



October 17, 2014

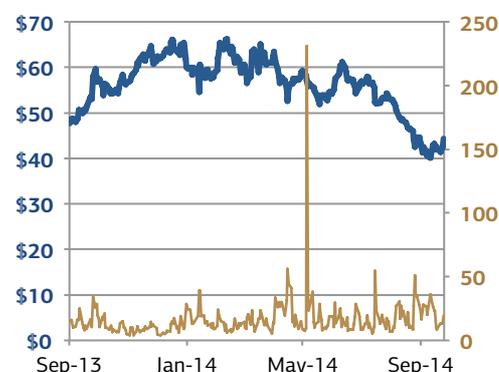
China | Gaming

# Sands China Ltd (1928 HK)

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**Sands China Ltd (1928 HK) one-year share price in HKD (blue) and volume (gold, in mln shares)**



Source: Bloomberg, October 17, 2014

## Sands China Ltd (1928 HK)

Price	HKD 42.55
<b>Rating</b>	<b>HOLD</b>
<b>Price target</b>	<b>HKD 41.52</b>
<b>Difference</b>	<b>-2.42%</b>
Last PT	HKD 63.65
Last coverage date	June 4, 2014
Market Cap	HKD 343.2 bln
Simple Moving Avg.	19.7 mln
P/E	16.7x

Source: Bloomberg, October 17, 2014

## How now, Macau?

### + All about the economy

The malaise in Macau gaming is not caused by the anti-corruption campaign or other temporary political measures, but by the protracted slowdown on the Mainland. This means bad news for Macau.

### + Sands is still comparatively strong; recommend HOLD, lower PT to 41.52 HKD.

With its strong franchise and focus on lower-end mass market gamers, Sands is still positioned better than others. That said, we have dramatically lowered our estimates of table drop growth going forward and lower our PT to HKD 41.52.

## Getting worse

Despite headline GDP growth of 7.3%, our research indicates that the Chinese economy is suffering from a serious contraction. With profitability down, consumers are gradually finding themselves with less spending power. This is driving down gaming spend in Macau.

**Macau’s weakness is due to a slowdown in the mainland economy**

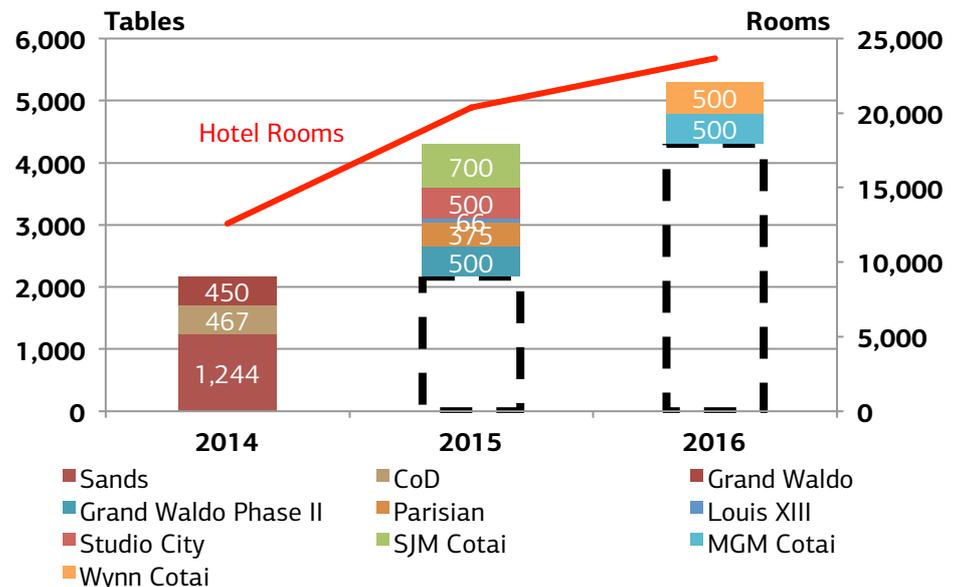
Moreover, we expect consumer spending to continue weakening. Our primary checks show that China’s economic malaise has worsened considerably since May.

### Table drops dropping

The recent weakness in Macau make clear that casino spending has been a derivative of the property and investment boom—a boom that is now over. The slowdown could not come at a worse time. In 2015 and 2016, a raft of new capacity is coming online, as Melco, Wynn, MGM, SJM, and the second monarch of House Bourbon all open properties on the Cotai Strip.

Going forward, average spend per tourist is likely to drop. In addition, visitors to Macau will not increase apace with table capacity. These trends will militate in favor of lower table drops.

**Chart 1. Cotai table increase vs. hotel room increase (next two years)**



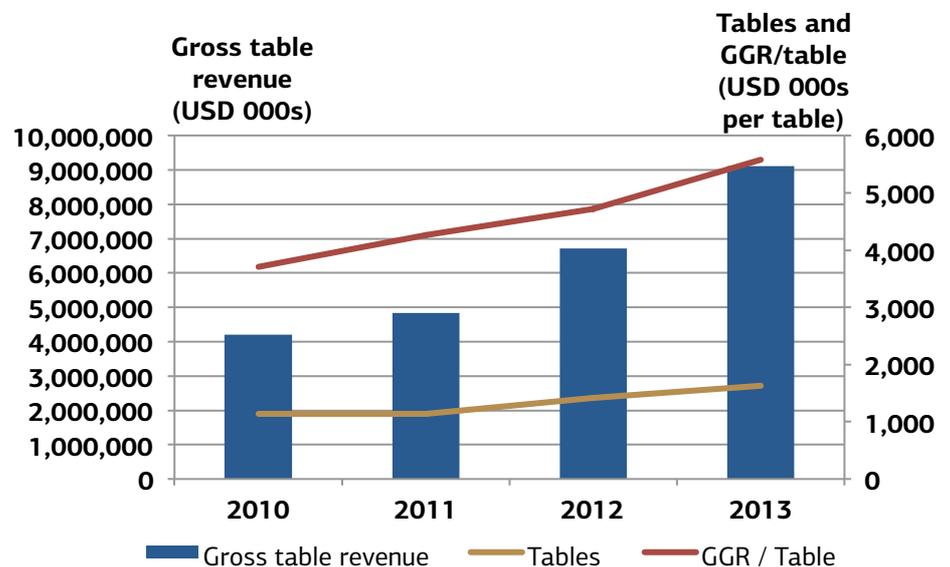
Source: Company filings

Over the next two years, Cotai hotel rooms are slated to increase 90% even as tables on Cotai more than triple. Table drops should, *mutatis mutandis*, decline. But Sands has consistently shown itself able to take market share. We give it credit in our model for flat table drops over the next five years.

The importance of flattening table drops cannot be emphasized enough. Rising table drops were the primary engine of revenue growth and margin expansion over the last three years.

**Chart 2. Gross table revenue, 2010-2013**

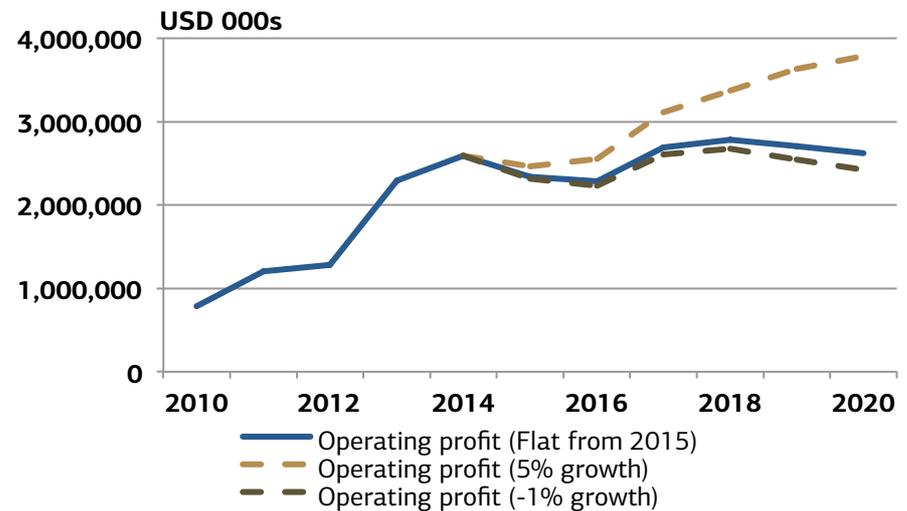
**Table growth will be more than double hotel room growth over the next two years.**



Source: Company filings

Our model shows that, assuming a one-time drop in VIP spending, flat mass market table drops and 5% growth in table drops will lead to a difference in roughly USD 1 bln per year in operating profit by 2016.

### Chart 3. Operating profit forecast (sensitivity to mass market table drop)



Source: Company filings, J Capital Estimates

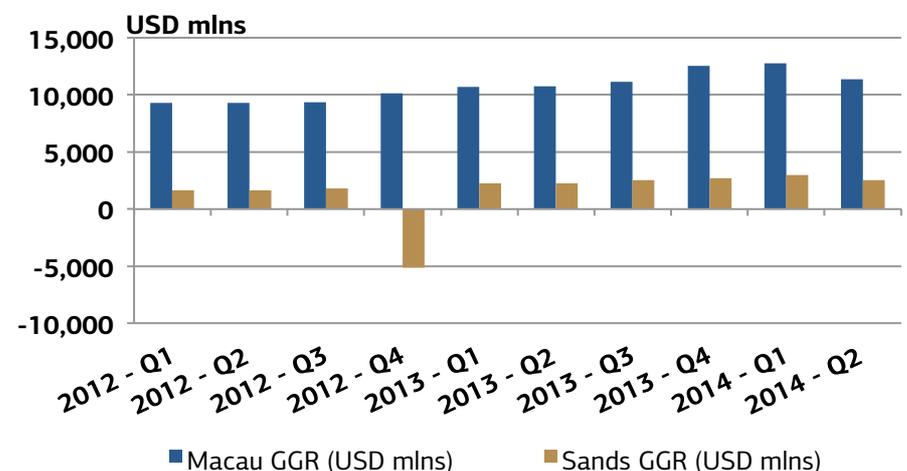
In brief, toggling from a base case of 5% growth in table drops virtually forever, to flat-lining table drops is the cause of our massive degrading of our price target.

**We do not recommend  
Sands as a short,  
here is why.**

#### Why not a short?

Sands will weather the storm better than most. Both its execution and its market positioning have been outstanding. In addition to consistently driving property EBITDAs higher than anyone else, Sands has managed to take market share by focusing on the mass market. It is striking, for example, that 38% of Mass Market growth in the first half of 2014 was accounted for by Sands China.

### Chart 4. Sands share of mass market growth



Source: DICJ, Company reports

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In a general slump, Sands will get hurt along with everyone else. But loss of profits is likely to be mitigated by market share grabs. Over the first half of the year Sands averaged 1% market share gains in the mass market.

Moreover, Sands has certain tailwinds that its competitors do not. Despite being a better positioned, better-run franchise, it trades at a discount to peers. Moreover, its mass market business is less reliant on premium players than Wynn, Melco, or MGM.

**Table 1. Casino Operator Comps**

	Forward P/E	Market Cap (HKD mlns)
Sands China (1928 HK)	15.25	335,966
Wynn Macau (1128 HK)	17.73	133,005
MGM China (2282 HK)	14.35	84,930
Melco Crown (6883 HK)	17.61	103,684

Source: Bloomberg

When it comes to shorting Macau, we think there is better risk/reward to be had with other names.

### Not about anti-corruption

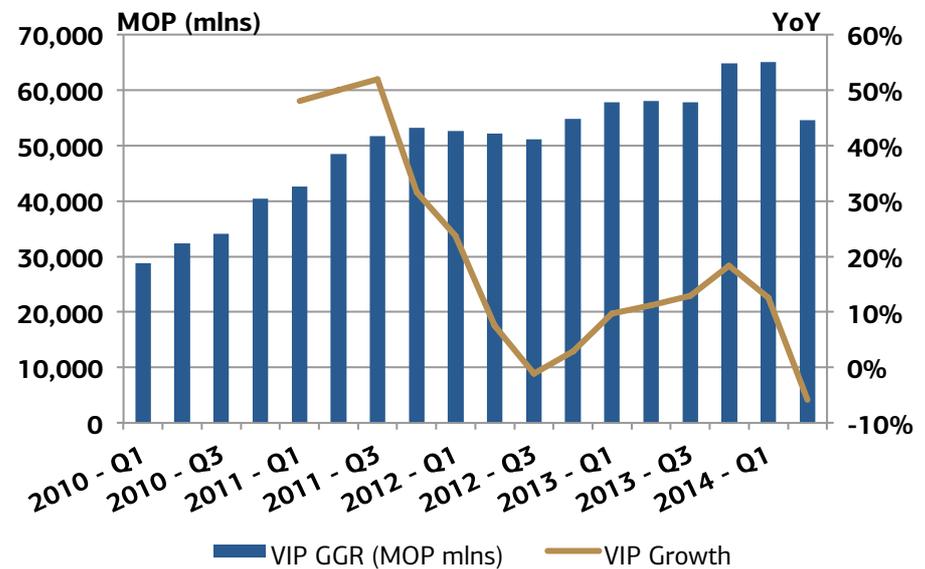
Brokerages and media reports have adduced continued growth in the mass-market segment as evidence that consumption is robust, while the VIP revenues that purportedly depend on money laundering have been crushed by Xi Jinping's anti-corruption campaign.<sup>1</sup>

Yet, our research suggests that, with the Chinese economy showing symptoms of a serious slowdown, confidence is at an all-time low. Money laundering should, if anything, be increasing.

**Our research suggests that the mass market segment will be affected by China's economic slowdown.**

<sup>1</sup> <http://online.wsj.com/articles/junkets-that-fuel-macau-casinos-are-on-a-losing-streak-1411698784>

### Chart 5. VIP share of GGR



Source: DICJ

Moreover, the anti-corruption campaign has been around for two years now—why the lag? Macanese “agents,” or “*mazai*,” are still shepherding VIP clients to casinos and insist that anti-corruption is not a significant problem. They complain that their clients were nouveau riche swimming in money from property, mining, and other boom industries. Now the money seems to be running out.

Even more important, to assume a healthy mass market next to a sickly VIP market is to misread the data. The mass-market trend is one of rapidly decelerating consumer growth. Though the Q3 data have not been released yet, early media reports indicate weak mass-market performance in Q3 and in October.<sup>2</sup>

In short, declining spend in Macau is symptomatic of broader economic malaise on the Mainland, and there is no bottom in sight for this.

**The weakening performance of junkets is not the result of the anti-corruption campaign, they are just being disintermediated.**

#### What’s wrong with the junkets?

One reason investors mistakenly attribute the downturn in VIP to anti-corruption is the weakness in the junket industry. Headlines showing junket losses and arrests of high-ranking junket managers seem to link weakness in the VIP segment to a crackdown on the middlemen. But this view, we believe, represents a misunderstanding of the junkets’ role.

<sup>2</sup> <http://macaubusinessdaily.com/Gaming/Casino-growth-stalling>

A junket is neither the only middleman nor the primary financier of VIP gaming; they are aggregators who bring gamers into Macau. In addition to junket operators, the casinos are full of independent “agents,” working for various guarantors, investment companies, and other shadow banks and/or underworld organizations from the mainland.

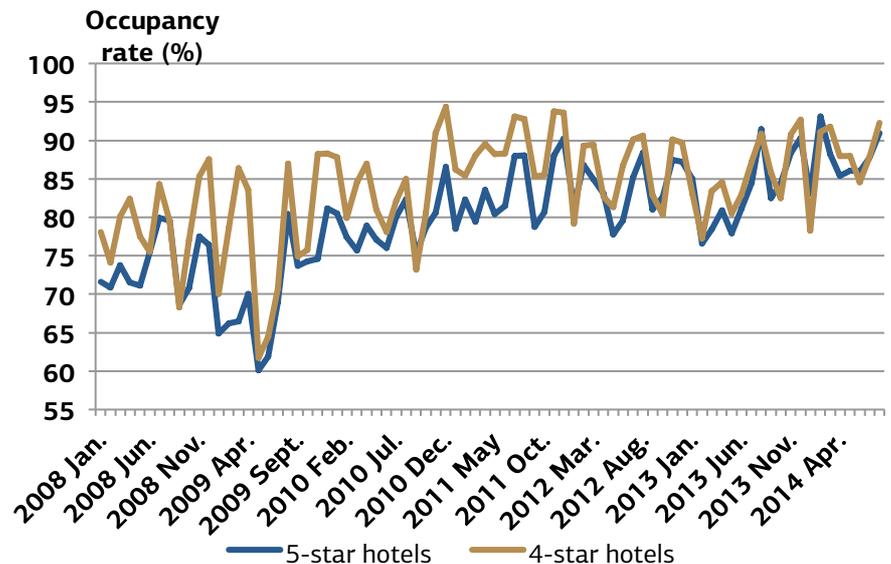
As casino operators become more familiar with customers and agents, there is less of a need for the Junkets to aggregate agents. Junkets are being disintermediated.

### No boost from Hengqin

With hotels bursting at the seams, we were once as sanguine as other analysts about the massive hotel developments on neighboring Hengqin island.

Everyone seems to believe that Hengqin will provide a boost to Macau’s gaming sector, except for those who are supposed to develop the project.

**Chart 6. Occupancy of Macanese four- and five-star hotels, Jan 2008 - Aug 2014**



Source: DSEC

Hengqin Island is a large land mass next to Cotai under the administration of Zhuhai. It’s scarcely possible to meet with casino IR without breathless descriptions of the throngs of tourists that Hengqin will bring. In LVS’s Q4 earnings call of last year, Sheldon Adelson highlighted Hengqin’s importance saying, “...the [Mainland] infrastructure investments include...more than \$20 billion of investment in the Special Economic Zone of Hengqin Island, which is adjacent to Macau and Guangdong Province.”



**Hengqin Island development Plan, LVS earns call presentation, 2013 Q3**

Similarly, Steven Wynn praised Hengqin in this year’s Q1 call, saying, “It’s a credit to the government of Macau that they saw this coming, and they cooperated with the Government of Guangdong Province in this whole Hengqin Island business that’s underway.” Unfortunately, our checks reveal significantly less optimistic facts on the ground.

**Not buying Hengqin**

It appears that Hengqin Island is a perennial heartbreaker. According to one developer we spoke to, “This is the fourth time they’ve had a development plan to develop Hengqin.” The developer was skeptical it would be successful, saying that “there isn’t anything to do on Hengqin,” believed that if this development plan failed it would prove that Hengqing was “hopeless.”

**There have already been three unsuccessful attempts to develop Hengqin.**

Moreover, the vaunted “government support” that Adelson and other operators are relying on is far more speculative than investors believe. Thought is true that the central government has

singled out Hengqin for development into an international trade and tourism zone, its plans have thus far been stymied by a recalcitrant local government. There is no sign of central/local conflict resolution, and favorable investment policies have yet to be implemented.

**Table 2. Research Notes**

Position	Research Notes
Zhuhai developer	The chance of getting overflow tourists from Macau is very small. This is because of the border gate. Right now only single-entry visas to Macau are approved, so no one wants to waste their visa by going into Macau and then going right back out.
Zhuhuai F&B industry	The greater majority of tourists I've seen do not go to Macau. It's impossible for people who can't get a hotel in Macau to stay in Hengqin. Think about it; Macau visas are single entry and valid for seven days. It's not easy to get to Macau. There's no way you'd just go for a couple of hours and then leave. It would be a waste of a visa.
Hotel development	There's no way you'll get Macau tourists staying in Hengqin unless they open up a special border.

Source: J Capital Research

**Visa issues make Hengqin unattractive as a lodging station for gaming tourists.**

Most crucially, the majority of Mainland visas to Macau are single-entry visas. This makes Hengqin Island completely impractical as a lodging station for gaming tourists—who would travel down to Zhuhai to spend six hours on a day-trip to Macau? This could explain why all three Hengqin developers we talk to claimed that visitation to Macau from Hengqin tourists was negligible.

**Valuation**

We lower our price target, from HKD 63.65 to HKD 41.52, owing to expectations that table drops will now be steady going forward. Our valuation is based on a DCF. Our recommendation is unchanged at HOLD.

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