-party just-in-time deals or phased construction projects. With smaller capital outlays, spread out over time, and shorter intervals between investment and positive cash flow, these deal structures are more capital-efficient and produce higher returns than traditional timeshare development deals.

You can see in our 2018 projects; six are conversions of room blocks in existing properties. One — the Quin in New York — is a full conversion, but it will continue to operate as a hotel and generate cash flow throughout its phased renovation. Only one project is a green-field development, but we're building on a fully-entitled site, which meaningfully expedites our development timetable.

Beyond 2018, we have just-in-time projects in New York and Okinawa, with the option to build 100 cottages in phases at our Odawara property.

And our fee-for-service business also remains an important part of our capital-efficient inventory program.

This quarter we successfully launched sales at our new Ocean Enclave property, a 300-unit fee-for-service deal in Myrtle Beach and our second new construction project there. Including Hilton Head and Charleston, four of our five fee-for-service properties in South Carolina are new construction.

I bring this up to point out that fee-for-service deals are not just a bear market phenomenon or the byproduct of broken real estate deals. Fee-for-service works through the real estate cycle. Our four properties in South Carolina, the Grand Islander in Hawaii, and our property in Tuscany, Italy are all purpose-built for HGV.

While we've talked about our own inventory lately, our fee for service program is still very active and will remain a third or more of our sales mix going forward. And if you look at our pipeline today, you will see that it remains skewed towards capital-efficient projects, with over three-quarters of the inventory sitting in either fee-for-service or just-in-time projects.

So at the end of the day, without layering a lot of incremental risk into the business, we are giving up some excess ROIC, which the market wasn't giving us credit for, in exchange for more robust growth, which the market ultimately should give us credit for.

To sum up, our new Chicago project is the perfect example of our growth and investment strategy at work. Chicago's a great new market for us. It's a prime destination for dining, shopping, theater,

sports, and entertainment. Our project's in an A+ location in a property undergoing a total renovation. Chicago gives us access to untapped customer base in a market where the Hilton brand has a very strong presence. We already integrated our HGV marketing into six key Hilton properties in the market.

This is an amazing deal. The owner is renovating the top six floors of the hotel and converting 122 hotel rooms to 78 timeshare units to our brand standards. We'll pay for the units in installments through 2022 for a total cost of approximately $50 million, and the project should generate high returns.

The way we look at it, for a Year-1 investment of under $12 million, we get access to a capital-efficient deal that nicely sums up our growth and investment strategy: incredible new market, expanded customer access, bite-size investment, capital-efficient deal structure, with strong returns.

In closing, the business had another great quarter as our teams continue to execute and engage our customers. We had a record quarter in Waikoloa despite headline chatter around the volcano. Our Cabo, Quinn, and Chicago announcements demonstrate that our '18 growth and investment strategy is on track. And while it's easy to get distracted by short-term noise, we remain focused on the long-term and are confident that this the best way to create meaningful value for our team members, our owners, and shareholders.

With that, I'll turn things over to Jim.

Jim Mikolaichik
Thank you, Mark, and good morning, everyone. We understand that AT&T is having some global issues with the call, so everything may not be coming through exactly clear for the listeners. We'll work, though, right afterwards to get a raw transcript posted to our IR site so that everybody has it, once the call concludes.

As Mark highlighted, second quarter results were solid across the board. Volumes increased in our real estate business for both new buyers and existing owners, with strong margins and bottom-line growth in our finance resort club and rental businesses. Our momentum continues, and we're again raising guidance. We now expect contract sales to increase by 9% to 11% and we've tightened our adjusted EBITDA range.

As a reminder, our results reflect new accounting rules under ASC 606. For better comparability and as required in this transition year, I will also discuss our results under the previous percentage of completion accounting, or POC. Tables T-18 through 23 in the press release reconcile our results between the old and new accounting views.

We completed construction of our Residences project in New York City. Under 606, we recognized all deferred revenues and expenses on this project in the quarter. Ocean Tower in Hawaii remains under construction, so we're continuing to defer revenues and expenses related to that project.

Under POC, total company revenues increased 9% in the second quarter to $478 million, reflecting growth in all business lines and total company revenue increased 28 percent under 606.

Under POC, net income increased 29.4% as this year's lower tax rate amplified the benefit of a 9% increase in pretax income. With 606, second quarter net income more than doubled to $107 million.

Under POC, total segment Adjusted EBITDA increased 12% and margins expanded 60 basis points.

As we discussed last quarter, we only defer direct revenue and expenses for projects under

construction. We don't defer indirect expenses, which causes a timing mismatch that depresses margins in quarters with net deferrals and inflates them in quarters with net recognitions.

As a result, under 606, total segment adjusted EBITDA margin expanded 510 basis points and segment adjusted EBITDA increased 46% to $221 million.

However, removing these effects for the full-year results, we expect margins to remain consistent with historical levels and in line with our raised annual guidance.

Second quarter real estate fundamentals were strong as tours, VPG, pricing and close rates all trended positively. Contract sales increased 10.5%. The Asia-Pacific region had an outstanding quarter with double-digit sales growth in Hawaii and Japan and South Carolina and Washington, D.C. were standouts on the Mainland. New York City continues to work with limited inventory through 2018, but is well-positioned into 2019 with two new projects coming on line.

With the Ocean Enclave launch, fee-for-service contract sales increased 16 percent in the quarter, while owned contract sales were up 4.5%. Our fee-for-service mix in the quarter was 54%, compared to 51% last year.

On a POC basis, which we detail on Table T-22, real estate revenues were up 13 percent and real estate margin increased 4% to $94 million dollars. The margin percentage declined 280 basis points to 34.1%, as last year we received a $10 million benefit from a one-time recognition of marketing package forfeiture revenues. Absent that, margin would have increased 18% and the margin percentage would have expanded 130 basis points.

In the 606 view, real estate revenues increased 49%, mostly reflecting $91 million of revenue recognition and favorable rescission reportability. Real estate margin under 606 increased 67% and the margin percentage was 41.3%, reflecting a positive impact from revenue and expense timing on previous deferrals.

To wrap up real estate, we still expect to complete Phase 1 construction of Ocean Tower in the fourth quarter and recognize all remaining deferrals at that time.

Turning to our financing business, margin increased 8% as modestly higher costs offset some of the revenue gains from growth in the receivables portfolio, a higher weighted average interest rate, and higher servicing fees.

The consumer finance portfolio increased by $28 million in the quarter and our average interest rate increased by two basis points. The long-term allowance increased to 12.6% from 11.8% last quarter.

At the segment level, on a POC basis, real estate sales and financing segment Adjusted EBITDA increased 8% to $107 million and the margin contracted 10 basis points to 30.6%.

Under the 606 view, real estate sales and financing adjusted EBITDA increased 65 percent.

Turning to resort and club, revenues increased 6%, aided by 7.2% NOG and margins remain strong at 70.3%.

Rental and ancillary revenues increased 15 percent as we continued to effectively yield-manage our rental inventory and as more fee-for-service inventory transitioned into our club rental program. Costs were down slightly and rental and ancillary margin increased 44% to $23 million and the margin

expanded 940 basis points.

At a segment level, second quarter resort operations and club management segment Adjusted EBITDA increased 12% to $58 million and margins expanded 270 basis points to 59.2%.

Bridging the gap between the segments and Adjusted EBITDA, license fees increased $2 million to $25 million. G&A expenses were down $2 million and our JV reported a small loss in the quarter related to a purchase accounting adjustment on the loan portfolio.

On a POC basis, Adjusted EBITDA increased 12% to $119 million.

Under the 606 view, Adjusted EBITDA increased 65% to $175 million.

Turning to the balance sheet, our corporate leverage at quarter end was 1.5 times or 1.2 times on a net basis.

During the quarter, we drew $160 million on our bank revolver and $100 million on our receivables warehouse.

We ended the quarter with $203 million in cash, including $73 million of restricted cash. Corporate debt was $637 million. We have $40 million of capacity on our revolver and $220 million of capacity on the warehouse.

We still expect to be in the market this quarter to upsize and extend our maturities on a new term loan and revolver and we also expect to market an ABS deal around the same time. We continue to believe the market conditions remain favorable for both transactions.

Second quarter adjusted free cash flow was negative $111 million compared to a negative $20 last year. The primary driver was the $176 million investment in the Quin in New York City, which was partially offset by a draw on the warehouse.

Before I get to the guidance details, I'd like to reiterate and expand on Mark's comments about our growth and investment strategy. As Mark indicated, we expect our Adjusted EBITDA growth for both 2018 and '19 to accelerate to 100 to 200 basis points above our 6% to 8% investor day base case before accelerating to 300 to 400 basis points above the base case for the subsequent 2-3 years.

As we get through this accelerated inventory investment period, $500 million this year and approximately $400 million for '19 and '20, ramping EBITDA should produce a rapid recovery in adjusted free cash flow.

When we invest in inventory we're building or acquiring timeshare units to sell. We're not acquiring hotels or building cruise ships to operate for multiple years. Inventory spending is a use of operating cash, not a traditional CapEx investing activity. We recover part of our inventory investment with each unit we sell as product cost. Cost of VOI on our P&L is a non-cash expense. It's an offset to inventory spending in operating cash. As such, ramping up inventory spending only has a short-term impact on operating cash flow.

Given this, we expect our adjusted free cash flow will be slightly negative this year and then ramp to the levels that Mark spoke about: $100 million next year, $300 million by 2021, and $300 to $400 million after that. And as a reminder, this is after steady-state inventory spending and net securitization proceeds, so this gives us the flexibility to return capital and/or pursue additional growth opportunities.

Turning to our 2018 guidance, we're raising full-year contract sales guidance by 100 basis points to 9% to 11%. We're also tightening our 2018 adjusted EBITDA guidance range to $489 million to $504 million from $405 million to $505 million for the 606 view.

This includes $67 million of adjusted EBITDA related to sales made at the Residences prior to 2018 and recognized in 2016 and 2017 under the old POC rules. As part of the implementation of 606, we had to unbook those profits at the beginning of 2018 and wait until we finished construction in the second quarter to rebook them.

To get to a POC view of our 2018 guidance you can subtract $67 million from our EBITDA guidance range, which would get you to $422 million to $437 million. This range would offer an apples-to-apples comparison to the $395 million of adjusted EBITDA we reported in 2017. So on a POC basis, we're guiding to 7% to 11% growth.

For reference, our previous 2018 adjusted EBITDA guidance under POC was $417 million to $437 million.

Also, as you refine your 2019 earnings estimates, you should apply 2019 growth rates to our POC view of adjusted EBITDA, not the 606 view. We don't expect to carry any deferrals into 2019 from 2018.

While we're not going to change our quarterly guidance policy, we know modeling has been tough this year with the transition of 606. To help get through the rest of the year, I'll walk through the deferrals and recognitions that form the $67 million full-year bridge between the POC and 606 adjusted EBITDA views.

We had a net deferral of $33 million in Q1 and a net recognition of $56 million in Q2. For the balance of the year, we expect a net deferral of approximately $24 million in Q3 and a net recognition of approximately $68 million in Q4. That should result in a full-year net benefit of $67 million.

Before closing, I have one last bit of housekeeping. We're planning on an Investor Day for early December, which will be two years since our initial event. Our intention is to take a deeper dive into some critical areas of our business, provide more details about our long-term strategy, and update our long-term financial outlook. We will provide more details as the event gets closer.

That completes the prepared remarks. I'll now turn the call over to the operator, and we look forward to your questions.

QUESTIONS AND ANSWERS

Operator
Thank you. As a reminder, ladies and gentlemen, it is star, one to ask a question. We will pause for just a moment to allow everyone an opportunity to signal.

We will take our first question from Brandt Montour, JP Morgan. Please go ahead.

Brandt Montour
Hi, everybody. Good morning. Thanks for the incremental color on the long-term growth outlook. That's helpful. I have a question on the accounting changes. Just given the impacts that we're seeing, has this changed the way that you're potentially planning some deals? I'll put it another way. Are you doing anything to try and minimize the future reportability disruption at all?

Mark Wang
Yes. This is Mark. We're not changing the way we run our business. We've had these reportability nuances in the past, but obviously this new change has created some bigger swings. The impact is more timing related and it's not related to value. So, our focus is to continue using the same discipline around growth and returns on investment, so we're not going to sacrifice investing in high-return deals based on timing.

That said, there are some opportunities to try to time some things better, but at the end of the day we're not going to shy away from really good investments if the timing doesn't fall within a — completion doesn't fall within a — particular quarter.

Jim Mikolaichik
I think as we move forward we are required to reconcile this year, between POC and ASC 606. Everything will be out in the wash by the end of the year and all deferrals will be recognized, and removing the $67 million dollars that I referenced from the 606 guidance should give you a good jumping off point for 2019 moving forward. Once we get that all through the system, our intention is probably to come out with something that is more of an economic model. So that any construction that we do that has the opportunity to potentially carry over a year doesn't at all impact the way we look at the business, which is the way we basically look at the business internally.

Brandt Montour
That's helpful. Thank you for that. Broadly on capital allocation, I was wondering if you could give us an update on capital allocation strategy, more broadly on investment spend now that you're a year and a half as a standalone company. Would you, and I guess the board, potentially revisit this based on the weakness you've seen in your shares recently?

Mark Wang
Well, I think, Brandt, we continue to believe that our strategy for growth is on the right track and I think—I'm not sure what's happening with the share price, but as you can see from this quarter's results, we've had really great operating performance and execution. When you — I think when you look back — and some of the questions we're getting is are we investing into the potential end of the cycle or a shift in the macro conditions.

I think historically our industry's done a lot better in downturns and we demonstrated resiliency through the worst conditions. In '09 and '10 we actually grew through the financial crisis. And, probably the best example I can provide is that our peak investment year in inventory prior to this year was 2007 when we spent $400 million on three projects in Hawaii, New York, and Orlando, all of which were very successful and ultimately met our financial goals. They also contributed substantial cash flow to Hilton during that period of time and, in fact, in that period of time our business outpaced the lodging side of Hilton from '09 to '12.

So, there's a big difference in our models and they tend to get bunched together with the lodging, cruise, and casino models — bunched more into the traditional supply-and-demand model. The big difference for us is we're built around demand creation, so it's not the conventional supply and demand model.

I think we're in a much better place today then we were in 2008, and we're really well set up for the future. I think we'll be able to endure any type of downturn and I actually think we'll be able to continue growing through the downturn.

Why do I think we're in a better place today than 2008? We have a high-quality base of owners. They're super, super loyal. We doubled the base of owners since 2008. We have the value of net owner growth and we have 25 years of that. And we have got a lot of recurring fees. In fact, in just the last five years we've seen our club and resort EBITDA double. We also have this imbedded upsell for our owners. And I talked to it in my prepared remarks, how we're yielding much better than the industry average. So, we know based on 25 years of data that the behavior of our owners will continue to be strong during any shift in the macros.

So, we feel comfortable. We have 50% of our sales are covered off there. Then, we have this tremendous untapped opportunity with Hilton customers. Today, our owner base represents only 0.5% of the Honors base. Then, on top of that, the margins in our business lines are very, very strong. If we need to pull back on inventory investment for whatever reason, we have ample inventory going forward to really carry us through a downturn.

So, I think perhaps there's a concern that we're investing into this cycle, but we're very confident that we're doing the right thing and that this is all going to play out very positively for us.

Brandt Montour
Great color, guys. Thanks for the time. Good quarter.

Jim Mikolaichik
Thank you.

Mark Wang
Thank you.

Operator
Once again, that is star, one.

And we'll take our next question from Stephen Grambling with Goldman Sachs. Please go ahead.

Stephen Grambling
Thanks, again, for the free cash flow commentary. As we think about the $300 million to $400 million run rate, which I think you said was in 2022, is that a stabilized free cash flow number, or are there other investments and one-time items in there? And, can you maybe help reconcile that range with the nearly $300 million in free cash flow in 2017. Think about the incremental return on the $500 million plus you're putting out.

Jim Mikolaichik
The $300 million in 2017 essentially had a couple of things embedded in it. It was tax deferrals and, as Mark said earlier, we pushed some inventory spend from '17 to '18. So, '17 was an elevated amount and what we said at Investor Day in 2016 is that a steady state run rate in the current business environment, as to the investments we're making, was about $150 million to $200 million, which is approximately what we would have had if you changed that inventory scenario and the tax deferrals last year.

After making the investments we think we're going to ramp adjusted free cash flow on the back end to a steady state that will be in that $300 million to $400 million range — and potentially above that — as we push forward. So, we do think that's a steady state run-rate on a bigger base of business after we make these investments.

Stephen Grambling
That's very helpful. Then, you alluded to having some flexibility in the inventory that you're deploying. How much of the inventory investment needed to get that step up in free cash flow has already been spent, and how much of what is still to come is just-in-time or has looser capital commitments?

Jim Mikolaichik
Most of the up-front capital commitments are happening this year. We just announced the Quin and we have one or two other projects that would increase the spending to the $500 million that we quoted. The spend that we have in the next two years is partially related to construction on developed projects and partially related to just-in-time phased inventory. It's a mix, but there is some flexibility on the construction side and we do have things paced out on the just-in-time side over the next several years.

Mark Wang
Just a follow-up, Stephen, I think one important thing that, hopefully, people are hearing out there is that we're not making moving away from capital efficiency. We still believe that this forward pipeline — I think I mentioned 78% of our sales in this second quarter were capital efficient — our pipeline is a very capital efficient pipeline.

What we're really looking at is we're looking at shifting some of these fee deals that we've been doing and shifting them into just-in-time deals. And as we've alluded to, we think there's some really strong benefits to making this shift and it makes a lot of sense for us at this point in time.

Stephen Grambling
Great. Maybe one last one. Are you seeing any change in consumer behavior or even any change in trends among the new customers, new owners, I guess, that you're signing up by market?

Mark Wang
I think trends right now are really good across the board. This year, not only have we seen improvements in just flowthrough of more customers coming through the door, but we're seeing conversion rates go up and we're seeing transaction rates go up. The performance in our Hawaii and Japan region has been extremely strong, but I'd say, across the board, it's been really strong. I think the one exception is New York. It's been flat. We've talked about that. That's really due to inventory availability. We see that fixing itself toward the end 2018.

But, all in all, if anything, we've seen a trend up in the add-on sales for buyers who bought over the last five years. I think at Investor Day we were talking dollar-for-dollar, now we're seeing, we saw it trend up to $1.10 for $1, and it's actually still trending up a bit from there. So, the consumer side is really good, and our demand strategy continues to play out really well.

Stephen Grambling
Great. Thanks so much. Thank you.

Operator
Our next question will come from Patrick Scholes with SunTrust. Please go ahead.

Patrick Scholes
Hi. Good morning. Just a couple questions here. Why don't you consider share repurchases at this level? Certainly, the stock is acting a little overdone today and it looks like you have the balance sheet there to add more leverage.

Mark Wang
I think, Patrick, we said from the beginning the first couple years that we were going to put our money into the business to help grow the business. Right now, as you've heard, we're investing in growth and we continue to be very disciplined around that.

So, we're looking at deals today that are generating 15% to 20% after tax un-levered IRRs, so these are really, really good deals and a lot of them are just-in-time. So, we see the investment that we're making now is really going to be a catalyst for strong growth.

That being said, as we ramp up our cash flow, and Jim alluded to this, more stable-state of $300 million to $400 million, at that point in time we're going to be a much bigger business with a lot more cash flow and we'll have the flexibility. Clearly, our board, and I think management, will be open to that conversation at that point.

Patrick Scholes
Okay. Second question, and you may have touched on this early in the call. Hawaii, it doesn't sound like to date really, as far as sales, the volcano has impacted things, but how about future tour volumes and reservations made for that property on the Big Island? How have those been tracking?

Mark Wang
Really well. I think — I was trying to really get across that the volcano, while it is — that volcano has been active for 25 years. The activity has really stepped up, but the business has been exceptional and when we look forward, we continue to see forward bookings remain strong. This this success we're having with Ocean Tower, Patrick, we had budgeted $64 million for the year at Ocean Tower and we're sitting here mid-year at $125 million. We're actually very, very pleased with how that's going.

So, all in all, I can tell you that I think business on the Big Island is well. Air traffic is up year-over-year and tourism seems to be strong there. So, at the end of the day, we think right now, unless something changes, it will continue to be strong the rest of this year.

Patrick Scholes
Okay. Thank you, that's it.

Operator
Move to our next question, which comes from Cameron McKnight with Credit Suisse. Please go ahead.

Cameron McKnight
Good morning. Thank you very much. A question for Mark, perhaps to start. When you sit down with your third-party developers, are they starting to see financial term tighten for development and is that perhaps why you're bringing some of this inventory spend forward?

Mark Wang
No. We haven't heard any of that out there. I know we're hearing some of that on the lodging side. I think the economics on our projects are different, it's a different profile. When they underwrite deals, the model is really generating a lot more cash flow up front, and we've had such success with our third-party partners. We're really excited to be working with the Related Group and Chartres on this new deal in Chicago. So, I guess to answer your question, we have not had any push back and aren't hearing that at this point in time.

Jim Mikolaichik

The inventory spend we're making, it's really because we found some really good values. We're able to be opportunistic in a couple areas and we jumped on it.

Mark Wang
I'd follow-up on Chicago. It's a really great proof point for us is we're seeing opportunities today on conversions where replacement cost is higher than what we can convert at. So, there's opportunity for us to take advantage of that right now.

Cameron McKnight
Fantastic. Thanks. Then, one follow-up if I may. Slightly bigger picture, the upper upscale segment of timeshare is going from the three companies to two. Are there any changes or impacts that you foresee?

Mark Wang
We don't see really any changes at all. We were competing against those two separate companies and, again, we're in this demand creation business that we basically — we basically control the demand creation. Marriott and ILG together, they're basically working off of the combined Marriott and Starwood data base, and we have our database. We have a tremendous amount of data out there. I think I mentioned earlier that we've only penetrated 0.5% of the Honors members today. So, the opportunities in front of us are strong. So, we don't see three going down to two having any impact on us at all.

Cameron McKnight
Thanks very much.

Mark Wang
Thank you.

Operator
We'll take our next question from Jared Shojaian with Wolfe Research please go ahead.

Jared Shojaian
Hi, everybody. Thanks for taking my questions. Can you just remind me, at the end of this year, after you spend the $520 million on inventory, how many years of contract sales will you have in fee-for-service inventory and also in owned inventory?

Mark Wang
You broke up a little bit. I think we're looking at right now we have about 5.8 years of sales. That bakes in everything we've announced. I think we spun out with 6.5, so we've been actually absorbing because of our limited spending over the first 18 months, we've been absorbing inventory.

Jared Shojaian
Okay. I'm sorry, we're just having some phone issues. It's still breaking up. I think, if I heard you correctly, you said five years in total for both owned and fee-for-service. Is that correct?

Mark Wang
Yes, it's 5.8 for both; that's correct. And that's based on our current sales pace, it's based on our trailing 12-month pace, so in reality, it's less than that because our sales continue to accelerate.

Jared Shojaian
Got it. Is there a specific targeted level that you guys want to be at? I mean, how do I think about that

over the longer term?

Mark Wang
I think, for us, one of the benefits we have is 35%, 40% of the inventory sits on somebody else's balance sheet. That being said, in our core markets, we need to make sure we're in these core markets where we're selling $200 million, $300 million a year. We need to make sure we have enough inventory out in the future, so we pro forma these to make sure that we have enough inventory.

I don't know that there's any magic number on that, but we continue to pursue a flexible spectrum of just-in-time, fee for service, hybrid deals. We feel good about our balance now. We'll probably add a little bit more to that. As we're adding more, we're burning inventory off.

Jim Mikolaichik
I think with what we guided in terms of cash flow and inventory spending through the next few years with what we see earmarked on developed and just-in-time deals, on the back of that, I think you could look for us to be leaning back towards fee-for-service, as a couple of our bigger projects in Vega and Hawaii will start to sell off. So we've always kept it at about a 50-50 mix, historically. We see that continuing for the next couple years and then increasing as the developed projects come on. When the spending normalizes, we can turn back to fee-for-service and try to get replacement inventory out there after a couple big projects in Hawaii and Las Vegas start to sell off.

So we should be set up really well for a number of years off of the spend that we have earmarked for the next few years and then see a really good crescendo to our adjusted free cash flow off of the back end, leveraging our inventory models in a really balanced way going forward.

Jared Shojaian
Okay, thank you. I may have missed this earlier on the call, as it was cutting in and out, but how are you thinking about the cadence of contract sales growth next year, and into the following years? And if we go back to Analyst Days before the span, you were talking about sort of a 5% to 7% sort of 3-year outlook, you've obviously surpassed that running at around 9% the last 2 years. Maybe you can just help me understand the new three-year outlook as this cadence sort of ramps with the inventory spending.

Jim Mikolaichik
We intend to give a new three-year and five-year look at Investor Day later in the year, but given the growth rates that Mark and I illustrated, you can expect contract sales to follow a similar model, with what we're seeing on the adjusted EBITDA side, so that 6% to 8% getting a 100 to 200 basis points, 300 to 400 basis points, again, in the outer years. And I would expect contract sales to follow a similar model, maybe even a slightly elevated model, because some of the new product that we're bringing on has slightly higher cost of product, so we may need to generate a little bit more on the contract sales side to generate the growth. But all in, it should follow a similar trajectory to what we're seeing on the bottom line.

Jared Shojaian
Got it. Thank you very much.

Operator
And we will take our next question from Edward Engel with Macquarie.

Edward Engel

Thank you for taking the question. Regarding your discussions with the development partners, how are they feeling about the current economic cycle and their future development plans, and how did that interest in new deals change at all over the past, say, year or two?

Mark Wang
I think right now we have a lot of opportunities that we're looking at and talking about. We're being very, very selective on deals, because at the end of the day, we talk a lot about the inventory, but it's really about the demand creation matching up to new inventory and to new markets.

I think, as I said earlier, we have a couple negotiations that are going on. I think people feel pretty good. And those that understand our business, and understand it's not the normal supply-and-demand model that we control a lot more of the destiny of how a project performs, they're very comfortable with the discussion of continuing to do new deals with us.

Jim Mikolaichik
And we just announced the Charleston deal, and as Mark said, we have a few other fee deals that we're currently negotiating. And ultimately, if we do see some headwind or recessionary indicators, I think those are the times where we make out even better because those are times when our partners step in and have the capital — because of who they are — to work with us on broken deals that create even cheaper sources of inventory. I think the fact that we're spending on our own balance sheet today, with the backstop on the fee side to have our partners step in, similar to what we did in the last recession, can step in on broken deals and generate even more inventory opportunities.

Edward Engel
And then, have you seen any, I guess, shift in preference from fee-for-service to JIT, as these developers kind of get more comfortable with them?

Mark Wang
No, I think, at the end of the day, these deals come to us, we have a couple developers that we've been exclusive fee partners with and we're now doing hybrid deals where we're doing a fee deal and then investing side-by-side with them in a developer partnership to benefit from some of the real estate and financing economics. Our preference, again, is in some new markets where there's more risk, we prefer to initially go in as a fee deal, and then markets that are more core, more proven with less risk, really put our money into those markets.

Edward Engel
Thank you, that's helpful. And then lastly, does a strong dollar have any impact on your sales to your Japanese client base?

Mark Wang
We haven't seen any impact. We've been selling to Japanese for 18 years and we've sold through a fairly wide range of yen from the 80s to 125s. So, right now, as I said earlier, our sales in APAC, which is partially Japan, and then we also sell to a lot to the Japanese that are traveling to Hawaii, have remained very, very strong.

Edward Engel
Great, thank you, and congrats on a great quarter.

CONCLUSION

Operator

And there are no further telephone questions at this time. Ladies and gentlemen, this does conclude the question-and-answer session.

I would now like to turn the call back to Mark Wang for any additional or closing remarks.

Mark Wang
Well thanks again everyone, for joining us this morning. We're having a great 2018, the business is performing well and our growth and investment strategy is unfolding as we expected. We believe the capital-efficient investments we are making today in exciting new projects are going to yield meaningful EBITDA growth and free cash flow production. And as always, we appreciate your continued interest in HGV, and look forward to speaking to you next quarter.

Operator
And this concludes today's call. Thank you for your participation. You may now disconnect.