

Macau Gaming Sector

Concessions renewal: prepare for an arduous journey

- The issue of gaming concessions is increasingly topical ahead of the government's expected mid-term review announcement (end-2016)
- We met with Macau legislator Mr. Jose Pereira Coutinho, who shared with us his view on the issue as well as the legal considerations
- All 6 licences should ultimately be renewed without the introduction of new contenders — but the process is unlikely to be timely or orderly

Negative

Neutral

Positive


Neutral
 (unchanged)

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What's new: As a follow-up to our report on Macau's concessions renewal ([On keeping the concessions](#), 19 June 2015), we now offer an alternative view on this critical and evolving issue. We discussed the topic with Mr. José Pereira Coutinho, one of the longest-serving independent and direct elected member of Macau's legislative assembly.

What's the impact: **Number of licences to remain unchanged, but renewal process unlikely to be orderly.** Mr. Pereira Coutinho expects the 6 gaming concessions and sub-concessions to remain upon renewal. He does not foresee major changes to the governance of the concessions, but highlighted that some clauses within the 6 gaming contracts may be amended. He also flagged potential headwinds and legal hurdles regarding the administrative process in handling the issue of renewals, which will likely make the process a drawn-out affair, in his view.

1) Licences up for open bidding upon expiry. The law stipulates that concessions may not be further renewed once the life of the concession agreement expires (post-2020/22 + a 5-year extension) and should be opened up for public tender thereafter. Mr. Coutinho believes the law will ultimately be amended to allow the existing concessions to operate beyond the stipulated timeframe. But he highlighted that Macau and China's policy stance and political environments are extremely fluid, and one cannot rule out the (limited) possibility of the government opening up the bidding for licences post-2022. Also, he does not rule out the underlying ownership structures of some casino operators seeing changes according to the prevailing social conditions of Macau.

2) Convoluted legal basis of the sub-concession and its elevation to concession status. Mr. Pereira Coutinho also expects the issue of licence renewal to be contentious and does not rule out the possibility of a public outcry if the government does not aptly handle the treatment of the sub-concessions. His view is premised on what he sees as the sub-concessions' questionable legal basis, as: 1) the law indicates there should be no more than 3 concessions, when there are effectively 6 today, and 2) the sub-concessions were not awarded through public tender, when the law indicates that such a step was required.

What we recommend: Investors should be mindful of the ramifications of sector developments, and we remain cautious on the sector's fundamentals. The contentious nature of the concession and sub-concession renewals is another reason to tread carefully, in our view.

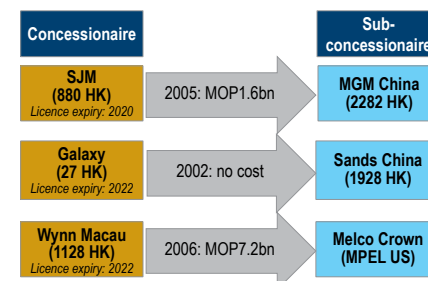
How we differ: We are one of the first brokers to explore the administrative and policy issues surrounding concessions renewal.

Mr. Jose Pereira Coutinho



Source: Daiwa

Structure of Macau's gaming concessions/sub-concessions



Source: Company, DICJ, Daiwa

Mr. José Pereira Coutinho's views are his alone, expressed in a personal capacity, and do not necessarily correspond with those of Daiwa or the Macau Government.

Prepare for an arduous journey

Where the sector stands today

Release of mid-term review delayed

The mid-term review, which had been slated to be completed by 2H15, has been delayed and its submission to the central government pushed back to end-2016

The gaming licences for Macau's 6 casino concessionaire/sub-concessionaires are set to expire in 2020-22. The market had largely expected the government to have completed preliminary discussions on licence renewal during the mid-term review in 2H15 and the results announced to provide some guidance to the public in 1H16.

However, in early March 2016, Macau's Secretary for Economy and Finance, Mr. Lionel Leong Vai Tac, indicated that progress on the mid-term review had been slower than expected and that a report on the review would be submitted to the central government by the end of this year. This announcement came 1 month after Mr. Leong had previously guided that the results of the mid-term review would be available "as soon as possible", which was to be sometime after the Lunar New Year holiday in February.

Mr. Leong did not specify when the findings of the report would be released to the public or whether the full report will ultimately be available to the public. He did assert that the findings of the mid-term review may influence negotiations on the specific terms in discussions of licence renewals. The government has in the past commented that the mid-term review would examine:

- 1) Development of the gaming industry
- 2) The economic impact on Macau
- 3) The impact on small and medium-sized enterprises
- 4) The impact on local society
- 5) The relationship between gaming and non-gaming sectors
- 6) Whether casino operators had fulfilled their concessionary contracts
- 7) The operational status of the gaming companies
- 8) Whether the gaming operators had fulfilled their social responsibilities and their management of junkets

More speculation than a reflection of fundamentals

Given the lack of clarity on the process, there has been much speculation on what the timing and terms of the renewals will look like (ie, the number of gaming licences, the sub-concession issue, tax rates, and one-off payments). As discussed in detail below, while the market's speculation on policy-making has influenced short-term sector share prices, the rhetoric does not necessarily reflect the underlying fundamentals, in our view.

Potential issues related to the handling of the sub-concessions may have prompted Mr. Leong's recent comment on "cautious processing" of data especially the legal data

This report is Daiwa's attempt to re-examine the critical issue of licence renewal in an alternative light, with the aim of offering some clarity on the process and highlighting some of the considerations that are likely to play out in the next few years.

It may also be noteworthy that Mr. Leong had attributed the recent delay in the mid-term review results to "cautious processing" of report data, especially data pertaining to legal issues relating to the mid-term review. Some of the issues we discuss in this report, especially the discussion on the issues relating to Macau's sub-concession, may provide some rationale for this comment.

Highlights of our meeting with Mr. José Pereira Coutinho

Biography



Source: Daiwa

Mr. Pereira Coutinho is a member of the Legislative Assembly in Macau, one of the highest governing bodies in Macau. His party, New Hope, occupies 2 of the 14 seats for elected members. Mr. Pereira Coutinho is now one of the longest-serving elected members of the assembly (on his 3rd term, with almost 12 years in office) and has been among the most vocal on issues relating to gaming. He also has a clear view on issues from a legal standpoint given his career in law prior to his entry into politics.

A comment on Macau's policy-making apparatus today

In Mr. Pereira Coutinho's view, the overarching theme within the Macau Government is the reactive and knee-jerk decision-making nature of policy makers who usually focus on issues that affect social stability. He remarked that this can, in part, be attributed to a high degree of collective indecisiveness among those in power.

As things stand, we have already seen tangible delays in the release of the results of 2H15's mid-term review, a process that was supposed to clarify some of the fundamental issues facing the sector today. Mr. Pereira Coutinho stressed that there is still a high probability of continued delays in the resolution of these issues, and that the administration may further miss its guided policy milestones.

1. Social stability is of utmost priority

Mr. Pereira Coutinho holds the view that under the "one-country, two systems" approach in Macau, maintenance of social and political stability will continue to be the Macau and China administrations' top priorities. Since Macau's gaming tax still constitutes almost 90% of its GDP and tax income, the issue of gaming licence renewal is an important and sensitive topic. Under this fundamental framework, Mr. Pereira Coutinho expects Macau's policy environment to remain anchored by the goal of not inciting significant volatility in the underlying social and political conditions of Macau.

As we discuss below, there has been much contention surrounding the granting of licences in the past, and the government is unlikely to want to arouse further controversy over this renewal process. Indeed, given the multitude of issues under consideration, the ultimate resolution of this key issue will likely render this process a long and arduous one. The recently delayed announcement of the mid-term review strengthens this assertion, in our view.

2. Gaming concessions/sub-concessions will remain the existing six

The 6 gaming concessions are likely to remain in place, with no more and no fewer than the existing 6 upon licence renewal. Moreover, there are unlikely to be major changes made to the governance of these concessions upon licence renewal in terms of rules and regulations.

However, among some of the possible changes under consideration are giving the government a greater ability to exert further influence over the operators. In Mr. Pereira Coutinho's view, this could involve: 1) shortening the new concession terms (from 20-25 years currently), and/or 2) amending the existing laws and regulations to add specificity on areas that the existing framework does not adequately address. Additionally, there have been public discussions of possible changes to the existing licence system, including a shift towards a "one premise/one licence" system similar to the Las Vegas model.

The 6 gaming concessions are unlikely to see major changes, though changes to the concession terms cannot be ruled out

Open bidding a possibility post concession expiration

Furthermore, Mr. Pereira Coutinho did not rule out the possibility that the underlying shareholding structure among some of the casino operators could see changes according to the prevailing social conditions of Macau.

Shareholding structure

Substantial shareholders					Note
	Entity No.1	% held	Entity No.2	% held	
Sands China	Las Vegas Sands Corp (LVS)	70.3%	N/A	N/A	Sheldon Adelson owns 52% of LVS
Galaxy	Lui family	50.5%	N/A	N/A	
Wynn	Wynn Resorts Limited	72.3%	N/A	N/A	Steve Wynn owns 11% of Wynn Resorts
MGM	MGM Resorts Int'l (Delaware)	51.0%	Pansy Ho	27.4%	
SJM	STDM	54.1%	Angela Leong	8.6%	
MPEL	Melco Leisure	34.2%	Crown Asia	34.2%	

Source: Companies, Daiwa

3. Potential for open bidding post-expiry

According to Article 13 of Law No. 16/2001 "Legal Framework for the Operations of Casino Games of Fortune", up to 6 months prior to its expiry date, a concession contract may be extended by the Macau Government up to a limit of 20 years. Beyond the 20 years, the concession may be exceptionally extended by the Macau Government up to a further limit of 5 years. Thereafter, the current legal framework does not allow these concessions to be further renewed.

Law No. 16/2001 (Article 8) further stipulates that a public tender must be conducted in order to award licences for the operation of casino games of chance in Macau. Hence, legally and technically, the gaming concession should be reopened for bidding once the 25 years (20 years + 5 years maximum extension) is up.

That said, given that the 6 operators have continued to invest significant resources in casino projects, it is perhaps a stretch to imagine the government driving out any of the 6 incumbent concessionaires when their terms technically expire. As such, upon the end of the concession period and as long as the existing concession system continues, the law will have to be amended.

Article 13 of Law 16/2001: Legal Framework for the Operations of Casino Games of Fortune

Portuguese	
Artigo 13.º	
Prazo das concessões	
1.	A atribuição das concessões para exploração de jogos de fortuna ou azar em casino é precedida de concurso público.
	Se uma concessão for adjudicada por um período inferior ao máximo permitido pela presente lei, o Governo pode, a qualquer momento e até seis meses antes do fim da concessão, autorizar uma ou mais prorrogações da concessão, desde que o período total não exceda o prazo
2.	máximo previsto no número anterior.
	Uma vez atingido o prazo máximo previsto no n.º 1, a duração da concessão pode, a título excepcional, ser prorrogada, mediante despacho
3.	fundamentado do Chefe do Executivo, por uma ou mais vezes, não podendo exceder, no total, o período de cinco anos.
	A prorrogação do prazo de uma concessão pode dar lugar a uma revisão do contrato de concessão, assim como à celebração entre as partes
4.	de adendas ao mesmo.
Chinese	
第十三條	
批給之期間	
一、	經營娛樂場幸運博彩之批給期間應在批給合同內訂定且不得多於二十年。
	如批給之判給期間低於本法律允許之上限，政府可隨時最遲在批給期屆滿前六個月，批准一次過或分多次將批給延長，但以期間之總數不超過上款規定之最長期間為限。
二、	如批給期間已達到第一款規定之上限時，有關期間可例外地透過具說明理由之行政長官批示一次過或分多次延長，
三、	但總數不得超過五年。
四、	批給期間之延長可引致批給合同被修訂，亦可引致由雙方簽訂合同附錄。
English (translated by Mr. José Pereira Coutinho)	
Article 13	
Term of concessions	
1.	The term of concession for operation of casino games of chance is set in the concession agreement and may not exceed 20 years.
2.	If a concession is granted for a period less than the maximum allowed by this law, the Government may at any time up to six months before the end of the concession, authorise one or more extensions of the concession, provided that the total period does not exceed the maximum period provided for in the preceding paragraph.
3.	Once the maximum period provided for in paragraph 1 is reached, the duration of the concession may be exceptionally extended by reasoned order of the Chief Executive, by one or more times, not exceeding, in total, a period of five years.
4.	The extension of the term of a lease may give rise to a revision of the concession contract, as well as the conclusion between the parties of supplements thereto.

Source: DICJ, Daiwa

4. Treatment of sub-concession may be a contentious issue

3 concessions were first granted in 2002; 3 sub-concessions were subsequently extended

A brief history of Macau's gaming concession/sub-concession structure

Under Law No. 16/2001 passed by the Legislative Assembly of Macau, the Macau Government could grant no more than 3 gaming concessions before 1 April 2009. In 2002, the Macau Government awarded 3 gaming concessions: to SJM, Galaxy and Wynn Macau.

Concession regime in Macau

Concession	SJM	Galaxy	Wynn
Start	28-Mar-02	24-Jun-02	26-Jun-02
End	31-Mar-20	26-Jun-22	26-Jun-22
Tenure (years)	18	20	20
Early redemption start date	Apr-09	Jun-17	Jun-17
Special levy	3%	4%	4%
Special gaming tax	35%	35%	35%
Committed investment	MOP4.7bn	MOP8.8bn*	MOP4bn

Sub-concession	MGM	Sands	MPEL
Start	20, April 2005	Dec-02	08-Sep-06
End	31-Mar-20	26-Jun-22	26-Jun-22
Tenure (years)	15	20	16
Early redemption start date	Apr-17	Dec-17	Sep-17
Special levy	4%	4%	4%
Special gaming tax	35%	35%	35%
Subconcession premium	USD200m	n.a.	USD900m
Committed investment	MOP4bn	MOP4.4bn*	MOP4bn

Source: Companies, DICJ

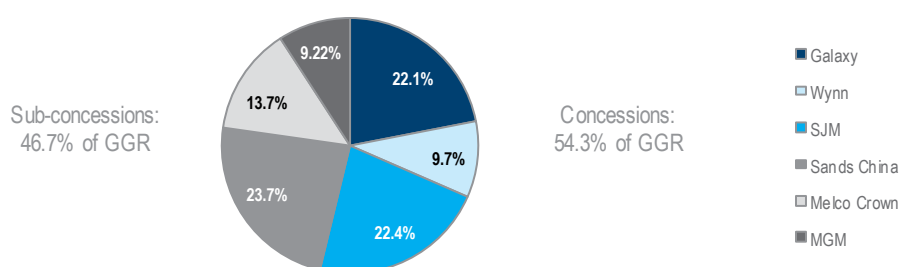
Note: *Sands did not pay a sub-concession premium to Galaxy; rather, it was responsible for MOP4.4bn of Galaxy's original MOP8.8bn investment commitment under the sub-concession contract

One of the 3 concessions that was eventually awarded to Galaxy was originally granted to a joint venture between VML (Venetian Macau Limited, the operational subsidiary of SCL) and Galaxy. However, due to differences in the development visions of the 2 companies, the government eventually split the concession into 2, thereby creating a 'sub-concession' status for SCL. SCL did not have to pay a sub-concession premium to Galaxy, but was instead responsible for MOP4.4bn of Galaxy's original MOP8.8bn investment commitment. This led to some inequities among the licence holders and, as a consequence, the Macau Government allowed each of the remaining 2 concessionaires to issue a sub-concession. MGM received its sub-concession from SJM at a cost of USD200m on 20 April 2005, while Melco was granted its sub-concession at a cost of USD900m from Wynn on 8 September 2006.

In 2015, the sub-concessions collectively generated MOP108bn in gross gaming revenue and represented a material 46% contribution to Macau's total gross gaming revenue.

Macau's GGR market share (by concession)

In 2015, Macau's sub-concessions collectively accounted for 46% of total GGR



Source: Company, Daiwa

Note: Blue shades denote Concessions; grey shades denotes sub-concessions

Sub-concessions were never put up for public tender, despite technically having the same legal obligations and status as full concessions

There were originally some notable legal differences between the concessions and sub-concessionaires (among other differences, the concessionaire was held responsible for any wrongdoings of its sub-concessionaire until end-2002). As things stand today, the concessionaires hold no superior rights over the sub-concessionaires. Hence, the 2 types of licence are effectively the same in terms of legal obligations and status. Sub-concessions are thus functionally independent of the concessions, and as such would not be affected by any suspension, redemption or termination of the concessions.

Treatment of sub-concessions upon renewal may be a contentious issue

Given that the sub-concessions now essentially share the same legal responsibilities and legal standing as the original concessions in substance, it would seem rational that the sub-concessions would see some form of modification of their legal status to bring them closer to a gaming full concession when it comes time to renewing the gaming concession licences.

To this point, Mr. Pereira Coutinho expects the issue of licence renewal to be a contentious one and does not rule out the possibility of a public outcry if the government is not viewed as handling the issue appropriately.

His view is premised on the convoluted legal basis and the rule of law supporting Macau's sub-concession licences, given that: 1) the Law (Article 7) clearly indicates there should be no more than 3, and 2) the Law (Article 8) clearly indicates that the award of licences for the operation of casino games of chance in Macau must be conducted through public tender when granting sub-concession licences. Hence, strictly speaking, there is no legal definition of what specifically constitutes a gaming "sub-concession" and Macau's Gaming Law technically does not acknowledge or regulate the granting of these sub-concession licences.

This situation gives rise to potential issues upon the 2020/22 licence renewal. Despite the gaming sub-concessions being essentially functionally independent of the gaming concessions and sharing the same legal obligations and status, their elevation closer to full concession status may create complications as sub-concessions were never put up for public tender (more than 20 bidders from around the world submitted applications for the original 3 casino concessions in November 2001).

Articles 7 & 8 of Law 16/2001: Legal Framework for the Operations of Casino Games of Fortune

Portuguese	
Artigo 7.º	
Regime da concessão	
1.	A exploração de jogos de fortuna ou azar é reservada à Região Administrativa Especial de Macau e só pode ser exercida por sociedades anónimas constituídas na Região, às quais haja sido atribuída uma concessão mediante contrato administrativo, nos termos da presente lei.
2.	É de três o número máximo de concessões para a exploração de jogos de fortuna ou azar em casino.
Artigo 8.º	
Concurso público	
1.	A atribuição das concessões para exploração de jogos de fortuna ou azar em casino é precedida de concurso público.
2.	O concurso público pode ser limitado com prévia qualificação.
Chinese	
第七條	
批給制度	
一、	澳門特別行政區保有幸運博彩之經營權，僅可由在特區成立並獲得批給之股份有限公司從事，而有關批給係按照本法律規定以行政合同為之。
二、	經營娛樂場幸運博彩之批給至多為三個。
第八條	
公開競投	
一、	娛樂場幸運博彩之經營批給須預先進行公開競投。
二、	公開競投可採用預先評定資格之限制競投。
English (translated by Mr. José Pereira Coutinho)	
Article 7	
Awarding Scheme	
1.	The Macau Special Administrative Region retains the right to determine which parties operate games of chance, and this right can only be exercised by the limited company established in this special administrative region which has also been awarded a concession by an administrative contract in accordance with this law.
2.	The operation of casino games of chance will be granted to a maximum of three concessions.
Article 8	
Open bidding	
1.	The operation of casino games of chance must first undergo open bidding.
2.	Applicants for open bidding will first be assessed for their eligibility.

Source: DICJ, Daiwa

5. Gaming tax regime expected to be unchanged

Upon the concession renewal, Mr. Pereira Coutinho asserted that Macau's existing tax structure for gaming revenue is unlikely to materially differ from the existing one see below).

Macau's existing gaming tax regime

Constituents	Tax Rate
Special gaming tax	35% of gross gaming revenue
Special levies:	
• Contribution to a public foundation in Macau	1.6% of gross gaming revenue - for promotion, development or study of culture, society, economy, education, science, and charity events
• Contribution to Macau Government	2.4% of gross gaming revenue ⁽¹⁾ - for urban development, tourism promotion and social security in Macau
Annual gaming premium:	
• Fixed Premium	MOP30m per annum
• VIP table	MOP300,000 per annum per table
• Mass table	MOP150,000 per annum per table

Source: DICJ, Company, Daiwa

Note: (1) 1.4% for SJM

That said, the Macau Government does have in place a progressive rate tax regime on taxable profit up to a cap of 12%. Today, all 6 operators enjoy some form of "tax holiday" against this 12% complementary bottom-line tax rate, and Mr. Pereira Coutinho asserted that there is a risk that these special tax exemptions would not be renewed upon their respective expiration. These exemptions include (and are not limited to) the following:

- i) **Exemption of the complementary tax** on casino gaming profits ('tax holiday') (a progressive tax rate of up to 12% on casino gaming profit is payable to the Macau Government if an operator is not exempt).
- ii) **Dividends withholding tax exemption** on dividends paid (tax exemption in the form of a fixed annual payment to Macau Government in lieu of a dividend tax).

Tax regime expected to remain largely unchanged, though there is a risk of non-renewal of current tax exemption

- iii) **Property tax exemption** on rental incomes (effective property tax rate of 16.8% of actual rental income is payable to Macau Government for respective properties if they are not exempt).

Among the gaming operators, some of the special tax exemptions will expire as early as 2016 and the possibility of non-renewal of these exemptions does present risks to the operators' earnings, in our view. The terms for special tax exemptions as disclosed by the 6 operators are detailed below:

Tax exemption details

	Tax exemption on gaming profits			Dividend withholding tax exemption			Property tax exemption on rental income		
	Start	Expiry	Details	Start	Expiry	Details	Start	Expiry	Details
Sands	2004	2018	Exemption granted on 30 September 2004 for 5 years; additional 5-year exemption granted on 21 May 2008; subsequent extension of 5 years granted on 3 October 2013	2011	2018	- Annual payment to the Macau Government in lieu of a dividend tax - Entered into another Shareholder Dividend Tax Agreement for an extension in May 2014	- The Venetian: 2007 - Plaza: 2008 - Sands Macao: 2004 - SCC: 2012	- Sands Macao: expired in August 2012; - The Venetian: technically expired in 2013, extension pending - Plaza: technically expired in 2014, extension pending - SCC: to expire in 2018	- Lease/right of use income exempted from property tax for first 4/6 years in Macau/Cotai, respectively - Upon expiration of the respective exemptions from property tax, Sands would be subject to an effective property tax rate of 16.8% of its actual rental income from the respective properties - Sands Macao was exempt until 2010, and was granted an extension to 2012, which subsequently expired in 2012
Galaxy	2009	2018	Exemption granted on 20 November 2008; 5-year extension granted on 30 December 2013	2013	2018	- Signed Dividend Tax agreement with the Macau Government on 31 December 2014, annual payment to the government in lieu of a dividend tax; - January 2015 signed extension - Extended tax concession arrangement on 18 December 2012	N/A	N/A	N/A
MGM	2012	2016	Granted on 22 September 2011	2012	2016	- Required to pay MOP15.4m annually from 31 December 2012 to end-2016 in lieu of a dividend tax	N/A	N/A	N/A
Wynn	2006	2020	Granted a 5-year tax holiday on 6 September 2006; 5-year extension granted in November 2011; additional 5-year exemption granted in October 2015	2006	2015	- 2006-10 annual payment to the Macau Government of MOP7.2m in lieu of tax on dividends; - Annual payment increased to MOP15.5m between 2011 and 2015 - Applied for an extension of the exemption in June 2015, which is pending approval	N/A	N/A	N/A
SJM	2012	2016	Tax exemption granted on 23 November 2011	2012	2016	- Approval granted on 10 August 2012 - Fixed dividend tax payment of MOP42.2m annually	N/A	N/A	N/A
MPEL	2007	2016	5-year exemption granted on 7 June 2007; extension granted in April 2011	2012	2016	- Approved in January 2014 - Annual lump sum of MOP22.4m to the Macau Government	- Altira: 2007 - COD hotels: 2011	- Altira: 2019 - COD hotels: 2023	- Property tax holiday of 12 years - Also granted a vehicle tax holiday, provided that there is no change in use or disposal of those vehicles within 5 years of the date of purchase

Source: Companies, Daiwa

Daiwa's view of the implications for the sector

What does the life of the concessions mean for new projects?

A realistic look at long-term ROICs

With uncertainty over the issue of concessions renewal (and potential shortening of new concession terms post-2020/22) becoming an increasingly material consideration for investors, we took another look at the new Cotai properties' longer-term return profiles.

Now that 2 of the 6 new Cotai properties are operational, we have re-examined the theoretical full ramp-up RoICs of the new Cotai properties. According to our stress tests, shown below, GM2 and Studio City's fully ramped incremental RoICs could be just 7-9%. Of the 2, Studio City perhaps provides the clearest picture of incremental demand for new capacity, as its performance probably faces the least distortion from potential cannibalisation of Melco's sister properties, based on the limited sharing of resources between them. At current run rate, Studio City's current implied RoIC is a mere 3% (based on annualised 4Q15 data), though this could theoretically increase to 9% if the property can ramp up its table yield to levels similar to that of City of Dreams in 4Q15.

Galaxy Phase 2: RoIC stress test

(HKDb)	
Galaxy Macau Phase. 1	
1Q15 EBITDA	1.82
2Q15 EBITDA	1.41
GM1: normalized EBITDA	1.61
Galaxy Macau Phase. 1 & 2	
4Q15 EBITDA	1.97
Less: normalized EBITDA from GM1 (above)	(1.61)
Implied incremental contribution from GM2	0.36
(times 4)	x4
Annualized GM2 EBITDA	1.4
GM1 capex	16.5
GM2 capex	19.6
Implied RoIC for GM1	39%
Implied RoIC for GM2	7%

Source: Company, Daiwa

Studio City: RoIC stress test

(USDm)	Studio City	
	(4Q15) ⁽¹⁾	(fully ramped)
Mass ⁽²⁾	136	212
Non-gaming ⁽³⁾	54	59
Total Revenue	190	271
Less: gaming taxes	(54)	(85)
Less: other operating costs	(117)	(135)
Quarterly EBITDA	18	51
Annualized EBITDA	71	204
Capex	2,300	2,300
Implied RoIC	3%	9%

Source: Company, Daiwa

Notes: 1) SC opened in 27 October 2015; figures represent implied full quarter; 2) assuming full ramp-up in table yield similar to City of Dreams' 4Q15 non-smoking mass tables yield; 3) assuming hotel ADR improves to USD150/night, in line with that of Sands Cotai Central in 4Q15; and 4) includes effect of incremental labour cost of additional gaming tables unavailable in 4Q15

In our view, these returns are especially unattractive when compared against the weighted cost of capital (WACC) of 13.6% and 8.3% for Galaxy and Melco Crown, respectively (based on Bloomberg).

Returns on new projects are at risk of lower returns than the operators' cost of capital

New project projected RoIC v WACC (sorted by project opening)

Operator	Property	Opening	WACC	New project theoretical ramped up RoIC
Galaxy	Galaxy Macau Ph. 2	May 2015	13.6%	7%
Melco Crown	Studio City	Oct 2015	8.3%	9%
Wynn Macau	Wynn Palace	2H16	9.0%	N/A
Sands China	The Parisian	2H16	11.4%	N/A
MGM China	MGM Cotai	1Q17	8.0%	N/A
SJM	Lisboa Palace	2H17	10.7%	N/A

Source: Company, Bloomberg, Daiwa

New projects unlikely to break even by 2020/22

At the range of returns shown above, none of the upcoming new properties would be able to achieve capex break-even upon the expiration of the gaming concessions in 2020/22. This is especially true for the capex-heavy properties that are slated to open further down the line, in particular:

- i) Lisboa Palace: capex of HKD30bn, opening in 2H17 (2.5 years from licence expiry), and
- ii) Galaxy Macau Phases 3 and 4: up to HKD57bn in capex cumulatively and possibly opening 2019/20 (3 and 2 years from licence expiry, respectively).

Furthermore, the ongoing deterioration in the quality of visitors to Macau and their overall spending ability, as discussed below, may mean that our analysis errs on the side of optimism and that there is potential downside to the assumptions we have drawn on the projects' long-term ROICs as discussed above.

Decline in visitor quality adds further pressure

Indeed, the above analysis may already be overly optimistic if one considers the potential effects of further pricing competition when additional capacity comes on line. Over the past 4 quarters, with the introduction of 2 of the 8 new properties slated to come on line over the next 4 years (inclusive of GM 3 and 4), we have already seen increasing competition among the operators as they seek to drive overall headcount growth in Macau through aggressive marketing promotions.

The local Tourist Guide Association recently requested subsidy from the Macao Government Tourist Office (MGTO) for each tour guide professional in Macau

Despite this, overall headcount failed to grow in 2015, with arrivals from China actually falling by 3.9% over the year. Mr. Pereira Coutinho even remarked that recently the local Tourist Guide Association requested some form of subsidy from the Macao Government Tourist Office (MGTO) for each tour guide professional in Macau because of insufficient tourists and business.

Perhaps even more alarming is the significant deterioration in both hotel room rates and pre-capita spending by tourists across all major geographies (among which Chinese tourists saw an even larger deterioration, of 9.1% YoY, in 4Q15). In the table below, we sort Macau's visitor arrivals from the Mainland by the respective province's GDP per capita. The GDP per capita among visitors in the highest quartile is over 2.5x higher than that of the bottom quartile. Among these provinces, there is a clear decline in the number of arrivals from the wealthiest provinces (1st quartile provinces fell by -13% YoY in 2015), which is only partly offset by steady number of visitor arrivals from poorer provinces (4th quartile was flat YoY).

Increasing competition created by new supply further exacerbated the trend of deteriorating visitor quality and slowing growth in visitor arrivals

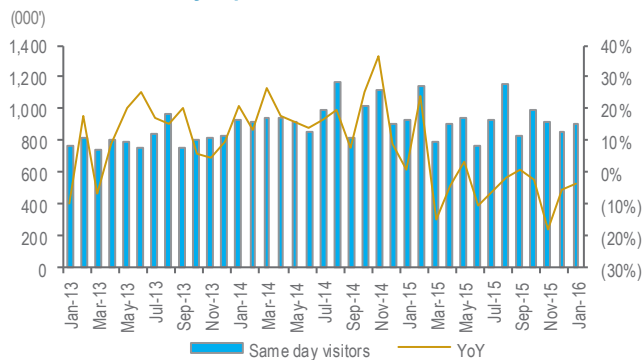
Visitor arrivals to Macau ranked by GDP per capita (by province) ⁽¹⁾

	GDP per capita ⁽²⁾	1Q15	2Q15	3Q15	4Q15	2015
(CNY)						
1st Quartile	86,590	-10%	-9%	-16%	-16%	-13%
Tianjin	105,231	-14%	-12%	-14%	-14%	-13%
Beijing	99,995	-16%	-7%	-13%	-16%	-13%
Shanghai	97,370	-6%	-12%	-11%	-8%	-9%
Jiangsu	81,874	-13%	-3%	-11%	-15%	-11%
Zhejiang	73,002	-5%	-13%	-25%	-19%	-16%
Inner Mongolia	71,046	-18%	-5%	-13%	-39%	-20%
2nd Quartile	62,837	1%	-1%	-6%	-9%	-4%
3rd Quartile	41,826	0%	-1%	-7%	-7%	-4%
4th Quartile	34,324	3%	2%	-2%	0%	0%
Sichuan	35,128	-2%	7%	5%	2%	3%
Shanxi	35,064	-7%	2%	-20%	-22%	-13%
Jiangxi	34,674	5%	-8%	-6%	0%	-3%
Anhui	34,425	4%	-4%	2%	5%	2%
Guangxi	33,090	12%	11%	2%	7%	7%
Total	49,531	-3%	-6%	-3%	-4%	-4%

Source: DSEC, CEIC, Daiwa

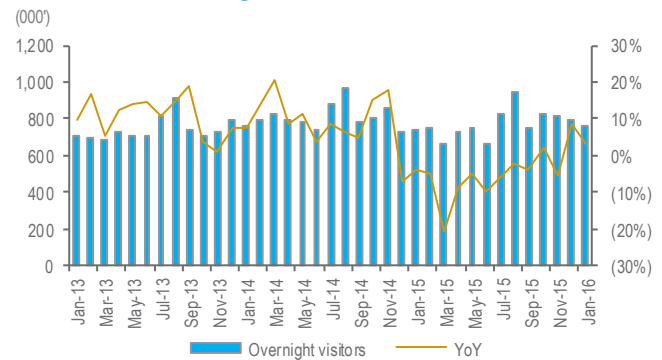
Note: 1) analysis excludes Guangdong province, which saw flat YoY visitor arrivals in 2015, 2) based on 2014 figures

Mainland China day-trip visitors to Macau



Source: DSEC, Daiwa

Mainland China overnight visitors to Macau



Source: DSEC, Daiwa

Per capita spending of overall visitors



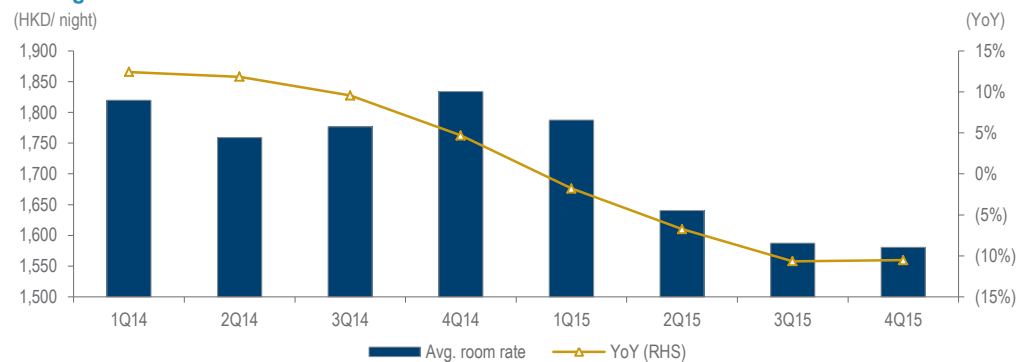
Source: DSEC, Daiwa

Per capita spending of Mainland visitors



Source: DSEC, Daiwa

Average hotel room rates



Source: DSEC, Daiwa

Consensus still expects increasing utilisation as additional capacity are introduced

Increasing table yields as capacity expands?

Given the aforementioned indicators, we believe the market remains too bullish in its revenue growth assumptions for the sector. For 2H15-18E (annualised), the Bloomberg consensus forecast a cumulative top-line CAGR of 11% among the 6 operators. This is set against an arguably more realistic 6.7% CAGR for gaming tables (assuming 200 tables per presently unopened property) and a 20% CAGR for hotel rooms, inclusive of GM2 and Studio City.

We forecast a cumulative 2.4% top-line CAGR for the 6 operators for 2H15-18E (annualised) which we believe to be more reasonable factoring in the expected gaming table CAGR over the same period and the decline in spending power of visitors.

What does this all mean?

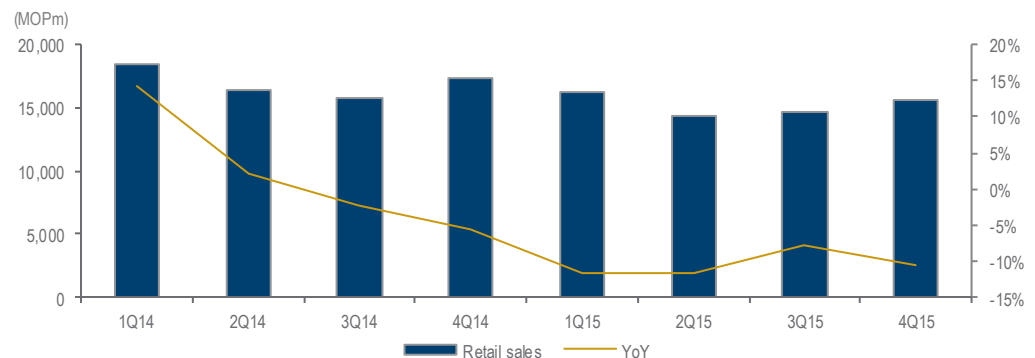
The street's top-line growth forecasts call for improving overall gaming table yields in an environment of capacity growth and visible declines in overall player quality.

Can non-gaming offset the operators' GGR risk? There may be some observers who rationalise the discrepancy between capacity growth and player quality discussed above by arguing for a marked rise in new properties' non-gaming revenue contributions. Non-gaming revenue contributed to around 11% of cumulative top-line among the six operators in 2H15. We believe this argument is misguided, given the following factors related to Macau's retail environment (which is among the biggest cash-generating component of non-gaming today):

- 1) Macau's overall retail sales declined by 9% YoY for 2H15 despite a 24% increase in retail GFA from new capacity introduced by the respective openings of Galaxy Macau Phase 2 (late-May) and Studio City (late-October).

Macau's overall retail sales declined YoY in 2H15 despite the new retail capacity introduced by GM2 and Studio City

Macau's overall retail sales



Source: DSEC, Daiwa

- 2) SCL's mall revenue (which accounts for >70% of Macau's retail market share currently) fell by 8% YoY for 2H15, while losing >7,000 sq feet of gross leasable area of tenant occupancy at Sands Cotai Central (compared with end-2Q15).
- 3) Despite these clearly declining comps, Macau's mall capacity introduced by the 6 operators should increase by a minimum of 1.64m sq ft, or 24% in total, in 2H15-17, and may face a high risk of oversupply given the current operating environment (the figures do not include potential capacity additions from GM 3 and 4 and Wynn Diamond).

Macau's retail capacity faces a high risk of oversupply, with capacity slated to grow by 24% between 2015 and 2017

Macau's retail GFA

	Retail GFA end-2015 (sq ft)	Retail GFA end-2017 (sq ft)
SCL	2,591,900	2,891,900
Galaxy	755,000	755,000
SJM*	0	50,000(!)
Melco	175,000	575,000
MGM	0	50,000(!)
Wynn	46,000	46,000
Total	3,567,900	4,407,900(!)^
growth		24%

Source: Companies, Daiwa

Note: (!) estimated figure; *excludes satellite casinos; ^includes estimated retail GFA of Macau Legend and the hotel property named the 13

Our stock preferences

Overall fundamentals remain weak

In our view, overall structural risks and overhangs in the sector persist, as we outlined in our most recent thematic report ([Fear and loathing in Macau](#), 3 December 2015). Both mass and VIP volumes have tapered off since the Lunar New Year peak season, and YTD run rates still point to a YoY decline in GGR in 2016 in the face of a rapidly rising cost structure with 4 new properties to open over the next 2 years (2H16: Wynn Palace, The Parisian; 1Q17: MGM Cotai, 2H17: Lisboa Palace).

We continue to prefer the Cotai-ready operators

The most recent developments strengthen our conviction in the argument we made in thematic report of 17 September 2015 ([Cotai approaches inflection point](#)). We continue to believe that the Cotai-ready operators are the best positioned fundamentally to capture the shift in market share from Peninsula to Cotai (ie, Galaxy, Melco Crown, Sands China). In our view, the shift will be catalysed by the opening of the Taipa Ferry Terminal (potentially opening in 4Q16). Indeed, we are already seeing a material shift in market share towards Cotai.

Macau GGR market share (Peninsula v Cotai)

	Jan-15*	Feb-15*	Mar-15*	Apr-15*	May-15*	Jun-15*	July-15*	Aug-15*	Sep-15*	Oct-15*	Nov-15*	Dec-15*	Jan-16*	Feb-16*
Peninsula	54%	52%	54%	54%	50%	53%	51%	50%	54%	49%	49%	48%	47%	48%
Cotai	46%	48%	46%	46%	50%	47%	49%	50%	46%	51%	51%	52%	53%	52%

Source: Compiled by Daiwa

Macau Gaming Sector: valuations and Daiwa's preferred pecking order

Order	Stock	Rating	Local currency	Share price	Valuation	Investment thesis
1	Galaxy	Buy	HKD	26.80	2016E EV/EBITDA of 6x for Starworld and 11x for Galaxy Macau. Unopened casinos (GM 3 & 4) valued at capex, discounted by 8% to 2016 from the estimated opening date (2019-22).	<ol style="list-style-type: none"> In mid-2016, GEG will have the newest ramped-up, high-end product in Cotai. Its holds the second-highest table capacity in Cotai, which is critical to cannibalising the high-end business on the Peninsula. Continues to be the No.1 in junket relationships; we expect it to markedly outperform the market in the VIP segment.
2	Melco	Outperform	USD	15.48	13x 2016E EV/EBITDA for City of Dreams; we value Altira and Mocha Clubs at 5-7x 2016E EV/EBITDA. We value Studio City at capex, and the Philippines operation (MCP PM, not rated) at market cap.	<ol style="list-style-type: none"> Cotai-centric property exposure likely to capture premium mass. Poised to be a key beneficiary of the premium mass spill-over from the Peninsula. Inflexibility of its table shift and uncertainty over the government's allocation could be a potential negative to the ramp-up of Studio City.
3	Sands	Hold	HKD	29.05	15x 2016E EV/EBITDA for Venetian Macao and Sands Cotai Central, 11x 2016E EV/EBITDA for Sands Macao and Plaza Macao. We value the Parisian Macao at capex.	<ol style="list-style-type: none"> Only operator to have direct and exclusive control of the Cotai ferries, a critical channel for foot traffic. This advantage is likely to grow once the new Taipa Ferry Terminal starts operating. Expect SCL to be a winner in the base mass segment as it: 1) can advertise all the way between HK and Macau, and 2) has a very cost-effective way to offer promotions (ferry tickets + rooms + shopping). Holds the biggest gaming table capacity in Cotai and the largest hotel-room inventory in Macau. Limited table risk even if The Parisian (late-2016 opening) receives no tables. Faces risk of being unable to maintain its existing dividend policy.
4	SJM	Hold	HKD	5.00	8x 2016E EV/EBITDA for the Grand Lisboa; we value the self-promoted and satellite casinos at 5x 2016E EV/EBITDA; we value the Lisboa Palace at capex, discounted by 8% to 2016.	<ol style="list-style-type: none"> 100% exposure to the Peninsula and the last Cotai property to open (Lisboa Palace in 4Q17) puts it at most risk of market-share losses to Cotai. Has the highest number of gaming tables; less reliant on highly uncertain government table allocations in the future. Inexpensive valuation and cash rich.
5	MGM	Underperform	HKD	9.33	9x 2016E EV/EBITDA for MGM Macau; we value MGM Cotai Phase 1 at capex, and MGM Cotai Phase 2 at estimated capex, discounted by 8% to 2016 from the estimated opening date of 2020.	<ol style="list-style-type: none"> Despite having a high-quality offering, MGM's existing single property exposure to the Peninsula means it faces a risk of market-share losses to Cotai. Has the lowest number of gaming tables among its peers and given the high uncertainty over government table allocations, MGM Cotai faces ramp-up and execution risks. Potential table movement to ramp up its Cotai property could exacerbate the impact of market-share losses at its Peninsula property.
6	Wynn	Underperform	HKD	9.68	9x 2016E EV/EBITDA for Wynn Macau. We value Wynn Palace at capex, and Wynn Diamond at estimated capex, discounted by 8% to 2016 (from the estimated opening date of 2020).	<ol style="list-style-type: none"> Single property located in the Peninsula, despite being a quality offering, faces risks of business spilling over to Cotai. Has the second-lowest number of gaming tables among peers and, given the high uncertainty of government table allocations, faces ramp-up and execution risks for Wynn Palace. Potential table movement to ramp up its Cotai property could exacerbate the impact of market-share losses for its Peninsula property.

Source: Daiwa

Note: some stocks are currently outside of Daiwa's investment rating bands due to the recent market volatility. Share price as of 16 March 2016

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Disclosure of investment ratings

Rating	Percentage of total
Buy*	63.9%
Hold**	21.3%
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Source: Daiwa

Notes: data is for single-branded Daiwa research in Asia (ex Japan) and correct as of 31 December 2015.

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