

Macau Gaming Sector

- Positive
- Neutral (unchanged)
- Negative

CNY weakness to hit VIP even harder

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- CNY devaluation increases junkets' cost of capital
- Potential 20% downward impact on VIP GGR...
- ...with implied 9% downside risk to EBITDA

■ What's new

In our [earlier note published on 12th August](#), we highlighted the potential negative impact on Macau Gaming's mass GGR if the PBOC sustains its devaluation of the CNY in 2015/16. In our view, the depreciation would have a bigger and more immediate impact on Macau's junket businesses.

■ What's the impact

Increasing cost of player repayment. Our on-the-ground checks indicate that, even erring on the side of optimism, VIP's average collection cycle sits at between 3 and 4 months. This implies that the entire junket system has extended ~HKD30-40bn of outstanding gaming debt (excluding receivables related to side-betting). Since casinos settle in HKD, the CNY devaluation increases the CNY-denominated repayment cost for Mainland-based

VIP customers. By our estimates, the recent ~4% drop in the CNY has already created a HKD1.2-1.6bn-equivalent haircut on gaming debts -- a significant sum comparable to ~15% of Macau's monthly VIP GGR.

Depending on the repayment terms, we understand that these forex losses will likely be borne by the junkets and/or the players. Moreover, junkets and agents sometimes issue CNY-denominated gaming chips which compounds this cost pressure. For the junkets, this pressure will be asymmetrically distributed, skewing to the mid-sized junkets, which have fewer resources and smaller capital bases to sustain this pressure. Further, the junkets will face hefty forex costs on CNY-denominated gaming debts collected recently that have not been exchanged into HKD.

Bad debts get even more expensive. It is normal operating practice for junket operators to receive Mainland-based assets and collateral as consideration for bad debts. These assets are typically liquidated and the funds repatriated to Macau for settlement. Admittedly, it is difficult to ascertain the absolute scale, but we suspect the balance is not insubstantial. Our ground checks also indicate the liquidation process for some of these assets can be lengthy, and further CNY depreciation points to additional forex losses.

Also, it is not uncommon for junkets to enter into pre-negotiated multi-year CNY instalment repayment plans. Daiwa's CNY forecasts imply a further ~3% decline by end-2015 (marking a 7.3% drop against the USD in 2015) and a ~4% drop in 2016. Hence, we think junkets with these arrangements will likely face greater forex risks heading into 2016.

Significant hit to VIP gaming appetite. Not only does the CNY weakness shrink HKD-denominated gaming budgets, it threatens to eat into the appetite for gaming. A weakening CNY implies that the longer it takes a player to repay a gaming debt, the more expensive it becomes (perhaps a leading indicator of a rise in gaming bad debts). It is also increasingly expensive for gaming patrons to visit Macau when we are already seeing a structural decline in player quality.

Another round of junket closures. Given the already highly depressed VIP environment, we think it is unlikely that all of Macau's relatively poorly capitalised mid-sized junkets will be able to withstand these new operating pressures. Market chatter is already pointing to a renewed wave of junket closures as a result of the developments of recent days. As we see it, it is not inconceivable that CNY weakness alone will have a 20% downward impact on VIP GGR (this estimate is already less than the sequential decline witnessed during the first round of junket closures in 2H14).

Our back-of-the-envelope stress test (next page) indicates that a 20% drop in VIP GGR would have a 9% negative impact on sector EBITDA.

■ What we recommend

We remain cautious on the sector's fundamentals, and the growing risk of CNY weakness is another reason to be cautious, in our view.

■ How we differ

While the market seems to favour supply-side-driven growth, we continue to base our stock picks on cost defensiveness.

■ Macau Gaming Sector: EBITDA stress test

	Today ⁽¹⁾			Scenario 1: VIP down 20%; mass flat			Scenario 2: VIP down 20%; mass less 8%			Scenario 3: VIP down 20%; mass less 10%		
	VIP	Mass	Overall	VIP	Mass	Overall	VIP	Mass	Overall	VIP	Mass	Overall
GGR ⁽²⁾	52	48	100	42	48	90	42	44	86	42	43	85
Change				-20%	0%	-10%	-20%	-8%	-14%	-20%	-10%	-15%
Operating costs												
Gaming tax ⁽³⁾	(20)	(19)	(39)	(16)	(19)	(36)	(16)	(17)	(34)	(16)	(17)	(34)
Junket commission ⁽⁴⁾	(23)		(23)	(19)		(19)	(19)		(19)	(19)		(19)
Other costs	(3)	(16)	(19)	(3)	(16)	(19)	(3)	(16)	(19)	(3)	(16)	(19)
EBITDA	5	13	19	4	13	17	4	11	14	4	10	14
EBITDA margin	10%	28%	19%	9%	28%	19%	9%	25%	17%	9%	24%	16%
Change				-32%	0%	-9%	-32%	-18%	-22%	-32%	-22%	-25%

(1) Based on 2Q15

(2) Re-based GGR to 100; VIP/mass split based on 2Q15 GGR breakdown

(3) 40% of GGR

(4) Based on 45% profit-sharing arrangement

Source: Daiwa

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