The 10-second briefing

When the chips are down

- Cutting further our 2015E sector GGR to -21% YoY; increasing systemic risk suggests more junket closures and fragmentation
- Mass market could see spill-over effect from VIP weakness
- Revising down 2015E EBITDA to a 24% YoY decline; adopting 12-month TPs; MGM and SJM continue to be our top picks

Macau Gaming Sector

- Positive
- **Neutral** (unchanged)
- Negative

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What's new

Our on-the-ground research points to a further deterioration in the VIP and mass segments' dynamics over the past 3 months. Thus, for 2015 we reduce our sector GGR forecast to -21% YoY (from -7% YoY) and look for sector EBITDA to decline by 24% YoY (previously -8% YoY). Our new 2015 sector EBITDA forecast is 28% below the Bloomberg consensus. As we see it, recent developments overturn the "build it and they will come" mantra for 2015 and we expect delays to new property openings.

What's the impact

VIP: junket closures and de-consolidation likely. Recent closures of some large junket operators indicate the systemic weakness of the sub-junket business model, one which is shared among the larger junkets in Macau. As such, we expect to see further room closures among larger junket operators this year, and our junket watch list assesses the impact for the operators we cover. As a result, we now forecast the VIP segment's GGR to fall by 30% YoY for 2015 (previously -19% YoY).

Macau junket watch list: table count

(No. of tables)	Mkt share	Sands	Galaxy	MPEL	MGM	Wynn	SJM
Suncity	25%	67	40	40	38	-	34
Guangdong	15%	48	34	12	48	18	68
Tak Chun	10%	32	26	6	-	-	14
Golden Resorts	10%	-	-	-	-	-	76
David Group	8%	12	16	6	16*	28	6
Heng Sheng	8%	8	22	8	13	10	14
Total VIP tables		369	325	216	200	214	552
% of VIP tables with top-6 junket exposure		45%	42%	33%	58%	26%	38%

*Source: Daiwa * Includes VIP rooms for which closures are planned in next few months*

We beg to differ with the common perception that the latest junket closures should weed out weaker players and spur healthy VIP segment consolidation, as: 1) we have not seen junket capital shifting from smaller to larger junkets, 2) surviving smaller junkets have adopted a cash-only model with low costs, little credit risk, and no incentive to consolidate, and 3) larger junkets still face a deteriorating climate and plan further cuts in VIP room numbers.

Mass: lacks growth drivers, likely spill-over of VIP weakness. The mass segment has benefitted substantially from junket operators' numerous ancillary services (providing liquidity, visa and logistics arrangements, and event sponsorships). Weaknesses among larger junkets have already prompted a scaling-back of these services, which we believe will have an adverse effect on the mass segment. Meanwhile, policy headwinds continue to suppress a number of the historical key mass growth drivers. Thus, we cut our 2015E mass GGR to an 8% YoY decline (previously +11% YoY).

What we recommend

Our stock ratings stand unchanged. We lower our target prices, now on a 12-month horizon, to reflect our EBITDA forecast cuts.

We remain Neutral on the sector and continue to prefer operators with more defensive cost profiles. Thus, **MGM** and **SJM** remain our top picks. We would steer clear of operators with earlier openings (**Galaxy**, **Melco**, and **Sands**), which will likely bear the brunt of cost pressures and risk of operational deleveraging. The key risk to our sector call is a larger than-expected swing in China's economic fundamentals.

How we differ

While the market expects a GGR recovery in 2H15 (from a low YoY base), we expect a sequential GGR deterioration and do not subscribe to the supply-side driven growth mantra.

Key stock calls

	New	Prev.
SJM Holdings (880 HK)		
Rating	**Outperform**	Outperform
Target	**12.60**	16.70
Upside	▲ **13.7%**	
MGM China Holdings (2282 HK)		
Rating	**Outperform**	Outperform
Target	**20.10**	23.80
Upside	▲ **12.3%**	

Source: Daiwa forecasts.

Sector stocks: key indicators

Company Name	Stock code	Share Price	Rating New	Rating Prev.	Target price (local curr.) New	Target price (local curr.) Prev.	Target price (local curr.) % chg	EPS (local curr.) FY1 New	EPS (local curr.) FY1 Prev.	EPS (local curr.) FY1 % chg	EPS (local curr.) FY2 New	EPS (local curr.) FY2 Prev.	EPS (local curr.) FY2 % chg
Galaxy Entertainment Group	27 HK	39.50	Hold	Hold	37.00	45.00	(17.8%)	2.470	2.600	(5.0%)	1.604	2.131	(24.7%)
Melco Crown Entertainment	MPEL US	22.96	Underperform	Underperform	20.80	23.00	(9.6%)	1.161	1.133	2.5%	0.348	0.555	(37.4%)
MGM China Holdings	2282 HK	17.90	Outperform	Outperform	20.10	23.80	(15.5%)	1.485	1.477	0.6%	0.843	1.328	(36.5%)
Sands China	1928 HK	38.15	Hold	Hold	36.00	40.00	(10.0%)	0.289	0.276	4.7%	0.213	0.253	(15.8%)
SJM Holdings	880 HK	11.08	Outperform	Outperform	12.60	16.70	(24.6%)	1.246	1.238	0.6%	0.800	1.033	(22.5%)
Wynn Macau	1128 HK	20.20	Underperform	Underperform	19.00	22.60	(15.9%)	1.298	1.294	0.3%	0.562	0.841	(33.2%)

Source: Daiwa forecasts

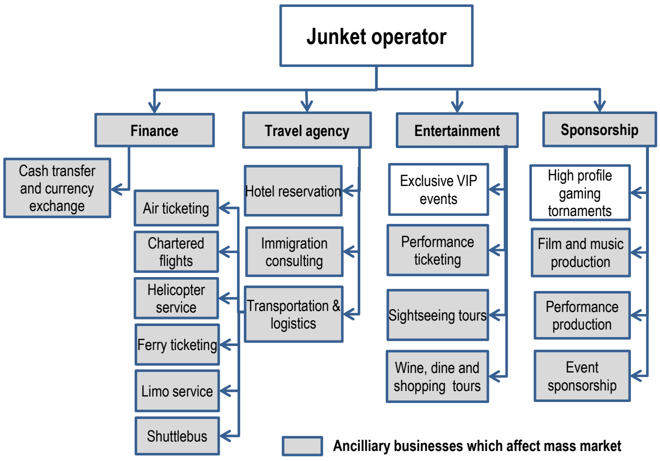
Contents

■ Macau Gaming Sector: revised GGR, cost and EBITDA forecasts

	2014E			2015E		
	VIP	Mass	Overall	VIP	Mass	Overall
GGR (1)	63.0	37.0	100.0	44.1	34.0	78.1
YoY growth				*-30%*	*-8%*	*-21%*
Operating costs						
Gaming tax (2)	(25.2)	(14.8)	(40.0)	(17.6)	(13.6)	(31.3)
Junket commission (3)	(26.8)		(26.8)	(18.7)		(18.7)
Fixed costs	(3.5)		(3.5)	(3.5)		(3.5)
EBITDA	7.6	13.0	20.5	4.3	11.9	16.2
EBITDA margin	*12%*	*35%*	*21%*	*10%*	*35%*	*21%*
YoY growth				*-44%*	*-8%*	*-21%*
Cost inflation						
Wage inflation (4)			8.5			10.2
Marketing and promotional expenses (5)			3.0			3.1
Fixed SG&A expenses (6)			22.0			20.7
EBITDA (cost-adjusted)			20.5			15.7
EBITDA margin (cost-adjusted)			*21%*			*20%*
YoY Growth						*-24%*

Source: Daiwa forecasts
(1) Rebased 2014E GGR to 100
(2) 40% of GGR
(3) Assuming profit-sharing arrangement at 42.5% of GGR
(4) Increase of 20% YoY to factor in base wage inflation and increase in staff count from new property openings
(5) 3% of GGR for 2014E to 4% of GGR for 2015E
(6) 6% deflation between 2014E and 2015E to factor in potential cost savings

■ Macau Gaming Sector: junket ancillary non-gaming services



■ Junket watch list: our on-the-ground table count of Macau's top junkets by property and by operator ^

	Est. rolling	Sands China					Galaxy			MPEL			MGM	Wynn	SJM				
(No. of tables)	Mkt share	Venetian	SCC	Plaza	Sands Macao	Total	GM1	SW	Total	COD	Altira	Total	MGM	Wynn	Grand Lisboa	Self-promoted	Satellite casinos	Total	Grand total
Suncity	25%	18	18	20	11	**67**	20	20	**40**	29	11	**40**	**38**	**-**	-	-	34	**34**	**219**
Guangdong	15%	14	12	10	12	**48**	18	16	**34**	12	-	**12**	**48**	**18**	43	-	25	**68**	**228**
Tak Chun	10%	12	20	-	-	**32**	12	14	**26**	6	-	**6**	**-**	**-**	9	-	5	**14**	**78**
Golden Resort	10%	-	-	-	-	**-**	-	-	**-**	-	-	**-**	**-**	**-**	52	20	4	**76**	**76**
David	8%	-	-	12*	-	**12**	16	-	**16**	6	-	**6**	**16***	**28**	-	-	6*	**6**	**84**
Heng Sheng	8%	-	8	-	-	**8**	10	12	**22**	8	-	**8**	**13**	**10**	-	-	14	**14**	**75**
Junket tables		67	113	56	43	**279**	188	115	**303**	151	50	**201**	**180**	**164**	162	40	350	**552**	**1679**
Direct VIP tables		44	24	13	9	**90**	22	-	**22**	15	-	**15**	**20**	**50**	-	-	-	**-**	**197**
Total VIP tables (*)		111	137	69	52	**369**	210	115	**325**	166	50	**216**	**200**	**214**	162	40	350	**552**	**1876**
% of VIP tables with exposure to top-6 junkets		40%	42%	61%	44%	**45%**	36%	54%	**42%**	37%	22%	**33%**	**58%**	**26%**	64%	50%	25%	**38%**	**41%**

Source: Daiwa
*Note: * VIP rooms for which closures are planned in the next few months*
^ Our estimates may differ from the operators' published/formal official counts

■ Macau Gaming Sector: summary of changes to earnings forecasts, target prices and ratings

		Recommendation			Target Price			Old EBITDA (HKDm)				New EBITDA (HKDm)		EBITDA change	
Operator	Curr. Share Price	New	Old	Currency	New	Old	Implied Upside	2013	2014E	2015E	2016E	2015E	2016E	2015E	2016E
SJM	11.08	Outperform	Outperform	HKD	12.6	16.7	14%	8,676	8,264	7,484	6,490	6,176	5,939	-17%	-8%
MGM	17.90	Outperform	Outperform	HKD	20.1	23.8	12%	6,366	6,709	6,249	6,558	4,948	5,241	-21%	-20%
Sands	38.15	Hold	Hold	HKD	36.0	40.0	-6%	22,624	24,384	23,547	25,748	20,070	21,140	-15%	-18%
Galaxy	39.50	Hold	Hold	HKD	37.0	45.0	-6%	13,476	13,101	11,357	14,259	9,148	10,077	-19%	-29%
Wynn	20.20	Underperform	Underperform	HKD	19.0	22.6	-6%	8,801	8,162	6,966	8,633	5,518	6,170	-21%	-29%
Melco	22.97	Underperform	Underperform	USD	20.8	23.0	-9%	10,045	9,259	9,309	9,701	7,092	7,456	-24%	-23%

Source: Bloomberg, Daiwa forecasts, share prices as of 23 Jan 2015

■ **Macau Gaming Sector: issues, concerns, and implications**

Issue	Key highlights	Implications
GGR/EBITDA revisions	1) 2015 GGR forecast:: -21% YoY (from -7% YoY) 2) 2015 VIP GGR forecast: -30% YoY (from -19% YoY) 3) 2015 mass GGR forecast: -8% YoY (from +11% YoY)	1) Reducing our 2015E EBITDA by 19% 2) We forecast a 24% YoY EBITDA decline for 2015E (from -8% YoY previously) 3) Our revised 2015E sector EBITDA is 28% below the Bloomberg consensus; we expect further downward revisions by the consensus in coming months
VIP	1) A number of larger junkets (eg, Heng Sheng, David Group) plan substantial room closures and consolidation of operations 2) Junket capital from junket closures has not shifted to larger junkets, larger junkets are seeing a deterioration of their table yields 3) Surviving small junkets continue to operate below contractual table-betting volume minimums and have shifted to the cash-only model. Casino operators are showing little incentive to stop doing business with these non-performing junkets 4) Shareholder bases of a number of junkets (eg, Heng Sheng) have spun out and formed independent small junkets	1) Closures of larger junkets signal to use increasing systemic risk associated with the sub-junket model which the larger junkets are built upon; this trend points to further larger junket closures likely ahead 2) Dispels conventional wisdom of a "healthy consolidation" in the VIP segment 3) Underpins our thesis that smaller junkets are unlikely to consolidate with larger junkets 4) Prevailing trend suggests industry fragmentation rather than consolidation ahead
Mass	1) A number of ancillary junket services facilitating liquidity and frequency of travel are being trimmed or terminated 2) China's recent policy tightening has made Macau's 4 key demand drivers increasingly unappealing (gaming, luxury purchases, entertainment, and facilitation of capital outflows)	1) These services have supported sustained mass market growth; the development is incrementally negative for the segment 2) Destruction of these core growth drivers means we are unlikely to see near-term incremental growth catalysts for the mass market
UnionPay	1) Increasing volatility and weakening of the CNY 2) China's policy tightening on UnionPay new machine issuances, increased scrutiny over transactions	1) Unfavourable exchange rate for Mainland Chinese visitors render Macau more expensive 2) Increasing currency volatility amid policy tightening compels jewellery and watch shops and pawn-shop operators to charge a wider spread, further increasing the cost for Mainland Chinese visitors to Macau
Macro	3) Policy-induced sector pressures continue unabated and have broadened in scope, increased in frequency, and amplified in intensity	3) Policy tightening appears to be forcing structural reform to result in healthier gaming growth and diversification of Macau's economy 4) Transition impacts the VIP and premium-mass segments the most; likely to see sustained sector weakness ahead
Operating costs	1) We estimate that 15-20% of costs allocated to the VIP segment are fixed rather than variable 2) Weakness in junkets' gaming business is likely to loosen its firm grip seen to date on the existing hotel room supply, which we estimate to account for 60% of Macau's hotel room inventory) 3) Wage inflation and costs relating to new staff hires ahead of new property openings continue to be a risk, but less so now due to the macro deterioration	1) Risk of significant operational deleveraging in an environment of VIP revenue decline 2) Ex-junket hotel room supply (reallocation of rooms from existing properties + new property openings) expected to double in 2015. Increasing comp-ing activities amid reduction in frequencies of existing high rollers and declining quality of new gamers points to profit margin compression 3) We expect a 20% sector wage increase in 2015 (from 35%) as a result of new property openings and wage inflation

Source: Daiwa

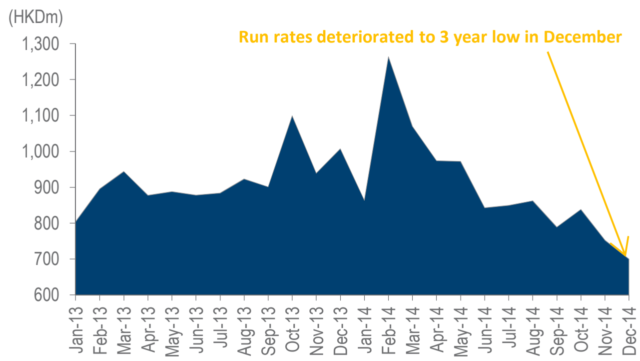
Revising down GGR growth forecasts

Run rates are still worsening

The Macau Gaming Sector's mass and VIP segments alike have seen a continuous deterioration in gross gaming revenue (GGR) run rates (both YoY and sequentially) over the past 3 months, as a result of China's further policy tightening over this period.

Our look at the recent run rate trend shows this was even weaker in December 2014 than in November (as the next chart shows), despite December being a seasonally stronger month historically and run rates last December being buoyed by very favourable win rates.

■ Macau Gaming Sector: GGR run rate trend



Source: APG, Daiwa

Admittedly, the deterioration in GGR run rates seen over the past 3 months and the further policy tightening have been even more severe than we were expecting at the time of our non-consensus sector rating downgrade report of 10 October 2014, *2015 to be much worse than 2014* (and also substantially below the Bloomberg consensus GGR forecasts).

We are revising down further our GGR forecasts as a result of new trends that have emerged, as well as pressures specific to each of the Macau gaming industry's segments, and which we assess in this report.

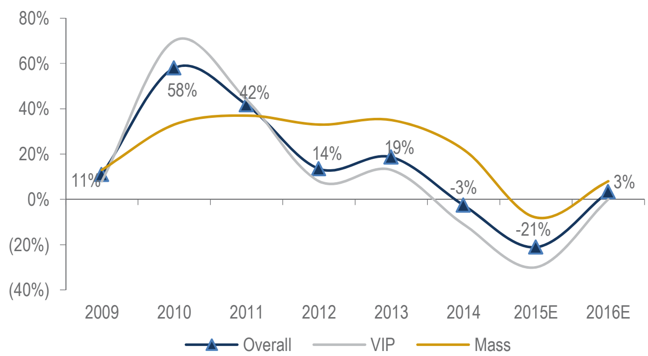
New GGR forecasts

Lowering our 2015-16E GGR. We are revising down our GGR forecasts for 2015-16 in the light of the following factors:

1) Weaker-than-expected run rates over the past 3 months, which we believe could persist this year.
2) The rate and scale of junket closures beginning in 4Q14 was faster than we were expecting, and more are likely to close this year, in our view.
3) A contagion impact we expect for the mass segment from the VIP segment's structural weaknesses.
4) The China Government's sustained and possible intensification of its anti-graft efforts, and depressed sentiment towards sector fundamentals for 2015 being worse than we had expected.

We now forecast GGR to decline by 21% YoY in 2015 and pick up slightly by 3% YoY in 2016. These figures compare with our previous forecasts of -7% YoY and +5% YoY for the respective years. For the VIP segment, we now expect a deeper and more prolonged trough cycle than before, and as such, we now forecast VIP GGR to fall by 30% YoY for 2015 (previously -19% YoY). We look for the mass segment's GGR growth to reverse from 15% YoY reported for 2014 to a decline of 8% YoY for 2015 (previously an increase of 11% YoY). The table that follows sets out our forecasts.

■ Macau Gaming Sector: revised GGR growth forecasts



Source: DICJ, Daiwa forecasts

■ Macau Gaming Sector: Daiwa GGR growth forecast revisions

		New		Previous	
(YoY)	2014	2015E	2016E	2015E	2016E
VIP	-11%	-30%	0%	-19%	0%
Mass	15%	-8%	8%	11%	12%
Overall	-3%	-21%	3%	-7%	5%

Source: Reported industry figures for 2014, Daiwa forecasts for 2015-16

■ Macau Gaming Sector: revenue forecasts

(HKDm)	Old revenue				New revenue			Revenue change (%)		Consensus		Variance (%)	
Operator	2013	2014E	2015E	2016E	2014E	2015E	2016E	2015E	2016E	2015	2016	2015	2016
SJM	87,651	83,488	73,863	68,932	79,605	64,344	63,379	-12.9%	-8.1%	76,490	75,624	-15.9%	-16.2%
MGM	25,728	26,621	26,591	29,252	25,555	21,288	23,354	-19.9%	-20.2%	25,923	31,196	-17.9%	-25.1%
Sands	69,303	78,724	77,992	80,012	73,919	59,331	65,809	-23.9%	-17.8%	75,056	85,849	-21.0%	-23.3%
Galaxy	66,033	77,865	72,357	90,108	71,514	54,832	58,282	-24.2%	-35.3%	81,027	92,665	-32.3%	-37.1%
Wynn	31,341	30,415	26,570	32,910	29,351	22,826	25,745	-14.1%	-21.8%	29,342	40,130	-22.2%	-35.8%
Melco	39,578	36,257	39,315	45,182	37,369	37,681	39,437	-4.2%	-12.7%	43,317	51,352	-13.0%	-23.2%
Sector	319,634	333,370	316,689	346,396	317,312	260,300	276,006	-17.8%	-20.3%	331,155	376,817	-21.4%	-26.8%

Source: Companies, Bloomberg, Daiwa forecasts

Do not bank on a recovery in 2H15

While in early January this year the consensus revised down its GGR growth forecasts for 2015, the market's new forecasts still point to a positive inflection point post-1H15, marked by: 1) sequential growth from new property openings, and 2) a low YoY comparison-base effect for 2H14.

We believe the consensus assumption of a GGR pick-up in 2H15 is overly-optimistic, as monthly GGR run rates continue to deteriorate sequentially amid the recent spate of China's incrementally negative policies for the Macau gaming industry. Arguably, new policy tightening over the past 2 months may still not be fully reflected in the most recent consensus gaming revenue numbers.

Unlikely blue-sky scenario: YoY GGR trend still negative in 3Q15E, slightly positive in 4Q15E
At the sector level, we consider a blue-sky scenario for GGR assuming the following:

1) Galaxy Macau Phase 2 and Studio City are granted 250 new gaming tables per property (representing an approximate 8-9% increase in the industry's total new table capacities), and
2) all these new tables yield the same table productivity rates as existing tables (a very bullish assumption, as we explain below).

The above scenario would imply an 8-9% sequential GGR improvement from 2Q15. However, when comparing run rates under this bullish assumption on a YoY basis, the GGR trend would still be a mid/high-single digit decline in 3Q15, then possibly resume low-single digit positive growth levels in 4Q15.

That said, to assume that new gaming tables' productivity will match that of existing tables looks a very aggressive assumption to us given that yields generally on existing tables are still declining. It is noteworthy that in 3Q14, the mass segment was still posting robust GGR growth of 16% YoY, thereby providing a difficult YoY comparison base extending into 3Q15.

Investors should also keep in mind that a number of sector cost pressures that we have highlighted on previous occasions and re-assess in this report will kick in during 2H15. All in all, we do not expect the incremental demand created by successive new casino property openings to offset the incremental costs of new property openings that stand to be incurred in 2H15.

Macro environment still worsening

Sector fundamentals continue to deteriorate amidst sustained policy tightening, pointing to a challenging outlook.

More policy headwinds likely

Since China's renewed effort to step up its anti-corruption drive in Macau in February 2014, we have seen a series of policies that have had a negative impact on the Macau Gaming Sector, as detailed in the table below.

At this point, there is no sign that these pressures will abate in the near term given that, over the past 2 months, these crackdowns have: 1) broadened in scope, 2) increased in frequency, and 3) amplified in intensity.

What have we learned from this?
Put simplistically, the impact of these policies on the Macau Gaming Sector can be assessed by looking at 3 key growth drivers:

Driver #1: capital availability
Driver #2: frequency of visits of high rollers
Driver #3: number of aggregate tourist arrivals

From our broad look at the developments of the past 12 months, all the restrictions put in place by China have been targeted selectively at the first 2 drivers (ie, clampdowns on the use of illegal UnionPay terminals, crackdown on the underground banking system, and transit visa restrictions). This has resulted in the significant weakening in capital availability and high roller visit frequency in the Macau gaming industry's higher-end segments (eg, VIP and premium mass).

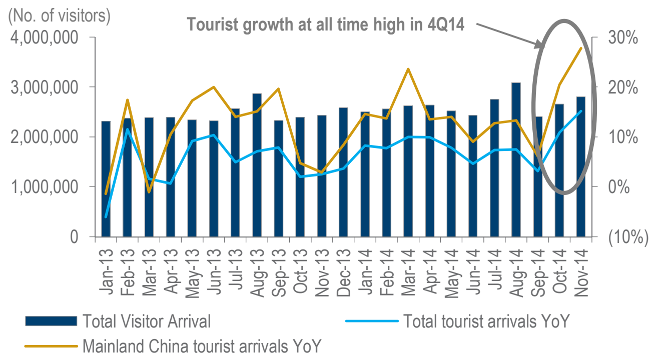
Not a headcount issue
Notwithstanding all these restrictions, we note that growth in the number of total Mainland Chinese tourists visiting Macau actually reached record-high levels in 4Q14, and that this growth accelerated in October and November last year (as the following chart shows).

■ China's policies and relevant news relating to and affecting the Macau Gaming Sector

Date	Event
13-Jan-14	President Xi stressed zero tolerance of corruption when addressing the 3rd plenary session of the CPC Central Commission for Discipline Inspection
10-Feb-14	Escalation of China's anti-corruption drive
17-Mar-14	Wife of one of Guangdong's shareholders detained for alleged money laundering
19-Apr-14	One of the principals, Huang Shan, of Kimren (junket) absconded with HKD8-10bn
8-May-14	Macau cracked down on the use of illegal mobile UnionPay terminals; simultaneous larger crackdown on underground banking system
1-Jul-14	Macau tightens transit visa policy; cut maximum stays for Mainland visitors with transit visas from 7 days to 5 days
6-Oct-14	Implementation of full smoking ban on mass and premium mass gaming floors
10-Oct-14	*Xinhua News* released a list of cases and officials involved in illegal gaming activities for the first time; more than 7,000 names were on the list
Late-Oct-14	Some casinos started banning phone betting
10-Nov-14	China APEC Summit 2014 took place, during which Xi announced the establishment of a cross-border law enforcement network to strengthen transnational anti-corruption cooperation
1-Dec-14	Increased scrutiny on transit visas at Chinese immigration checkpoints of persons seeking to travel to Macau
4-Dec-14	100 prostitutes and 22 alleged members of prostitution syndicate arrested at Venetian Macau
11-Dec-14	Hong Kong police's investigation into Cheung Chi Tai (ex-shareholder of Guangdong Group) led to freezing of his personal assets along with 7 of his personal companies
19-Dec-14	President Xi's visit to Macau for the region's 15th handover anniversary
1-Jan-15	New junket agent applicants allegedly required to submit background checks to Macau authorities to prove absence of criminal records
5-Jan-15	The Monetary Authority of Macau requested all banks to submit a list of high-risk merchant accounts together with respective business registration copies and records of UnionPay transactions. All banks are required to provide the above information for all new merchant applicants regardless of business type
8-Jan-15	Press reports mentioned possible further tightening of transit visa checks at Mainland immigration check points. (travellers entering Macau using a 5-day transit visa without travelling to a third country are to be put on watchlist. Travellers who repeat the offence within 60 days will be issued with a 1-day transit visa. Repeat offenders might be banned from leaving China for a period of 1-5 years.)
13-Jan-15	Prostitution ring bust; over 100 people arrested, including the nephew of Stanley Ho
14-Jan-15	China's Ministry of Public Security allegedly met with financial regulators and senior bankers in Macau to discuss details of a 'live monitoring system' to give them access to all money transfers made in Macau through China UnionPay bank payment cards.

Source: Daiwa

■ Tourist visitors to Macau



Source: DSEC, Daiwa

Deciphering China's motives

Our read is that China's motive in regulating Macau gaming stem not from a wish to wipe out gaming entirely, but rather from an aim to: 1) force a structural shift of the gaming industry to what is deemed to be healthier growth in its gaming revenue mix (ie, tourist-driven mass gaming market), and 2) encourage a diversification of Macau's economy (as expressed by President Xi during his visit to Macau in December 2014).

Early signs of such a structural shift are already visible. Our on-the-ground research indicates that an increasing number of visitors and hotel patrons are either casual gaming or non-gaming customers.

The transition process of this structural shift in Macau gaming's revenue mix could result in sustained sector headwinds, in our view.

Thus, we expect to see sustained selective crackdowns by China impacting the sector during 2015, including more policies targeting: 1) capital outflows from China, and 2) the frequency of high rollers' visits to Macau.

VIP segment: further consolidation or increasing fragmentation?

Amidst deteriorating VIP segment dynamics, surviving small junkets ironically appear to face the least risk.

The state of VIP deterioration

Over the past 12 months, we have seen a progressive weakening of the VIP segment's GGR and operating dynamics, driven by lower demand amidst a challenging liquidity and policy environment.

Operationally, for the VIP segment this has resulted in: 1) reduced cage capital, curtailing substantially the ability of junkets to conduct business, 2) mistrust among industry participants, and 3) the beginning of junket closures, primarily among the capital-constrained small and mid-sized operators.

■ VIP segment-specific negative developments in 2014

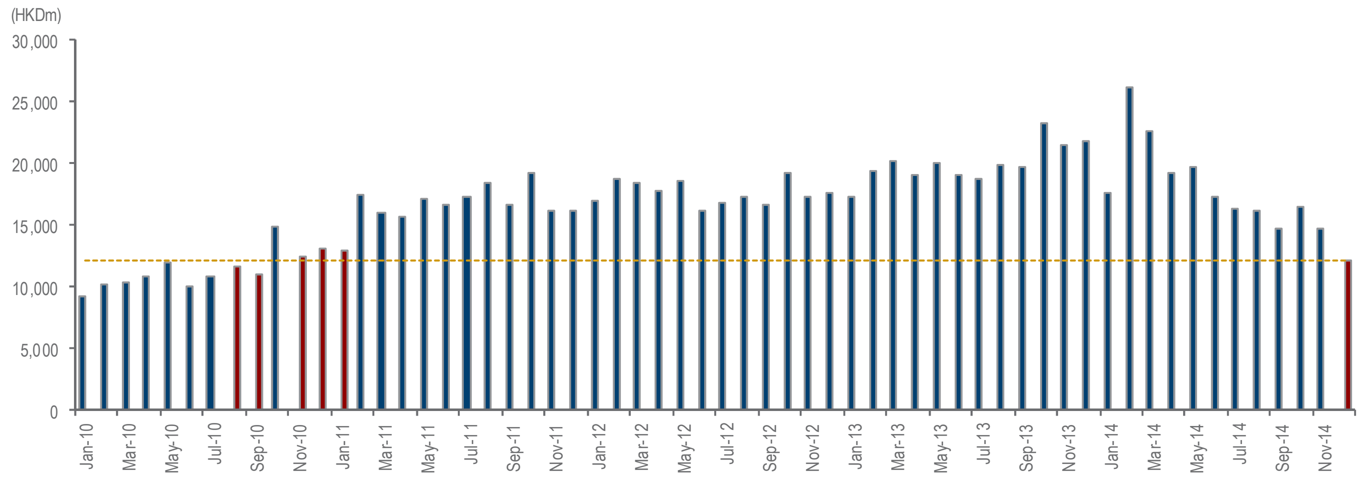
Date	Event
Feb-14	Anti-corruption drive stepped up in China
Mar-14	Wife of one of Guangdong's shareholders detained for alleged money laundering
Apr-14	Kimren junket incident (a principal absconded with HKD8-10bn)
May-14	Crackdown on illegal use of UnionPay terminals, and crackdown on underground banking system
Jul-14	Macau tightens transit visa policy; cut maximum stays for Mainland visitors with transit visas from 7 days to 5 days
Oct-14	Smoking ban made a number of VIP rooms non-smoking ones
Nov-14	Some casinos started banning phone betting in VIP rooms
Dec-14	Further scrutiny of transit visas, detainment of triad members impaired debt-collecting ability in China
Jan-15	Further round of scrutiny of transit visas, mandatory criminal checks on newly registered junket agents, prostitution ring bust at Lisboa, China's Ministry of Public Security met with financial regulators and senior bankers in Macau to discuss details of a "live monitoring system" on all money transfers made in Macau through China UnionPay cards

Source: Daiwa

These factors culminated in a number of junket closures, including the partial closures of Heng Sheng in October 2014 and David Group in January 2015, both of which are among Macau's top-10 junket operators.

December 2014 marked the worst-performing month for rolling daily run rates on the VIP segment since 2011, effectively wiping out 4 years of segmental growth. The next chart highlights this.

■ Monthly VIP rolling daily run rates (2010-14)



Source: APG, Daiwa

Not too big to fail?

The significance of recent junket closures
While investors have largely shrugged off the latest round of junket closures among Macau's top-10 junkets, we believe this development represents a fundamental change for the VIP business going forward. We go on to gauge the degree of further VIP segment weakness that we could see this year.

Understanding the weaknesses of the sub-junket model

The multiplier effect has historically spurred exponential growth for the VIP segment
Over the past 5 years, revenue growth experienced by most junket operators (regardless of their size) has been largely propagated through the sub-junket model – we illustrate this model on the next page. This has resulted in a form of junket financial leverage, leading to a multiplier effect and a consequent expansion of the available credit supply to enable junkets to conduct business.

This abundance of liquidity stimulated a period of exponential revenue growth for the VIP segment over 2009-1Q14. As the VIP business grew, so new investors and industry participants alike flocked to the junkets, thereby adding liquidity into the system.

The party ground to a halt in April 2014
This unprecedented multi-year growth cycle for the VIP segment amidst an abundance of liquidity was halted in April 2014, when Mr Huang, a principal of a small junket operator (Kimren), disappeared with HKD8-10bn.

This resulted in a significant ripple effect for the VIP segment: 1) deposits in junket operators once deemed safe were no longer considered safe, triggering large-scale cash withdrawals, 2) mistrust arose among industry participants and halted some junket businesses, and 3) confusion arose over counterparty risks and obligations when Mr. Huang and his associates fled the industry, which led to an increase in bad debts and uncollectibles.

Policy moves exacerbated the VIP segment's slowdown and woes
The months following April 2014 saw confusion, reorganisation and rebuilding of relationships between industry participants.

Then the VIP segment encountered a second round of pressure: China's escalation of its anti-corruption drive. In May 2014, China's authorities made a concerted effort to clamp down on the use of illegal UnionPay terminals. Further, July 2014 saw the start of a clampdown on transit visas for Mainland Chinese visitors to Macau and further restrictions have since been imposed. (Note that this has been the main method of entry into Macau by frequent gaming customers and high rollers).

Weakening VIP demand amidst a challenging operating environment resulted in further downward pressure on the VIP segment's GGR during 2H14, which also prompted incidents of theft, scamming and bad debts. The result was a further flight from junkets, among both sub-junkets and major junket shareholders.

Reduced capital has brought about an exponential VIP revenue decline
Hence, the robust VIP segment growth that had occurred during the 2009-1Q14 period of capital inflows for the junkets was followed by an exponential revenue downturn as capital exited the business.

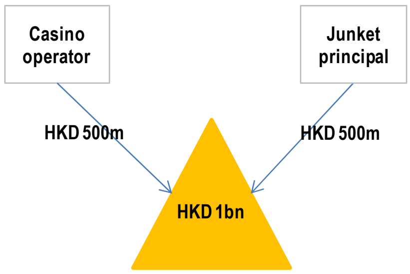
2H14 saw this reduced liquidity bite among the junket operators. This was exacerbated by a lengthening of the accounts receivable period (from 15 days to over 1 month), which in turn has put further pressure on junkets' working capital in an environment of low liquidity.

During 2014, junkets have seen their operations further burdened by continued policy tightening (curbs on transit visas, detainments of alleged triad members, reduced ability to collect gaming debts, mandatory criminal checks on newly registered junket agents, etc.). This has led to sustained junket closures into 4Q14 and the first weeks of this year.

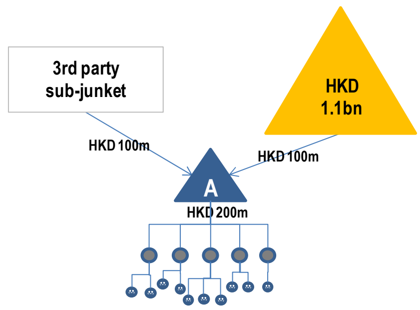
All of this points to a challenging and fragile operating environment for the junkets and thus for the VIP segment today. Our junket watch list (shown at the start of this report and reproduced in the subsequent table in this section), compiled by us from our on-the-ground research, shows the exposure levels of the operators in our coverage universe to the top junkets.

■ Macau gaming industry, VIP segment: how the sub-junket business model works

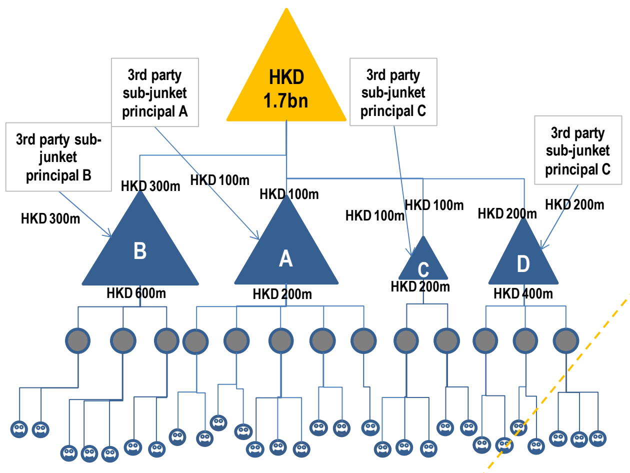
1. In this example, the junket principal contributes HKD500m in return for the casino operator's hotel rooms, VIP tables and a working capital advance of HKD500m. Total junket working capital stands at HKD1bn.



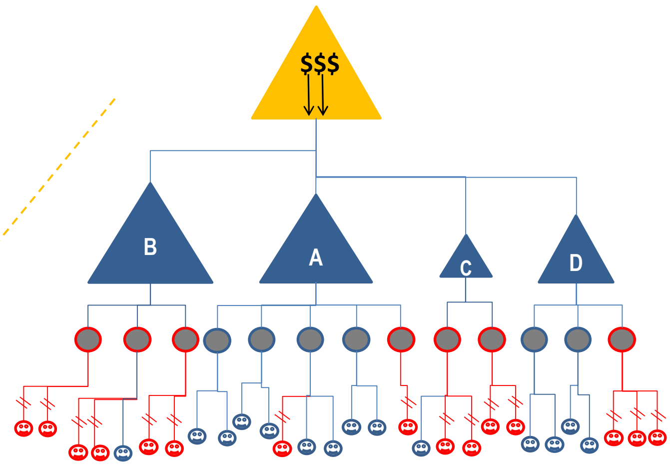
2. A third-party sub-junket negotiates to operate in a junket room. The sub-junket guarantees certain betting volumes to the junket and contributes HKD100m in return for junket advance of HKD100m, capital at the sub-junket level totals at HKD200m. The total exercisable capital for the junket group now stands at HKD1.1bn.



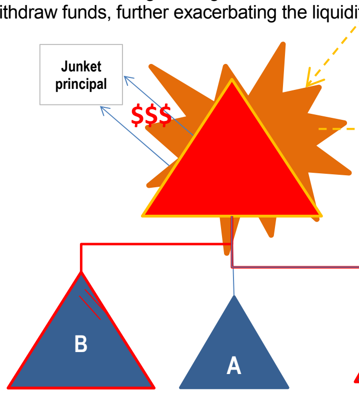
3. Proliferation of this model expands the junket group's capital in multiples of the junket's original contribution (HKD500m in this example). The sub-junket extends credit to its VIP customers through its own agent network. The gaming activity generated contributes to the sub-junket's negotiated betting volumes.



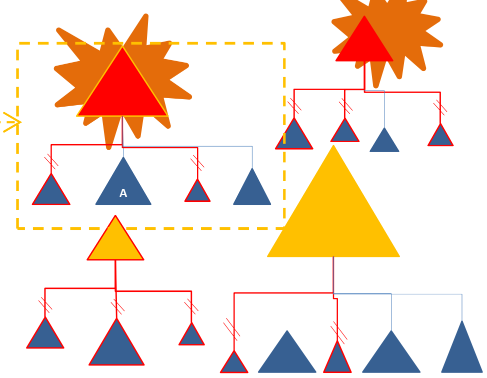
4. Some sub-junkets overextend themselves through excessive leverage, and this aggressive credit extension sees mounting bad debts and a strain on working capital for the sub-junkets amid a deteriorating macro climate.

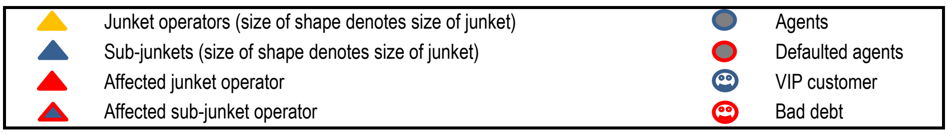


5. Agent defaults lead to uncollectable bad debts at the sub-junket level. The sub-junkets then exit the business due to poor liquidity and an inability to sustain credit lending. Facing sector weakness, some junket principals also withdraw funds, further exacerbating the liquidity shortage.



6. Proliferation of sub-junket defaults and closures ultimately affect junket liquidity, resulting in unsustainable working capital levels, ultimately leading to closures of junket rooms.





Source: Daiwa

■ Junket watch list: our on-the-ground table count of Macau's top junkets by property and by operator ^

	Est. rolling	Sands China					Galaxy			MPEL			MGM	Wynn	SJM				
(No. of tables)	Mkt share	Venetian	SCC	Plaza	Sands Macao	Total	GM1	SW	Total	COD	Altira	Total	MGM	Wynn	Grand Lisboa	Self-promoted	Satellite casinos	Total	Grand total
Suncity	25%	18	18	20	11	**67**	20	20	**40**	29	11	**40**	**38**	**-**	-	-	34	**34**	**219**
Guangdong	15%	14	12	10	12	**48**	18	16	**34**	12	-	**12**	**48**	**18**	43	-	25	**68**	**228**
Tak Chun	10%	12	20	-	-	**32**	12	14	**26**	6	-	**6**	**-**	**-**	9	-	5	**14**	**78**
Golden Resort	10%	-	-	-	-	**-**	-	-	**-**	-	-	**-**	**-**	**-**	52	20	4	**76**	**76**
David	8%	-	-	12*	-	**12**	16	-	**16**	6	-	**6**	**16***	**28**	-	-	6*	**6**	**84**
Heng Sheng	8%	-	8	-	-	**8**	10	12	**22**	8	-	**8**	**13**	**10**	-	-	14	**14**	**75**
Junket tables		67	113	56	43	**279**	188	115	**303**	151	50	**201**	**180**	**164**	162	40	350	**552**	**1679**
Direct VIP tables		44	24	13	9	**90**	22	-	**22**	15	-	**15**	**20**	**50**	-	-	-	**-**	**197**
Total VIP tables (*)		111	137	69	52	**369**	210	115	**325**	166	50	**216**	**200**	**214**	162	40	350	**552**	**1876**
% of VIP tables with exposure to top-6 junkets		40%	42%	61%	44%	**45%**	36%	54%	**42%**	37%	22%	**33%**	**58%**	**26%**	64%	50%	25%	**38%**	**41%**

Source: Daiwa
*Note: * VIP rooms for which closures are planned in the next few months*
^ Our estimates may differ from the operators' published/ formal official counts

Looking forward: gauging the underlying significance of recent junket closures

Underlying junket model weakness points to systemic issues faced by the larger players

David Group and Heng Sheng are 2 of Macau's top-10 junkets, which, like many of their larger peers, operate a sub-junket model. This model has enabled them to grow their capital and revenue base substantially in recent years, through the multiplier effect resulting from capital injections (primarily driven by new sub-junket participation) that we have described above. Due to the adverse developments we have highlighted in this report, both junkets have announced the closure of part of their operations, in October 2014 (Heng Sheng) and January 2015 (David Group).

In our view, these recent closures highlight the fundamental weakness of the sub-junket business model, especially against the backdrop of a contraction of the VIP market and poor liquidity. We believe that much of the risk faced by David Group and Heng Sheng is systemic to junkets operating a similar business model, and that their partial closures may signal a contraction of larger junkets' size going forward.

Furthermore, the lengthening seen since 2H14 of the junket debt-collection cycle is a negative trend which looks structural in nature. Our industry research indicates that customers now see this longer debt-collection cycle as the new norm, which will likely increase the risk of bad debts and thus further impair existing junkets' ability to optimise their shrinking capital bases.

A point to note is that David Group is among the oldest junkets, with over 10 years of operating experience. David Group thus differs from Heng Sheng, which is a relative newcomer with less experience and a shorter track record. Over the years, David Group has: 1) amassed a vast network of agents across China, 2) cultivated key relationships in both Macau and China, and 3) been operated by a very seasoned and experienced management team.

The decision to close a junket is not one that is made lightly, especially for a well-established and reputable junket operator. In our view, David Group's partial closure appears as a strong indicator that its operating team could be expecting further weaknesses in the VIP business that its operating team could be expecting in the months ahead.

Dispelling the myth of "healthy consolidation"; industry now undergoing fragmentation

Some investors have argued that the recent round of junket closures is healthy for the VIP segment, as it effectively: 1) weeds out the smaller (and generally worst-performing) junkets, 2) frees up valuable resources (ie, gaming tables and hotel rooms), and 3) allow larger (and generally better-performing) junkets access to these resources.

We disagree with this. Our counter-argument against consolidation among junkets rests on 3 key considerations, which we discuss below.

No signs of substantial capital shift to larger junkets

The VIP segment, by and large, is capital-driven (ie, no money = no business). If the thesis of "consolidation" holds true, then we ought to be seeing substantial increases in larger junkets' capital bases upon the closures of their peers, yet we have not observed this so far.

This is not surprising to us, as the closures or partial closures seen so far of larger junkets such as David Group and Heng Sheng have resulted largely from the underlying weaknesses of their third-party sub-junkets partners (to which these large junket operators have also extended credit). Consequently, we believe weaknesses among sub-junkets will create a chain reaction that will ultimately affect the capital base of the now troubled junket operators themselves. Given the circumstances of these junket closures noted above, we believe their closures are unlikely to result in any substantial capital spillover to the larger junkets still in operation.

Furthermore, the sub-junket business model is based to a large degree on trust. Thus, a sub-junket closure in one junket operator does not necessarily mean that the sub-junket operator will be readily able to partner with another junket operator.

It is noteworthy that some incremental increase in cage capital has been evident in recent months among the larger junkets. This is driven primarily by cash players and non-junket affiliated third-party agents that have withdrawn funds from the smaller junkets and deposited them into the larger ones. However, this increase is has been marginal when compared with the capital that has been withdrawn or lost from the junket system as a result of junket closures.

Surviving smaller junkets should be the main beneficiaries: likely shift to a low-cost and low-risk model. Contrary to a common perception in the market, small junkets that are surviving today actually face the least operating risk with no incentive to consolidate with a bigger junket operator, in our view.

As discussed in our sector report of October 2014, smaller junkets had already dipped below their contractual per table betting volumes during 3Q14. Anecdotal evidence shows that today, some small junkets are operating at below 50% of their contractual table minimums.

However, in the currently challenging macro environment for the gaming industry, there is little marginal benefit for a casino operator from closing these VIP rooms or re-allocating these tables, in our view, given falling mass-table yields and a lack of higher-quality junkets that are willing to take up the tables. As such, a number of small junket operators continue to operate today without having to cut junket commissions or surrender some of their gaming tables.

Compared with its large junket counterparts, the small junket model looks enviable since small junket operators:

1) face no pressures from meeting contractual minimum betting volumes per table: they fell below this in 3Q14
2) bear little risk of forced closures or cuts in junket commissions: they have already fallen below contractual minimums for several months, yet are still allowed to operate
3) bear no credit risk: most surviving small junkets switched to a cash play-only model in 2H14 and have long stopped extending credit to gaming patrons, and
4) have very low operating costs, with no need to support ancillary services, unlike their larger counterparts (see our discussion of these services further on).

We expect more of the bigger junket players to downsize. Under a consolidation scenario among junkets, we ought to be seeing a bigger footprint (ie, table count, casino property exposure, etc.) among the larger junkets as smaller players progressively exit the industry. Yet we have not observed this trend either so far.

Admittedly, larger junkets generally have seen market share expansion in recent months. However, our analysis shows that this has stemmed not from growth in their business, but rather from smaller junkets' closures and greater declines in table productivity vs. their larger peers. Our latest research shows that a number of larger junket operators are looking at opportunities outside Macau (ie, other South East Asia gaming hubs), which we believe can be considered a further indicator of the persistent weakness they expect in Macau's VIP segment going forward.

We are already seeing increasing fragmentation

Our look at the shareholder bases of some of the new small junkets operators reveals that their owners have already left larger junkets to form their own smaller junket operators.

An example of this is the large junket operator Heng Sheng, which underwent some room closures which hit the headlines in October 2014. Heng Sheng's shareholders have divested and already formed 3 separate and independent junket operations – JD, Heng Chang, and Heng Sheng. We have also observed this trend among other junket operations and expect it to continue over the course of 2015.

Mass segment: potential contagion from VIP weakness

We see headwinds for the mass segment from a lack of structural growth drivers and potential contagion from the VIP segment's weaknesses.

Structural growth drivers seem lacking

Looking at the Macau gaming industry's mass segment, our on-the-ground conversations with industry participants suggest Macau's appeal for a typical Mainland Chinese tourist falls broadly into combinations of the following 4 demand drivers, listed below and illustrated in the following chart:

1) Gaming/gambling

2) Luxury purchases

3) Entertainment

4) Facilitating capital outflows

In recent months, a series of crackdowns in Macau (as discussed earlier in this report) have made all 4 of these demand-drivers a less appealing proposition for the typical mass/ premium-mass-segment customers from Mainland China. There is no sign that the policy pressures on Macau's gaming industry, including on the mass segment, will ease anytime soon. Not only is mass gaming demand weakening, those factors that over past years have supported demand and the mass segment's growth are also impaired (as we discuss below).

In our view, the overall decline in Macau's appeal for mass gamers and erosion of the factors that had supported the mass segment's past consumption habits point to sustained weakness in mass segment GGR this year.

Implications of VIP weakness for mass segment

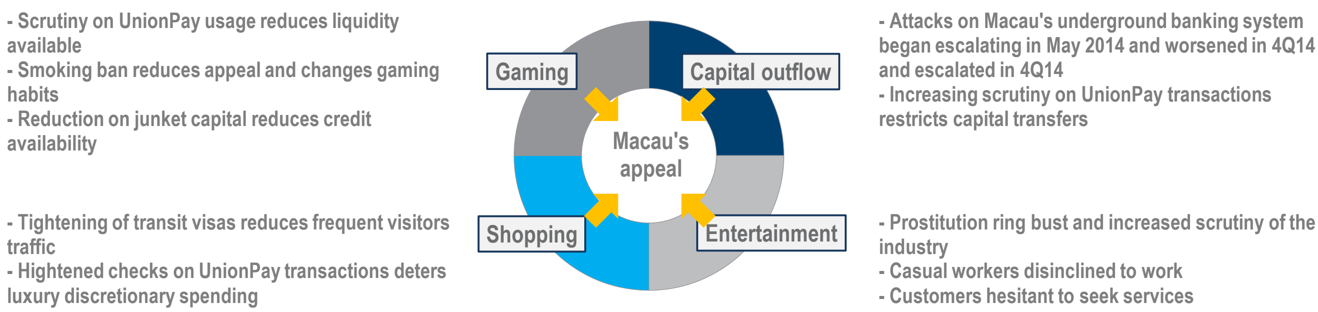
Ancillary services of junket operators have supported mass segment growth

We believe that the VIP segment's structural weakness will have a tangible impact on business for the mass segment. Our in-depth look at both segments shows that a number of ancillary non-gaming services sponsored by junket operators (shown in the subsequent chart) have helped to support the sustained growth of the mass segment over the years.

We have found anecdotal evidence that a number of these junket-sponsored ancillary services are not profitable for the junket operators, but have been established to help support their core VIP gaming businesses.

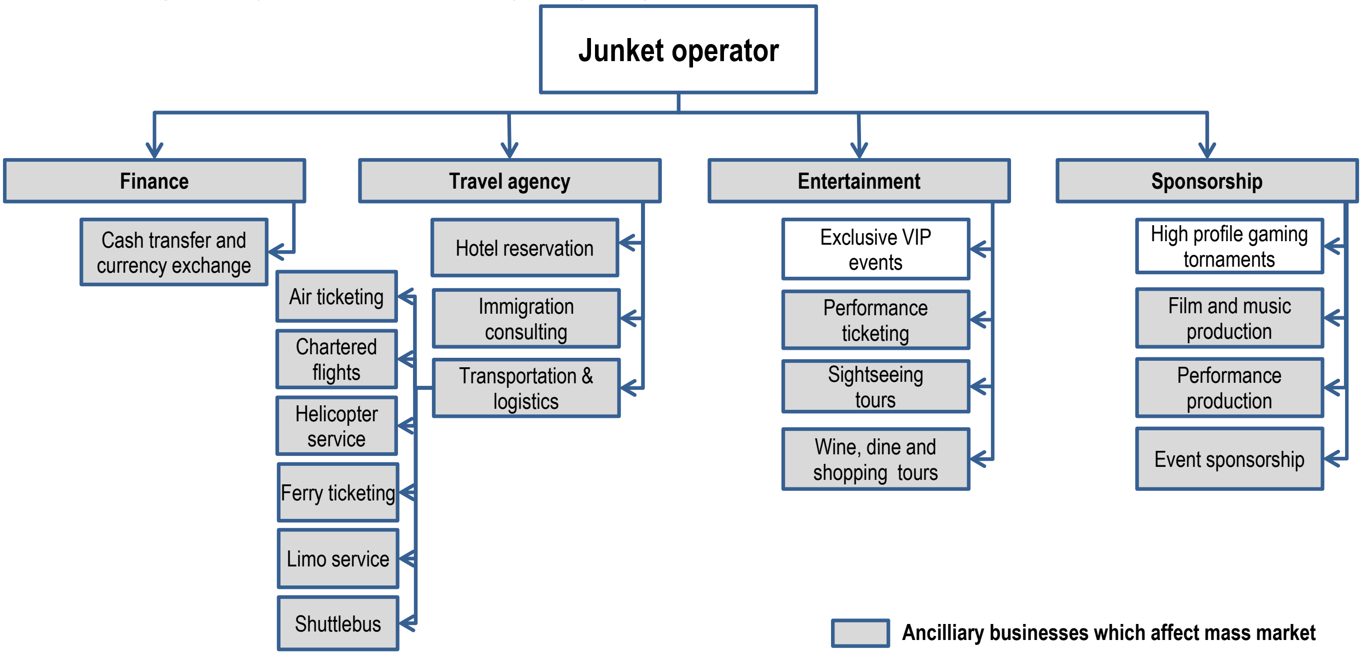
With the larger junkets now facing increasing sector pressures (as discussed in the preceding chapter on the VIP segment), we believe it is increasingly likely that ancillary non-gaming services will be scaled back or terminated. Such a move would be negative for the mass segment, in our view.

■ Factors influencing Macau's appeal as an entertainment haven



Source: Daiwa

■ **Macau Gaming Sector: junket operators' ancillary non-gaming services**



Source: Daiwa

Cash and currency exchange. One of the major ancillary services provided by junket operators is access to liquidity via: 1) UnionPay terminals within jewellery and pawn shops, and 2) the underground banking system. Over past years, customers in the mass gaming segment have piggy-backed off of these channels to service their spending in Macau.

The junket closures seen over recent months and that we expect in the coming months are likely to result in disruptions and weaknesses in the above channels, which will also likely affect adversely mass-segment customers' ability to access liquidity.

During our recent visit to Macau, we already observed 10 jewellery and pawn shop closures in the Dynasty region (the epicentre of UnionPay activities). As we counted about 55 UnionPay jewellery and watch shops around the region, this implies that 18% of such stores have closed to date.

■ **Jewellery and watch store closures in Macau's Dynasty region**

Source: Daiwa

Snapshot of some junket-sponsored travel agencies in Hong Kong and Macau sponsored by junket operators

Source: Daiwa

Travel agencies. A number of the larger junket operators have also established their own travel agencies to service primarily their VIP patrons, and by extension, the mass gaming segment

These travel agencies offer a wide range of services, including:

1) Immigration consultations: transit visas, business visas, etc.

2) Travel services: ferry, aeroplane and helicopter services, private cars and shuttle bus services

3) Hotel reservations: one-stop shop services for lower-cost rooms, leveraging off junket operations in multiple casino properties

4) Entertainment: sightseeing tours, private entertainment arrangements, and tickets for shows and concerts (some of which are junket-sponsored events).

Disruptions these travel agency services would hamper travel to Macau for Mainland mass-segment customers.

Special events and sponsorships. Junket operators have traditionally sponsored numerous major events, as a form of advertising to broaden their client reach and also to draw VIP customers to Macau.

Many flagship events held in Macau (eg, the Macau Grand Prix, concerts, golf and poker tournaments) have historically drawn high visitor numbers to the city (and by extension gaming dollars). A number of these events also rely heavily on sponsorships by junket operators.
A decline in such junket-sponsored events would lead to either a decline in quality or the frequency of such events, which in turn would have a negative impact on the headcount and gaming dollars they represent for the mass gaming segment, in our view.

Examples of junket-sponsored special events in Macau

Source: Daiwa

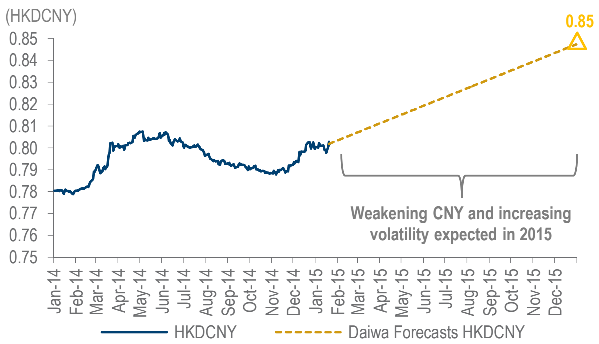
UnionPay liquidity continues to weaken on clampdowns

According to our on-the-ground research, since the Lunar New Year month of February 2014 (which marked the single-month all-time high for the Macau Gaming Sector's GGR, the liquidity provided through UnionPay terminals via jewellery and pawn shops has declined by as much as 60% compared to 1Q14 levels, with no signs of a recovery at this time.

This is likely due to the following key reasons:

1) **CNY weakness and volatility.** The CNY has depreciated by about 2.5% against the HKD over the past year, while the HKD/CNY exchange rate has become increasingly volatile in recent months.

■ HKD/CNY exchange rate



Source: Bloomberg, Daiwa

The jewellery, watches and pawn shops that provide liquidity for mass gaming customers through UnionPay devices charge a spread over the prevailing HKD/CNY exchange rate as a profit. The combination of 1) a cheaper CNY, 2) increasing CNY/HKD exchange rate volatility, and 3) a widening of the forex spread charged by the UnionPay shop operators over recent months, have made converting the CNY and withdrawing Hong Kong Dollars in Macau much more expensive compared to a year ago.

Furthermore, Daiwa's economics team forecasts the CNY to weaken further against the HKD by another 6% and become increasingly volatile during 2015, which would be unfavourable for Mainland visitors to Macau.

2) **Crackdown on illegal UnionPay devices in May 2014.** This is the use of Mainland registered point-of-sale machines operating in Macau. This method of withdrawing cash has enabled Mainland Chinese visitors to Macau to bypass the overseas daily cash withdrawal limits (CNY1m/day) and offer a lower transaction cost for the UnionPay terminal operator (thereby enabling the operator to charge a lower spread on the exchange). Anecdotally, the cost of using UnionPay terminals has increased since China restricted their use starting in May last year.

3) **Further policy tightening.** Since early 2014, China has stepped up its scrutiny of new UnionPay machine issuances, specifically targeting the jewellery and watch shops that have traditionally provided cross-border liquidity. Additionally, recent reports (South China Morning Post, among others) indicate that China's Ministry of Public Security will be working with the Macau Monetary Authority and local banks to introduce a "live monitoring system" on UnionPay transactions conducted in Macau to track illicit funds.

Implications for sector's financials

We expect the weak operating climate to prompt casino operators to devise operational strategies to protect cost structures and margins.

EBITDA margin contraction likely for 2015

Over the past 6 months, we have identified and discussed a number of cost pressures for Macau casino operators arising from revenue declines: notably staff cost inflation, pre-opening costs, deleveraging effects of fixed SG&A expenses, increased advertising & promotion costs. We examined these cost components in detail in our report of 10 October 2014.

We believe these cost pressures are still not assessed adequately by the investment community.

Our view stems from the fact that for 2015, the Bloomberg consensus is currently looking for an 8% YoY decline in sector GGR but EBITDA growth of 2% YoY and a stable EBITDA margin on a YoY basis of 21%. All of these assumptions look too bullish to us. Our argument is premised upon the following considerations:

Cost analysis during past period of market GGR growth was largely immaterial. In past year, detailed scrutiny by investors of the Macau Gaming Sector's cost structure, and of the fixed and variable cost components, was not substantial, largely overlooked and considered immaterial as any cost inflation was readily absorbed by: 1) overall GGR growth, and 2) the change in the sector's revenue mix change from VIP to encompass increasingly the fast-growing mass segment.

In our view, this is no longer the case given the GGR contraction that we and the consensus expect in 2015. When examining the cost structure of an integrated casino property, the bulk of the costs are arguably fixed, regardless of how they are allocated, implying upward pressure on a casino property's costs at a time of declining GGR.

VIP segment's relevance to sector cost analysis
It has been widely argued that the VIP segment, while representing 60-65% of Macau's GGR annually over recent years, only accounts for 20-30% of the sector's EBITDA mix and is therefore relatively insignificant in the sector's EBITDA make-up – we disagree.

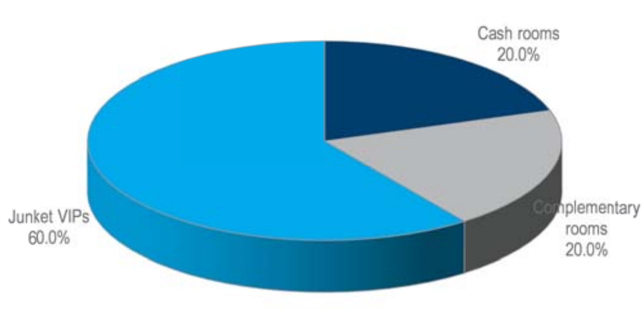
We note that within the VIP segment, there are only 2 genuinely variable cost drivers: gaming tax (40% of GGR) and junket commission (about 40-45% of GGR).

Stripping out these 2 cost items would imply that roughly 12-15% of the post-gaming tax operating costs historically allocated to the VIP segment is fixed (assuming a normalised EBITDA margin for the VIP segment of 12%).

Hence, our forecast of a 30% YoY decline in the VIP segment's GGR for 2015 should result in a 2pp decline in this segment's EBITDA margin to 10% in 2015 alone (before accounting for any of the macro cost pressures discussed in this report).

Junket room closures should lead to a doubling of Macau's hotel room supply in 2015, implying further margin pressure
We expect junket room closures to result in a decline in demand and allocations of hotel rooms by casino operators to junkets this year. We estimate that approximately 60% of Macau's existing hotel room supply has historically been allocated to junkets in Macau. These hotel rooms are typically sold at a discount (near cost levels) to junket operators to service their customers. In other words, junkets have indirectly supported financially 60% of the casino operators' hotel operating costs in the past.

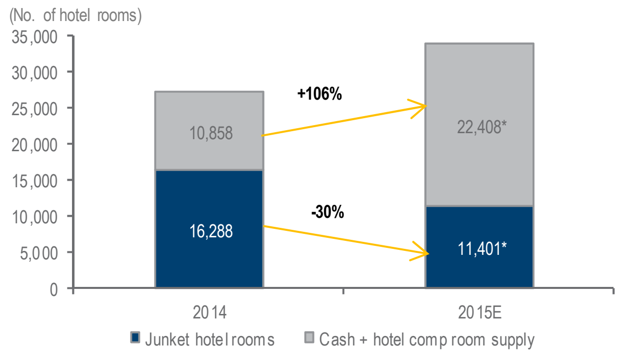
■ Macau Gaming Sector: current average hotel room allocation by the 6 major casino operators



Source: Daiwa

The weakening VIP segment implies that Macau's hotel room supply will increase, not just on the back of new property openings, but also from room reallocations of existing properties. Assuming that VIP demand for hotel rooms falls by 30% YoY for 2015 (in line with the GGR decline we forecast for the VIP segment), this implies a doubling of Macau's hotel room supply (existing + new supply) in 2015, as shown in the following chart.

Macau's hotel room supply



Source: DSEC, Daiwa forecasts
*Note * Our forecasts for hotel rooms assumes: 1,350 rooms for Galaxy phase .2: 1,600 rooms for Studio City: 3,000 rooms for the Parisian: 373 rooms for Hotel Roosevelt, and 320 rooms for Broadway (previously Grand Waldo)*

We expect an increase in the hotel room supply to prompt casino operators to step up their comp-ing activities (providing free rooms for gaming customers is more profitable than selling the rooms for cash). However, this increase in the hotel room supply looks to be coming at a time of declining new player quality, reducing frequencies of visits of existing high-rollers, and mass revenue slowdown. As such, we expect the increased hotel room supply to be a further drag on the sector's profit margins in 2015.

Staff-cost pressure persists. As highlighted in our October 2014 sector report, we believe the staff cost increases at the casino operators that we expect in 2015 will be driven by: 1) wage inflation, and 2) new staff hires from new property openings.

Admittedly, these cost pressures now look less pronounced due to: 1) an easing of the pressure on the existing labour supply due to the sector's much worse-than-expected run rates over the past 3 months, and 2) the increasing likelihood of delays in new property openings. Nevertheless, we still expect total staff costs to increase by a material 20% YoY for 2015. Those operators with casino openings this year should see the highest wage inflation and thus negative operating leverage in 2015. These are Galaxy Phase 2 (May 2015), Melco Crown Studio City (3Q15), and Sands' Parisian (4Q15).

What does this mean for EBITDA and margins? Granted, this year we could see some degree of EBITDA margin improvement stemming from a favourable revenue mix shift from the VIP to the higher-EBITDA margin mass segment, given that we forecast VIP GGR to decline faster than mass GGR this year. However, we believe that even this shift will not be sufficient to offset EBITDA margin pressure arising from the combination of overall weakening top lines and cost inflation for the casino operators.

When taking into account sector cost inflation that we expect (wages, marketing, SG&A expenses), we forecast the sector's EBITDA margin to contract by at least 1pp to 20 % in 2015, resulting in a 24% YoY decline in our sector EBITDA for 2015E when factoring in our revised sector GGR forecasts – as we illustrate in the table below. This compares with our previous forecast for an 8% YoY EBITDA decline for 2015.

Note that our forecasts already factor in what we consider as very prudent cost control. This is based on our underlying assumption that the casino operators will be very responsive and aggressive in cutting costs in this macro environment (we have already begun to see operators' managing the labour pool more actively).

If the casino operators are unable to manage costs effectively, this could lead to further downside to our already below-consensus EBITDA forecasts.

Macau Gaming Sector: revised GGR, cost and EBITDA forecasts

	2014E			2015E		
	VIP	Mass	Overall	VIP	Mass	Overall
GGR (1)	63.0	37.0	100.0	44.1	34.0	78.1
YoY growth				-30%	-8%	-21%
Operating costs						
Gaming tax (2)	(25.2)	(14.8)	(40.0)	(17.6)	(13.6)	(31.3)
Junket commission (3)	(26.8)		(26.8)	(18.7)		(18.7)
Fixed costs	(3.5)		(3.5)	(3.5)		(3.5)
EBITDA	7.6	13.0	20.5	4.3	11.9	16.2
EBITDA margin	12%	35%	21%	10%	35%	21%
YoY growth				-44%	-8%	-21%
Cost inflation						
Wage inflation (4)			8.5			10.2
Marketing and promotional expenses (5)			3.0			3.1
Fixed SG&A expenses (6)			22.0			20.7
EBITDA (cost adjusted)			20.5			15.7
EBITDA margin (cost-adjusted)			21%			20%
YoY growth						-24%

Source: Daiwa forecasts
(1) Rebased 2014E GGR to 100
(2) 40% of GGR
(3) Assuming profit-sharing arrangement at 42.5% of GGR
(4) Increase of 20% YoY to factor in 15% YoY base wage inflation and increase in staff count from new property openings
(5) 3% of GGR for 2014E to 4% of GGR for 2015E
(6) 6% deflation between 2014E and 2015E to factor in potential cost savings

New property openings: delays still likely

Better to open late than be wrong
If, as we expect, GGR during the Lunar New Year proves lacklustre, this should provide further evidence that the "build it and they will come" mantra is unlikely to hold up in 2015 when it comes to the casino operators' planned new property openings.

For the casino operators, the most critical decision to be made, in our view, is whether the business trends during Lunar New Year will warrant them delaying their new property openings planned during 2015.

New property openings continue to face risks of opening delays. We believe all the new property openings scheduled this year by the 6 casino operators we cover are likely to be delayed. These include Galaxy Macau Phase 2, the property slated for the earliest opening among our coverage, announced on May 27, 2015. In our view, new properties opening amid the market contraction that we expect in 2015 risk being delayed. Further, the likely lacklustre Lunar New Year could prompt a rethink on the timing of these new property openings.

Our view stems from the following observations:

1) In the current period of VIP segment weakness, junkets are continuing to close rooms and reduce their operating bases (even some of the biggest junkets in Macau), as discussed in this report. We believe that operators with new capacity face short-term difficulties in finding sufficient demand from quality junket partners if they open the new capacities early.

2) Driving mass segment GGR growth is much more passive in nature (ie, allocating further table resources to this segment does not necessarily generate an incremental return of an equal magnitude). The Macau casino operators continue to see a negative-growth environment, where table yields have declined sequentially in 2014. This is arguably a sign that the mass table count is facing saturation in the prevailing macro environment.

   We note that all new casino property openings have historically created incremental new demand. In 2015, however, we expect this new demand to be small, and may be insufficient to warrant earlier new property openings.

3) An increase that we expect in Macau's hotel room supply this year is unlikely to drive significant new gaming demand. It is well known that Macau's hotel room supply is constrained and some have argued that new hotel room supply will drive gaming revenue for the casino properties.

   In our view, the above argument is only true to an extent, since Macau is seeing an increasing number of casual gamers or non-gamers. However, increasing numbers of Mainland Chinese visitors and hotel patronage do not necessarily translate into gaming dollars. We already saw this in October 2014 – there were no new hotel rooms then compared to the prior peak season, but average hotel spot rates fell by 30% and mass GGR growth was negative YoY yet tourist arrivals from the Mainland reached a new all-time high.

Earnings, stock pecking order and valuation

Investment thesis

Continue to be defensive

In the context of our outlook for lacklustre revenue growth, rising costs, and EBITDA margin erosion in 2015, we continue to prefer operators with more defensive cost profiles.

We do not believe the "build it and they will come" mantra will hold up in 2015. As such, operators with earlier new property openings, ie, Galaxy and Melco, will likely continue to bear the highest immediate risk of cost increases and the greatest potential for EBITDA margin erosion, in our view.

We leave our SOTP valuation methodology for all 6 operators in our coverage unchanged but adopt 12-month target prices (as discussed below). Our stock ratings and pecking order stand unchanged, as shown in the table below. Our 2 top picks continue to be MGM and SJM, both rated Outperform (2).

■ **Macau Gaming Sector; current pecking order**

Order	Stock	Rating	Investment thesis
1	MGM	OP	1) 2nd last new Cotai property opening; less labour cost hike pressure, especially with likely property opening delay 2) Solid operator with strong junket mix; mass table yield also the highest in Macau 3) Small property and small operating base, nimble cost control that is much easier to manage than mega-resorts amid a market contraction
1	SJM	OP	1) Defensive revenue mix; takes 3-5% of satellite casino revenue; opex incurred borne by third parties 2) Least immediate labour cost pressures, given the last Cotai new property opening (Lisboa Palace due in 2017) 3) Cash-rich and likely the only operator able to maintain its current dividend policy through this capex cycle (regular and special) 4) Grand Lisboa has among the highest VIP table yields, as it has the highest mix of quality junkets among peers 5) Valuation looks cheap
3	Sands	Hold	1) Cotai property opening scheduled in 2015 faces labour cost pressure but less than Galaxy and Melco, in our view, given a lower incremental capacity increase from existing higher base 2) Grind mass-centric and best retail offering attracts headcount and, by extension, gaming dollars 3) Risks of negative operating leveraging (ie, margin erosion) with lowest table yields among peers 4) Recent aggressive table shift to mass appears unsuccessful; further table shift to mass unlikely to create new demand
4	Galaxy	Hold	1) Earliest new property opening among our universe means it will likely see the greatest cost pressures 2) One of the highest incremental increases in table/hotel capacity – a negative; partly offset by strong VIP and market-leading table yields 3) Best junket management programme; we expect its VIP segment to outperform peers but it is likely to see greater-than-peer top-line pressures due to its VIP-heavy business mix
5	Wynn	UP	1) Likely to see top-line pressure/market-share losses from collapse of high-end gaming market 2) New Cotai property opening likely in 2016, so should see less immediate labour cost hikes pressure 3) Pre-opening staff hiring should also impact Wynn in 2015; hit in 3Q/4Q15 ahead of Wynn Palace's opening, slated for Lunar New Year 2016 4) Most expensive valuation relative to peers at current share prices
6	Melco	UP	1) Among the largest incremental increases in table/hotel capacity with Studio City's opening expected in 3Q15, which is a major negative 2) We expect its VIP segment to underperform that of industry in 2015 due to an unfavourable junket mix 3) Its underperforming Altira property will likely take time to adjust

Source: Daiwa

■ **Macau Gaming Sector: summary of changes to earnings forecasts, target prices and ratings**

	Curr. Share Price	Recommendation			Target Price		Implied Upside	Old EBITDA (HKDm)				New EBITDA (HKDm)		EBITDA change	
Operator		New	Old	Currency	New	Old		2013	2014E	2015E	2016E	2015E	2016E	2015E	2016E
SJM	11.08	Outperform	Outperform	HKD	12.6	16.7	14%	8,676	8,264	7,484	6,490	6,176	5,939	-17%	-8%
MGM	17.90	Outperform	Outperform	HKD	20.1	23.8	12%	6,366	6,709	6,249	6,558	4,948	5,241	-21%	-20%
Sands	38.15	Hold	Hold	HKD	36.0	40.0	-6%	22,624	24,384	23,547	25,748	20,070	21,140	-15%	-18%
Galaxy	39.50	Hold	Hold	HKD	37.0	45.0	-6%	13,476	13,101	11,357	14,259	9,148	10,077	-19%	-29%
Wynn	20.20	Underperform	Underperform	HKD	19.0	22.6	-6%	8,801	8,162	6,966	8,633	5,518	6,170	-21%	-29%
Melco	22.97	Underperform	Underperform	USD	20.8	23.0	-9%	10,045	9,259	9,309	9,701	7,092	7,456	-24%	-23%

Source: Bloomberg, Daiwa forecasts, share prices as of 23 Jan 2015

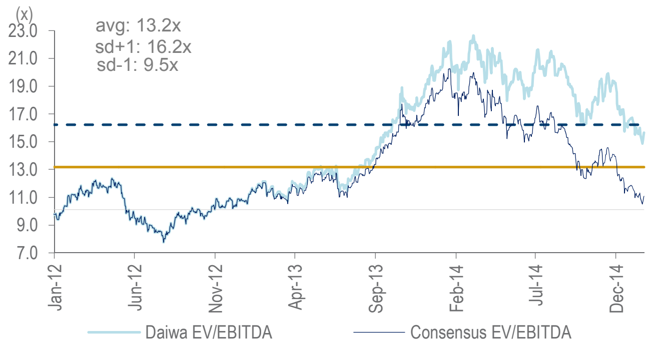
Valuation

We lower our target prices for the 6 operators we cover, now on a 12-month horizon (formerly 6-month horizon). These reductions reflect our lowered 2015 EBITDA margin forecasts, and our target adjusted EV/EBITDA multiples continue to range between 7x and 11x, based on the properties' business mix, Peninsula/Cotai exposure and sensitivity to cost inflation.

Valuations still look unattractive; sector share prices do not appear to have fully factored in the prospect of lower 2015E earnings. For 2015E, the Bloomberg consensus still forecasts: 1) sector EBITDA growth of 2% YoY, and 2) flat EBITDA margins of 21%. Based on our forecasts, the sector is currently trading at a 2015E EV/EBITDA of 16.1x, 22% above its 3-year average of 13.2x.

We continue to argue that the Macau Gaming Sector may still see a further de-rating from here given that the sector's valuation over past years has factored in market expectations of a 36% EBITDA CAGR (2008-1H14), rather than a YoY decline in EBITDA that we forecast for 2015. Our new sector 2015E EBITDA forecast is now 28% below that of the consensus. Over the coming months we expect further clarity on emerging trends we have identified in this report and envisage further cuts to consensus earnings, suggesting the sector could mark time or see a further derating over the coming months.

■ Macau Gaming Sector: EV/EBITDA multiple



Source: Bloomberg, Daiwa

Assessing the downside from here. The sector has shed 48% of its value since its peak in January 2014. However, based on the Bloomberg consensus forecasts it is still trading at an average 2015E EV/EBITDA multiple of 11.1 x, which is higher than its trough 7.7x EV/EBITDA multiple reached in 2012. If the sector were to revert to its trough EV/EBITDA multiple, this would imply 32% share price downside from current levels.

Risks to our sector call.
The main upside risk to our Neutral sector rating would be unexpected improvements in China's economic fundamentals and an easing in the monetary policy by the China Government.

A secondary upside risk would be the Macau government relaxing its policies on transit visas and gaming table allocation.

The main downside risk to our sector call would be if the China Government were to crack down even further with its anti-graft measures.

Secondary downside risks would be delays in new property openings, a steeper downturn in the VIP segment compared with our expectations, any further unfavourable structural shifts in the tourist mix to Macau, lower-than-expected new table grants, and further adverse visa policy changes.

■ Macau Gaming Sector: target multiples

	Share price				New implied 2015E multiples (x)		Prev. implied 2015E multiples (x)		Historical 1-yr fwd EV/EBITDA (x)			Historical 12m fwd PER(x)		
Operator	(23-Jan)	Recommendation	Currency	Target price	EV/EBITDA	PER	EV/EBITDA	PER	Peak	Trough	Average	Peak	Trough	Average
SJM	11.08	Outperform	HKD	12.6	11.0	15.8	9.8	16.2	15.7	3.2	8.1	19.4	8.4	13.6
MGM	17.90	Outperform	HKD	20.1	16.0	23.8	13.5	17.9	18.8	6.0	10.8	21.4	6.4	13.0
Sands	38.15	Hold	HKD	36.0	14.9	21.7	12.9	20.3	20.0	9.1	13.4	34.3	12.0	20.1
Galaxy	39.50	Hold	HKD	37.0	16.7	23.1	14.8	21.1	24.0	2.3	9.5	46.8	8.5	19.1
Wynn	20.20	Underperform	HKD	19.0	20.7	33.8	19.1	26.9	19.1	7.5	12.2	24.1	10.4	16.9
Melco	22.97	Underperform	USD	20.8	13.0	19.9	13.6	15.8	42.5	5.4	12.2	28.4	11.3	19.5

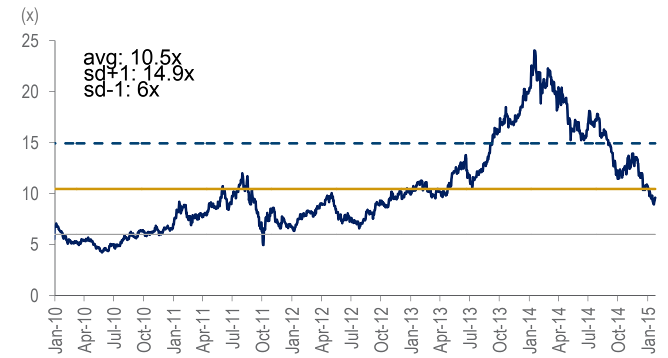
Source: Daiwa

■ Macau Gaming Sector alongside global gaming companies: valuation summary

Company	Ticker	Share price (local cur.)	Market cap (USDbn)	Rating	EV/EBITDA		EBITDA Growth YoY (%)		PER		2-yr EPS CAGR (%)	Div yield (%)		FCF (%)	
					2014E	2015E	2014E	2015E	2014E	2015E	2013-15E	2014E	2015E	2014E	2015E
Macau large cap															
Galaxy	27 HK	39.50	22.0	Hold	11.8	17.7	(2.8)	(30.2)	16.0	24.6	(17.0)	n.a.	n.a.	1.6	n.a.
Melco Crown	MPEL US	22.97	12.7	Underperform	11.4	15.7	(7.8)	(23.4)	19.8	66.1	(45.0)	n.a.	n.a.	n.a.	n.a.
MGM China	2282 HK	17.90	8.7	Outperform	9.9	14.3	5.4	(26.2)	12.1	21.2	(22.5)	2.9	1.6	0.2	n.a.
Sands China	1928 HK	38.15	39.7	Hold	12.8	15.8	7.8	(17.7)	17.0	23.1	(11.9)	4.7	3.5	4.5	2.7
SJM	880 HK	11.08	7.9	Outperform	4.3	7.1	(4.8)	(25.3)	8.9	13.8	(24.0)	8.2	5.2	7.2	n.a.
Wynn Macau	1128 HK	20.20	13.4	Underperform	13.5	21.5	(7.3)	(32.4)	15.6	35.9	(38.5)	5.1	2.2	n.a.	n.a.
Macau large cap - market cap weighted avg					**11.6**	**16.1**	**0.6**	**(24.2)**	**15.9**	**29.5**	**(22.2)**	**4.9**	**3.2**	**2.6**	**1.0**
Macau s/mid cap															
Paradise Group (KR)	1180 HK	2.51	0.3	NR	8.9	6.1	38.8	38.0	24.5	13.4	12.2	1.4	2.7	4.2	6.3
Grand Korea Leisure (GKL)	577 HK	3.60	0.4	NR						5.4	191.2	0.0	0.0		
Macau Legend Development Ltd	1680 HK	2.57	2.1	NR	19.4	13.6	24.0	56.9	27.3	16.8	31.1	0.0	0.0	(12.9)	(10.0)
Macau s/mid cap - market cap weighted avg					**9.6**	**7.7**	**5.8**	**17.9**	**18.5**	**15.9**	**8.0**	**1.9**	**2.2**	**4.0**	**6.6**
Asia															
Paradise Group (KR)	034230 KS	25,700.00	2.3	Outperform	14.4	9.9	(5.3)	39.1	17.8	15.4	18.8	1.8	2.7	4.1	4.4
Grand Korea Leisure (GKL)	114090 KS	40,000.00	2.5	Outperform	12.5	9.4	(19.5)	27.9	19.5	15.6	7.3	2.6	2.8	4.6	9.9
Kangwon Land	035250 KS	32,500.00	7.0	Outperform	10.1	8.3	25.4	18.7	17.8	15.6	22.4	3.1	3.5	2.0	5.5
Genting (Malaysia)	GENT MK	8.85	9.2	NR	7.2	6.3	0.6	9.2	18.9	16.3	(5.4)	0.9	0.9	5.4	7.0
NagaCorp (Cambodia)	3918 HK	5.97	1.8	NR	8.4	6.6	3.9	20.8	12.4	11.2	(1.8)	5.6	5.8	0.4	1.0
Summit Ascent	102 HK	4.23	0.8	NR			22.4	184.6		34.4	234.6	0.0	0.0		
Asia - market cap weighted avg					**9.6**	**7.7**	**5.8**	**17.9**	**18.5**	**15.9**	**8.0**	**1.9**	**2.2**	**4.0**	**6.6**
US															
Las Vegas Sands	LVS US	53.89	43.2	NR	10.1	10.6	14.9	(3.5)	15.6	16.2	7.2	3.7	4.7	7.0	4.9
Wynn Resorts	WYNN US	146.01	14.8	NR	11.7	13.0	0.9	(4.9)	18.9	20.8	(4.3)	3.5	4.1	(2.8)	(1.1)
MGM Resorts	MGM US	20.00	9.8	NR	11.1	11.0	14.6	4.2	41.7	40.4	43.6	0.0	0.0	(0.1)	(8.2)
Caesars Entertainment Corp	CZR US	11.66	1.7	NR	13.3	12.2	258.9	12.7	n.a.	n.a.	45.7	0.0			
US - market cap weighted avg					**10.7**	**11.2**	**17.8**	**(2.3)**	**19.6**	**20.2**	**10.8**	**3.1**	**3.8**	**3.7**	**1.7**
Australia															
Crown Resorts Ltd	CWN AU	12.21	7.0	NR	13.6	13.0	(4.3)	5.9	15.0	13.3	2.4	3.1	3.3	0.8	2.7
Echo Entertainment Group Ltd	EGP AU	3.94	2.6	NR	8.0	7.7	17.3	4.1	17.1	16.3	12.0	2.7	2.9	4.7	3.7
SKYCITY Entertainment Group Ltd	SKC AU	3.81	1.8	NR	9.8	9.6	17.9	9.2	17.4	15.9	9.2	4.9	5.0		
Australia - market cap weighted avg					**11.8**	**11.3**	**4.0**	**6.0**	**15.9**	**14.4**	**5.6**	**3.3**	**3.4**	**1.5**	**2.5**

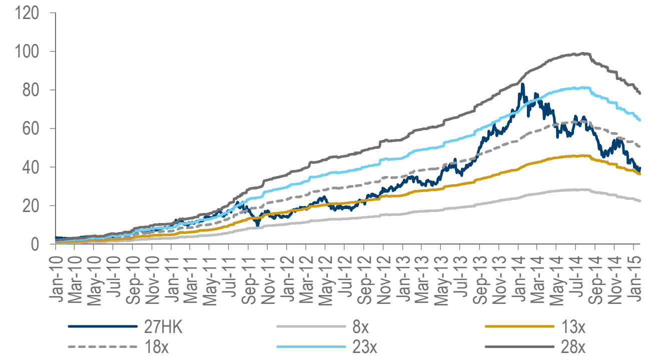
Source: Bloomberg (unrated companies), Daiwa forecasts (rated companies)
Note: based on share prices as of 23 January 2015

■ **Galaxy: EV/EBITDA multiple (x) based on Bloomberg consensus**



Source: Bloomberg, Daiwa

■ **Galaxy: 12-month forward rolling PER (x) based on Bloomberg consensus**

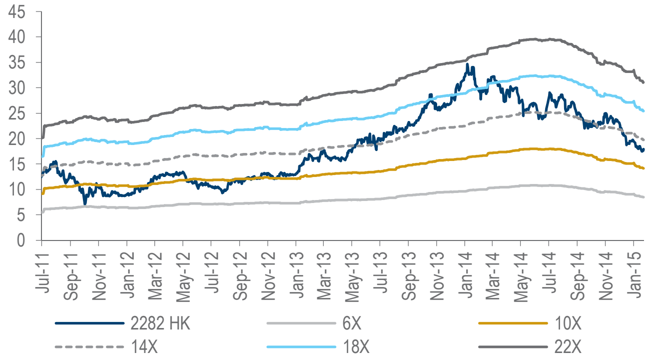


Source: Bloomberg, Daiwa

■ **MGM China: EV/EBITDA multiple (x) based on Bloomberg consensus**

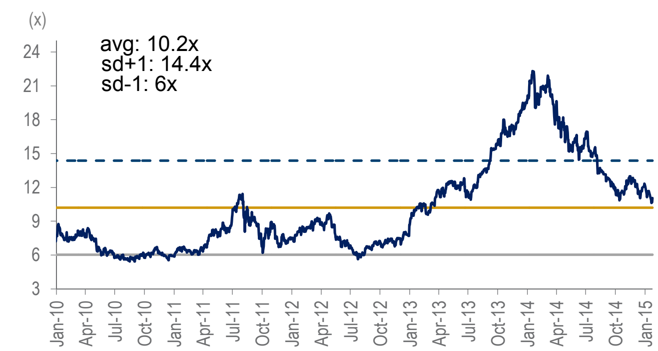
Source: Bloomberg, Daiwa

■ **MGM China: 12-month forward rolling PER (x) based on Bloomberg consensus**



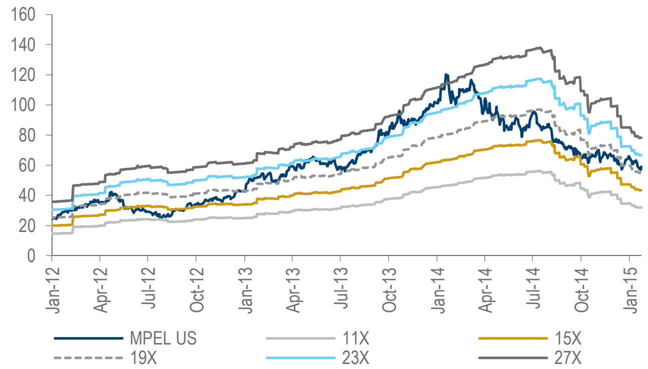
Source: Bloomberg, Daiwa

■ **Melco: EV/EBITDA multiple (x) based on Bloomberg consensus**



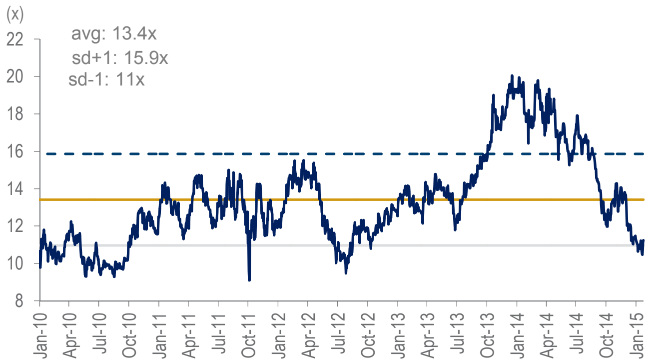
Source: Bloomberg, Daiwa

■ **Melco: 12-month forward rolling PER (x) based on Bloomberg consensus**



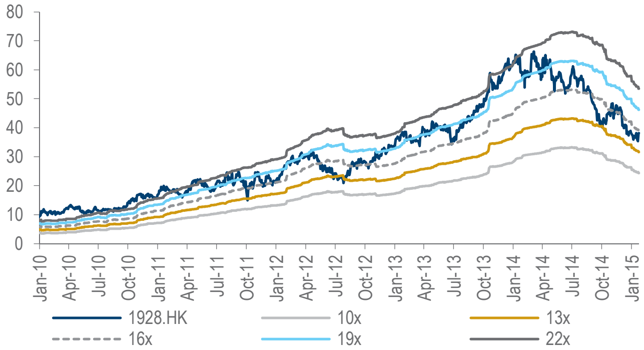
Source: Bloomberg, Daiwa

■ Sands China: EV/EBITDA multiple (x) based on Bloomberg consensus



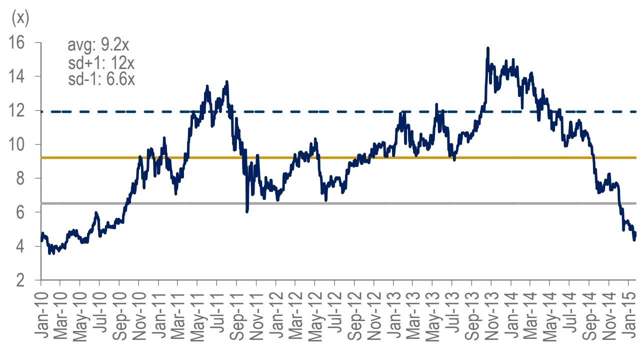
Source: Bloomberg, Daiwa

■ Sands China: 12-month forward rolling PER (x) based on Bloomberg consensus



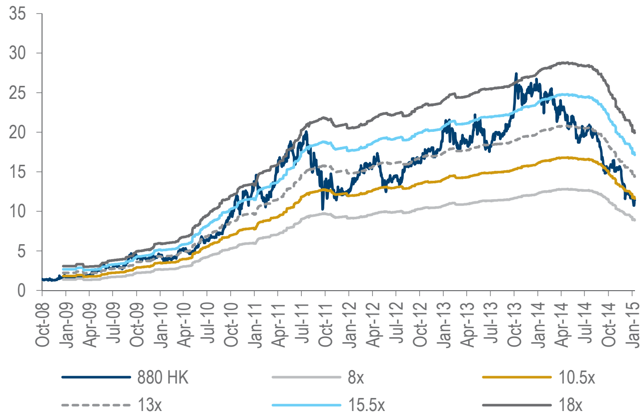
Source: Bloomberg, Daiwa

■ SJM: EV/EBITDA multiple (x) based on Bloomberg consensus



Source: Bloomberg, Daiwa

■ SJM: 12-month forward rolling PER (x) based on Bloomberg consensus

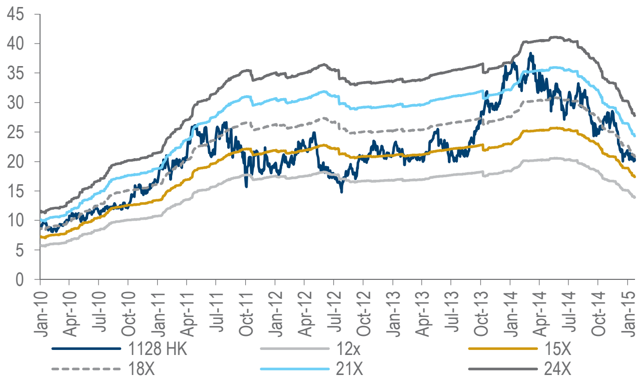


Source: Bloomberg, Daiwa

■ Wynn: EV/EBITDA multiple (x) based on Bloomberg consensus

Source: Bloomberg, Daiwa

■ Wynn: 12-month forward rolling PER (x) based on Bloomberg consensus



Source: Bloomberg, Daiwa

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