Resilient casinos

+ **Rumors of death exaggerated**
We think the property slowdown in China will drag down casino revenues, but only by around 10%—much less than the market expects. When that happens, we see a buying opportunity in Sands China. Over the coming three years, we believe Sands will gain share and stands to rise significantly in value. Competitors Wynn, Melco, and MGM are the most exposed to the property downturn and are likely to lose out to Sands.

+ **VIP to get hit**
We expect the property malaise—not anti-corruption or the UnionPay crackdown—to push down May VIP spending by about 10% YoY. By analyzing gaming in the 2009 downturn and also comparing Macau with Monte Carlo, we feel confident that Macau will weather the incipient downturn in China much better than will real money-laundering channels such as online gaming and lotteries. We are skeptical of claims that money laundering is an important driver of Macanese results.

+ **Mass Market still growing**
The Mass Market is still benefiting from a penetration story. As infrastructure and gaming capacity expand, tourists from farther afield are coming to Macau. Over the next decade, we believe the Macanese market could more than double.

+ **Recommend HOLD, raise PT to HKD 63.65**
We raise our price target to HKD 63.65 based on a DCF.
China’s slipping; now what?

There is increasing evidence that the mainland slowdown is not restricted to property and related industries but has also affected consumption demand in industries as diverse as food products, retail, and luxury. Investors in Macau are understandably jittery. If the slowdown deepens, what will happen to the casinos? Predicting the future is a mug’s game, but at the very least we can examine the possible outcomes.

Crackdown

The proximate cause for market skittishness appears to be rumors of an intensifying PRC crackdown on money going into Macau. The arrest of Neptune’s Mandy Ng\(^1\) and the crackdown on illegal UnionPay machines\(^2\) have lent new credence to old fears.

Interviews with junket operators and the shadowy “agents” that provide junket financing indicate no slowdown in their business from the anti-corruption campaign.

Perhaps surprisingly, even the UnionPay crackdown has not had an effect. Illegal UnionPay machines are another source of funding. They allow gamblers to flout currency controls, and take out as much currency in HKD as they want at a favorable exchange rate, which can then be exchanged for gambling chips. Such machines are a mainstay of VIP floors and pawn shops, which advertise “PRC card services” in gaudy, neon lights.

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\(^{2}\) [http://www.reuters.com/article/2014/03/13/china-unionpay-idUSL3N0MA4NA20140313](http://www.reuters.com/article/2014/03/13/china-unionpay-idUSL3N0MA4NA20140313)
The property correction and economic slowdown will be painful to VIP gaming.


Our research indicates the UnionPay crackdown has not had an effect, largely because credit from black-market currency dealers is still flowing freely. Contrary to popular view, junkets rely mainly on offshore financing, supplying cash directly in Hong Kong dollars in return for onshore RMB. We were surprised to find that they earn no interest on these transactions; their only profit is in earning a few bps on the currency exchange. This helps explain why previous PBOC credit tightening has not affected Macau in the way analysts predicted.

It’s the economy, stupid

The real danger to Macau is not policy, but an economic slowdown precipitated by a property correction. Investors seem to be of two minds on the issue. Many believe that, as Macau is a money-laundering channel, it is immune to cyclical downturns and may even benefit from money exiting the country. We do not hold to this view.

Macau gaming consistent with other markets

One reason we do not believe that Macau is all about money laundering is that its wild growth over the last decade has been matched by similarly spectacular—albeit on a lesser scale—growth in Chinese gambling abroad. Baccarat, which we take as a proxy for Asian gambling, has surged in other markets. In addition,
Southeast Asian markets catering to Chinese tourists, though small, have thus far been wildly successful.

Chart 1. Macau GGR vs. Nevada baccarat

Chinese gamblers have become vital to Las Vegas. Presumably they are not going halfway around the world to launder cash.

Bank assets

If money laundering were the main driver of Macanese gaming, then the majority of money coming into Macau would not be captured by casino operators’ net income. This means “extra” money will be coming into Macau and we should see an explosion of bank deposits in excess of GDP growth. But deposit growth is only slightly in excess of GDP, indicating a marginal amount of cash left over after gambling. Indeed, growth of non-resident deposits has been particularly unexciting.
If the money flowing through Macau were due to money-laundering, it would be just too costly.

Over a 10-year period, non-resident deposit growth has exceeded real GDP growth by a CAGR of only 6%. Excess over nominal GDP growth will be even lower. Over the last three years, since the Chinese economy began to suffer from the excessive stimulus in 2009, non-resident deposit growth has accelerated sharply, surpassing GDP growth for the first time since 2008. But the differential is only 8% per year over three years. This indicates that while there is indeed significant money laundering, it is not likely to be the main driver of the gaming industry.

**Consumer behavior**

The foremost reason to doubt the “Macau equals money-laundering” thesis is qualitative, not quantitative. Interviews with junkets, agents, and pawnshops indicate a large number of defaults. To quote one agent, “Generally our clients go and gamble until they don’t have any cash left with them. Then they go home.” They often have to tell their clients to stop gambling when losses get too extreme. Pawnshops tell us NPLs are about 15%. That is low by a pawnshop standard, but would constitute a prohibitively high cost to laundering money. In addition, side betting is rumored to be even higher than legitimate VIP gambling. Side betting is illegal and does not return receipted cash, hence defeating the purpose of money laundering.
In a prolonged slowdown, the difference between VIP and Mass Market will become more pronounced.

**Balance of Payments**

While even a rough approximation of the amount of money being laundered is exceedingly difficult, we estimate the amount by looking at gross “Other Investments” in the balance of payments. It is interesting to note that this line item tripled [!] in the Asian financial crisis, and soared in 2012, in the wake of an abortive mainland slowdown, indicating that it is indeed tied to capital flight.

**Chart 3. VIP GGR vs. BoP (other investment)**

Of course not all “gross other investments” are money laundering and not all money laundering goes through the casinos. But if half of it represents chips being cashed out of VIP rooms, then over the last three years roughly 23% of VIP spend has been tied to money laundering. Not just peanuts, but hardly the driving factor.

**VIP vs. Mass Market**

For those who share our view that Macau is primarily driven by leisure demand, consensus appears to be that in a Mainland slowdown, Macau will get slammed along with the rest of China. But this view ignores that VIP gaming and Mass Market gaming have behaved and are likely to continue behaving very differently.
We expect VIP May revenues to be down YoY.

We believe that the VIP market will be severely impacted by the property downturn. One junket operator told us VIP business was down 20-30% in May. VIP agents tell a similar story. While the numbers will not look quite that bad for the casino operators—part of the decline in junket revenues derives from the operators increasingly cutting them out as middlemen—we do expect May VIP revenues to be down YoY.

Table 1.  Junket interviews

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<thead>
<tr>
<th>Interviewee</th>
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<tr>
<td>Check 1</td>
<td>Slowdown in China is affecting the VIP market a lot. He’d guess it’s down 20-30% this May. It started to hit in April but the May 1 holiday was very bad. Mass Market is not hit as much as VIP. Growth may have slowed a little, but it is definitely still growing. This is really still about increasing penetration. Everyone from Guangzhou knows about Macau; the market is saturated. But you still have people have never been coming in from Xi’an and other cities. There still isn’t enough supply to meet all this demand so the market grows every time you add supply.</td>
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<td>Check 2</td>
<td>Anti-corruption doesn’t have much of an effect on business. A little pressure, but not much. Business is up 10% month on month in May but down 5% YoY. That’s the effect of [economic] policy and the economy.</td>
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<tr>
<td>Check 3</td>
<td>Anti-corruption has no effect on us, but the economy does.</td>
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Source: J Capital Research

But we were also told that the Mass Market was still growing apace, as market penetration increases outside of Guangdong.
Rise of the Mass Market

By treating VIP revenues and mass-market revenues as separate variables, we can narrow the range of likely outcomes in a China slowdown. This is because not only the customer base, but the profitability, of Mass Market gaming differs substantially from VIP gaming.

Chart 5. VIP GGR vs. Mass Market GGR

As of 2014 Q1, 36% of GGR derived from Mass Market gaming. The shift to the Mass Market has been a boon to the casinos. Even as the Mass Market drives top-line growth, it also boosts margins since the junkets do not get a cut. The company estimates that while it is only 32% of GGR, fully 68% of operating profit now derives from the Mass Market.

While a sustained decline in gaming dollars from VIP is eminently possible—and we think likely—it is difficult to imagine long-term negative growth in the Mass Market, which still has enormous unmet demand. Since Mass Market has higher margin than VIP, operators strong in this segment are well positioned to weather a downturn.

Macau’s Mass Market still has vast enormous unmet demand, which will prevent it from experiencing long-term negative growth.
Even with a fall in VIP gaming revenue of 10%, we expect Sands’ operating profit to remain flat at worst.

Table 2. Sensitivity analysis of GGR growth: VIP vs. Mass Market growth

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Source: J Capital Research estimates

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Source: J Capital Research estimates

What our analysis shows is that even with a fall in VIP gaming revenue of 10%, we expect Sands China’s operating profit to remain flat at worst.

Case study: 2009

An oft-repeated refrain is that Macau has never been through a downturn, hence it is impossible to know how it will fare in a downturn. But this is not strictly speaking true. Macau’s performance during the global financial crisis is as good a bellwether as any for predicting how it will do in China’s impending financial slowdown.
If Macau stumbles as it did in 2009, Mass Market growth could fall to about 10%, while VIP growth could go negative.

Chart 6. Macau GGR growth

In 2009, Macanese gaming growth remained positive, but growth absolutely collapsed. Growth went from 31% to 9.7%, dipping below double digits for the first time in five years. VIP GGR growth fell from 32% to 8%.

If Macau stumbles again as it did in 2008, it is easy to see Mass Market growth falling from over 30% to about 10%, while VIP growth could go negative.

Case study: Monte Carlo

It is impossible to know how serious a VIP retrenchment will be. But we can look at Monte Carlo as a kind of case study in how VIP gaming markets fare in a slowdown.

Chart 7. Societe de Bains de Mer income

Source: Societe de Bains de Mer company filings
Monte Carlo suffered a 34% pullback over two years when the financial crisis hit. Things are not that bad in China—yet—but we take that as a plausible worst-case scenario. If VIP spend were to plunge by that amount on flat mass market spend, it would send the industry’s profits down by 10%.

**Winners and Losers**

Market skittishness has tended to treat all the gaming names as a class. Rumors of a UnionPay or corruption crackdown, as well as macro fears, have sent all the stocks down together.

But by taking a more nuanced view, which accounts for the differences in VIP and Mass Market gaming, it is clear that some operators will fare much better than others. Owing its strength in the Mass Market, Sands is by far the best positioned of any of the operators. In the event of prolonged Mainland downturn, Wynn, MGM, and Melco Crown are at a serious disadvantage.
Sand’s Mass Market gross revenue is first among its peers, and the company is the most protected against a pullback in VIP spending.

No other operator comes close to having the amount of Mass Market gross revenue that Sands does. We like Sands China because we believe Mass Market gaming revenues are likely to continue growing, and that Sands is the most protected against a pullback in VIP spending and positioned to lap up more of Mass Market growth than anyone else.

Sands’ advantage is reflected in the Q1 results, with visitation increasing in areas where Sands has the most capacity. Specifically, with the completion of the Gongbei border gate expansion, visitor growth continues to be disproportionately due to overland travel. This suggests greater use of high-speed rail to arrive at Macau.
Moreover, Cotai crossings including Hengqin land crossings, Gongbei land crossings, and Taipa ferry crossings, accounted for fully 76% of visitation growth. This is significant because Sands has a huge capacity advantage on the Cotai strip, with 71% of all gaming operator hotel rooms and 58% of all gaming tables.

**Chart 10. Cotai hotel rooms by operator**

Sands China has the most capacity in Cotai in terms of hotel rooms.

![Bar chart showing hotel rooms by operator][1]

Similarly, visitation is trending more and more in favor of same-day visitors. This is bad for the market on the whole because same-day visitors spend less than multi-day visitors. However it means Sands will continue to take share. Same day visitors tend to be lower end. Sands and Galaxy are essentially the only operators that cater to this demographic.

**Taking share**

Sands’ positioning is translating into market share growth. In 2014 Q1, Sands boasted market share of 23.2%, up from 21% a year ago. But what is truly impressive is Sand’s incremental market share. Sands was responsible for 34.5% of annual GGR growth and fully 99.4% of quarter on quarter growth in Q1 2014.
Sands dominates Macau's Mass Market, with a 31% share in 2013.

We believe Sands’ dominance should only continue as time goes on. It is not only strong in the VIP segment, but also dominates in the Mass Market, with 31% share in 2013.

Growth runway

Compared to Taiwan and Guangdong, several Chinese provinces have relatively low penetration. Even if China’s growth collapses in a drawn-out, Japan-like scenario, Macau should continue to grow simply by finding visitors further afield. Of course, the low-hanging fruit has been picked: visitation rates inland will never ascend to Cantonese levels. But even adjusting for lower household income and further distances, inland penetration has a long way to go.
Over the long-term, the Macanese gaming market should at least double. It is hard to tell how much of this Sands will take. New entrants will come to market in 2015 and 2016, and to peripheral markets such as Philippines and Japan further down the road. But as long as Sands does not lose share, then Sands should be making USD 20 bln in revenue and USD 6 bln in profit by 2020.

Valuation

We believe Sands’ best days are ahead of it. The main driver of Sands’ continued revenue and earnings growth will be the Parisian Macau, slated for a 2015 opening. Our model assumes zero growth in VIP table profitability and a 30% rise in mass-market table profitability in 2014, with the growth rate tapering down to 5% over the next three years. We further assume that the Parisian Macau will ramp to maturity by 2019, adding another USD 3.3bln in gross gaming revenue.

Under these assumptions, Sands China’s USD 8.9 bln in revenue and USD 2.1 bln in net income should grow to USD 15.8 bln and USD 4.2 bln, respectively, by 2020. This is an impressive operating performance, but capital expenditures underway of over USD 3 bln and a P/E of 26X does not leave much alpha left for investors. Sands’ growth is largely priced in. We raise our price target to HKD 63.65, for a 14% upside, and downgrade our call to a HOLD.

Historical background

Macau’s seemingly inexorable growth has proven uncorrelated to almost anything. Even in 2011, when China flirted with recession before resorting to massive stimulus, Macau scarcely blinked.

Over the last five years, GGR has grown from MOP 119 mln to MOP 360 mln, a 25% CAGR. It has eclipsed Nevada gaming revenues four times over, and as of 2013 has likely overtaken the entire US gambling market. This meteoric growth can obscure important changes that have occurred during this time. The most obvious of these changes is both visual and geographic.

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1 Media reports that GGR is correlated to FAI are based on faulty analysis that tends to confuse FAI, a stock, with GGR, a flow. Our own correlations have shown that nameplate FAI and GGR are correlated only because they both always go up; when the data is analyzed correctly and the growth rates are compared, the correlation is insignificant.
Macanese gaming used to be a government-sanctioned monopoly. In 1962, the gambling concession went to the STDM syndicate, which, as a monopoly, had little incentive to provide quality service or leisure experiences. Macanese casinos were tawdry affairs; shoddy smoke-filled rooms run by gangsters whose disputes—with rivals and clients alike—were often settled in blood.

In 2002, the STDM’s monopoly status was withdrawn. Western operators were brought in to establish world-class resorts and quickly began to attract clients away from the STDM. The move was supposed to help Macau transition into a gentler, more lawful, more regulated market. But as late as 2004, SJM—STDM’s majority-owned operating subsidiary—was still operating roughly 80% of all casinos, so the transition was incomplete.

The final blow to Macau’s film-noire era of gaming came in 2004, when Sands opened the Venetian on the Cotai strip. The development was originally seen as a fool’s errand, with Steve Wynn famously calling it a “stupid idea.”

But Cotai proved wildly successful. By 2008, the Venetian Macau was grossing USD 1.6 bln and reached USD 3.8 bln in 2013. Cotai now accounts for a significant portion of GGR, and the character of Macau gambling has changed.

Photos of Macau before the boom. Leroy W. Demery, Jr.

Venetian Macau: http://www.venetianmacao.com/mice.html

Macau has become less seedy; the resorts are glitzy and up to the world-class standards one would find at luxury resorts in Hong Kong or the West.
Valuation

We base our valuation on a DCF model with a WACC of 7.1% and terminal growth of 1%.

Risks

On the macro side, China could suffer a more dramatic economic and financial crisis than we anticipate, and that could drag down results.

China also has many administrative tools at its disposal to curtail transactions at the casinos: the government could limit visas to Macau. It could squeeze off access to currency. It could even curtail operating licenses for the casinos.

Finally, the market has a weak understanding of revenue drivers at the casinos, and regulatory issues conspire to support the opacity. Gamblers from the Mainland—the great majority—may be gambling with illicit gains. They may be helping others launder money. Their access to hard currency is obtained through gray channels. Although we have a good deal of primary research, we may misunderstand the casinos’ revenue drivers and therefore underestimate the impact of financial shifts in Mainland China.
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