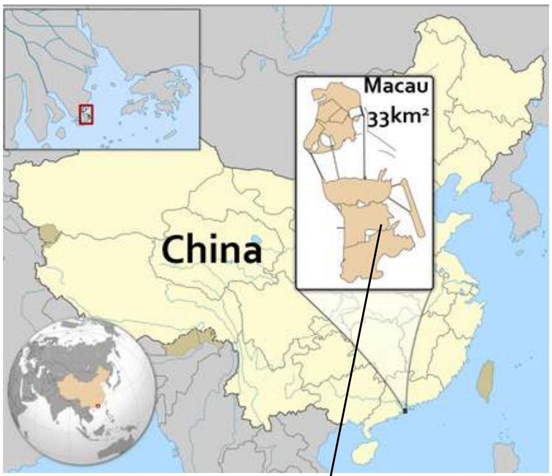
PERPETUA INSIGHTS

Investment opportunities in the "Las Vegas of the East" - Macau

About Macau

Macau is known as the "Las Vegas of the East" due to the large number of casinos in the region. It is technically a special administrative region (**SAR**) of China located on its southern coast and neighbours its other SAR, Hong Kong [Figure 1]. Macau is a US$51bn economy with a population of 695k giving it one of the highest GDP's per capita globally. At only 33km^2, Macau is a densely populated area receiving over 100k daily visitors which is impressive for its size. Macau is the only place in China where gambling is legal, making gambling tourism the enclave's primary economic driver. It contributes around 60% of Macau's GDP and over 80% of its domestic fiscus. In contrast, gambling is banned in mainland China due to its historical links to issues such as corruption and financial instability. In 1949, the Communist Party outlawed gambling as part of a broader campaign to eliminate activities perceived as harmful to social cohesion.

Figure 1: Location of Macau within the greater China area



Source: gif-map.com

Gambling, the lifeblood of Macau

Macau is the largest gambling hub in the world generating around $30bn in gross gaming revenues (GGR) annually, dwarfing the second largest region being Las Vegas at circa $16bn. The gambling industry in Macau is highly regulated with only six companies licenced to operate integrated resorts (IRs), which are casinos with additional amenities like hotels, entertainment and conference venues.

These IRs are clustered on the Cotai strip in the heart of Macau [Figure 2]. Identifying their revenue sources is simple: for every $100 of revenue generated, about $83 comes from GGR and remainder from non-gambling amenities such as luxury retail, concerts, rooms and entertainment parks. After all operating expenses are deducted including a 40% tax[1] on GGR, operators generate between $25-33 in property profits (**EBITDA**). Thanks to the business model's high **operating leverage** and strong visitor spending, operators generate attractive profit margins and **returns on invested capital** (ROIC).

Figure 2: Map of Cotai Strip and estimates of 2024 revenues

Integrated Resort Operator	Revenues (US$)	Rooms	Tables
Sands China	7.2bn	12,392	1,680
Galaxy Ent.	5.7bn	5,669	1,000
Melco Resorts	4.6bn	4,504	750
MGM China	3.9bn	2,048	750
Wynn Macau	3.7bn	2,714	570
SJM Holdings	3.7bn	2,305	1,250

Source: Factset estimates, JP Morgan, Perpetua Research

As a leisure industry, casinos are heavily dependent on the business cycle; consumer discretionary spending and the political situation in mainland China. However, what makes Macau unique is its ability to attract high-end patrons who are more resilient to economic downturns, and high barriers to entry given the restriction on licenses issued. The most notable risk of operating in Macau, however, are regulatory changes – discussed in more detail below.

[1] This is among the highest gambling tax rates in the world, but it is offset by the fact that these businesses are so profitable.

A decade of challenging performance

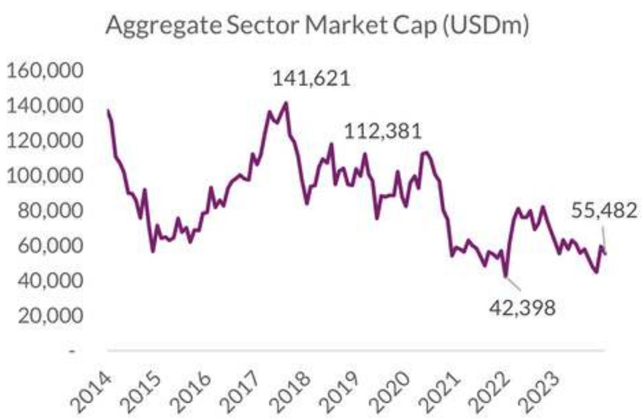
The sector has experienced several shocks over the last decade ranging from crackdowns to root out corruption; severe Covid lockdowns; license renewal risks and more recently fears surrounding the slowing growth of the Chinese economy.

Our analysis shows that the six operators did not waste these crises and have emerged as much stronger businesses especially post-Covid after having restructured themselves after each shock. Our assessment is that the sector is now set up to deliver attractive and sustainable returns for shareholders. Some positive structural changes we have observed are:

- The $83 GGR example from earlier is broken down further into $70 mass[2] GGR and $13 VIP[3] GGR. In the past, this split was closer to 50/50. However, the VIP business has been decimated over the last few years due to perceived corruption in that segment. The substantial mix-shift towards mass has made the sector less risky and more profitable because mass gambling economics are more favourable and less cyclical than VIP economics.
- Covid was a painful period as operators recorded very low levels of revenue between 2020 and 2022 due to harsh lockdowns. Operators were forced to streamline costs and are now more efficient businesses with higher profit margins than compared to the past.
- During Covid, all operators renewed their operating licenses, which are valid until 2032, removing an important regulatory uncertainty and overhang.
- Most operators used the Covid period to upgrade and extend their IRs which are now refreshed with the capacity to welcome more visitors than in the past.

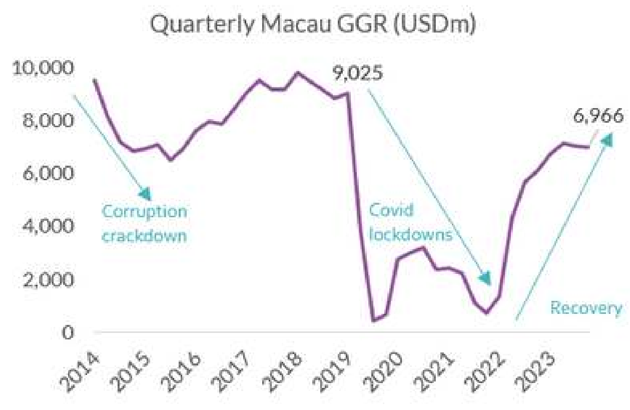
Third quarter 2024 GGR stood at $7bn [Figure 4], about 80% of the third quarter 2019's number – which is considered the last normalised comparable print before Covid. However, when you compare the sector's market capitalisation over the same period [Figure 3], it is only 52% - implying that the market is not fully valuing the recovery story in Macau and is potentially concerned about other factors. We believe these concerns include the potential spillover from the Chinese economic slowdown, which is valid given that 70% of all visitors to Macau are from China. However, we believe the market is overly negative on their views of the state of the Chinese gambling consumer, whom we believe is more resilient versus consensus expectations.

Figure 3: Macau's six gaming operators' aggregate market capitalisation



Source: Bloomberg, Perpetua Research

Figure 4: Macau's six gaming operators' aggregate GGR as of 30/10/24



Source: Bloomberg, Perpetua Research

The recovery has finally begun

Over the last two months, Macau gambling shares have risen around 25% with investors initially cheering China's economic **stimulus package,** announced in late September 2024, only to be subsequently disappointed by the lack of detail. Whilst there is an ongoing debate about whether the Chinese government's efforts will be sufficient to lift consumption meaningfully, we are confident that Macau casino operators will continue to grow irrespective of stimulus interventions for the following reasons:

- Macau lagged the rest of the world only lifting Covid lockdowns in 2023 therefore it is recovering off a lower base relative to other Chinese discretionary goods and services [Figure 5].
- The typical Macau patron is wealthy, more resilient and values experiences highly.
- Macau is unique, being the only place in China where gambling is legalised. The next closest gambling destination for Chinese nationals is the Philippines with $3bn of GGR compared to Macau's $30bn.
- Better structural profit margin set-up means faster bottom-line growth.
- The IMF projects Macau's real GDP to grow by 14% in 2024, 10% in 2025, and 4% in 2026, reflecting the expected ongoing recovery of its gambling sector, the main economic driver.

[2] Mass refers to customers betting lower amounts and requiring less personalised services.

[3] VIPs are high rollers who wager significantly larger amounts and receive exclusive benefits like luxury suites and rebates.

Figure 5: Macau's recovery as a % of 2019 compared to other China Industries

Industry	Industry/Metric	% of 2019						
		1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	Jul & Aug 2024
Macau gambling	Macau GGR	45%	62%	69%	75%	75%	77%	80%
	Macau VIP	15%	24%	23%	24%	23%	23%	28%
	Macau Mass	68%	90%	97%	105%	113%	114%	110%
	Chinese visitation to Macau	66%	75%	80%	88%	83%	76%	91%
China Discretionary	Gold, Silver & Jewellery Sales	134%	122%	132%	125%	138%	118%	118%
	Tobacco & Liquor Sales	145%	142%	141%	142%	163%	158%	143%
	Cosmetics Sales	143%	149%	130%	141%	149%	154%	130%
	Sports & Recreational	140%	148%	131%	152%	161%	166%	151%

Source: Morgan Stanley

Our preferred Macau casino investments

Of the six casino operators, we favour the following three:

Sands China: dubbed "The King of Macau", it is the dominant operator with its massive footprint of four interconnected properties right in the heart of the Cotai gaming strip. With over 12k rooms, it has more than double the capacity of the number 2 operator [Figure 2]. This powerful clustering creates efficiencies and cost advantages unmatched by peers, as evidenced by its superior operating margins and returns on invested capital. Sands is 70% owned by Las Vegas Sands Corp, a leading American IR operator behind the famous Marina Bay Sands property in Singapore.

Figure 6: The Parisian Macau

Source: tripadvisor.com

Galaxy Entertainment: it is the second largest operator. It also boasts the second-best operating metrics supported by the best balance sheet of the six. It has net cash amounting to about 15% of its market capitalisation which is unusual for this type of business. It is also the only operator with significant expansion growth left with its "Phase IV" development property opening in 2027 which will increase its room capacity by 34% [Figure 2]. This will enable Galaxy to scale to almost the size of Sands over time which is not being valued by the market.

Figure 7: Galaxy Macau

Source: tripadvisor.com

Melco Resorts and Entertainment: the only truly diversified operator in Macau with additional exposure to the Philippines, Cyprus and a new partnership in Sri Lanka offering investors global exposure to the gambling sector. We see Melco as a **relative value** opportunity because it invested heavily in expanding its Macau and Cyprus portfolio during Covid, causing its profitability and valuation to lag behind peers as the new properties are still ramping up. Melco will benefit from an enlarged and refreshed portfolio in the coming years which the market is not valuing.

Figure 8: Studio City Macau

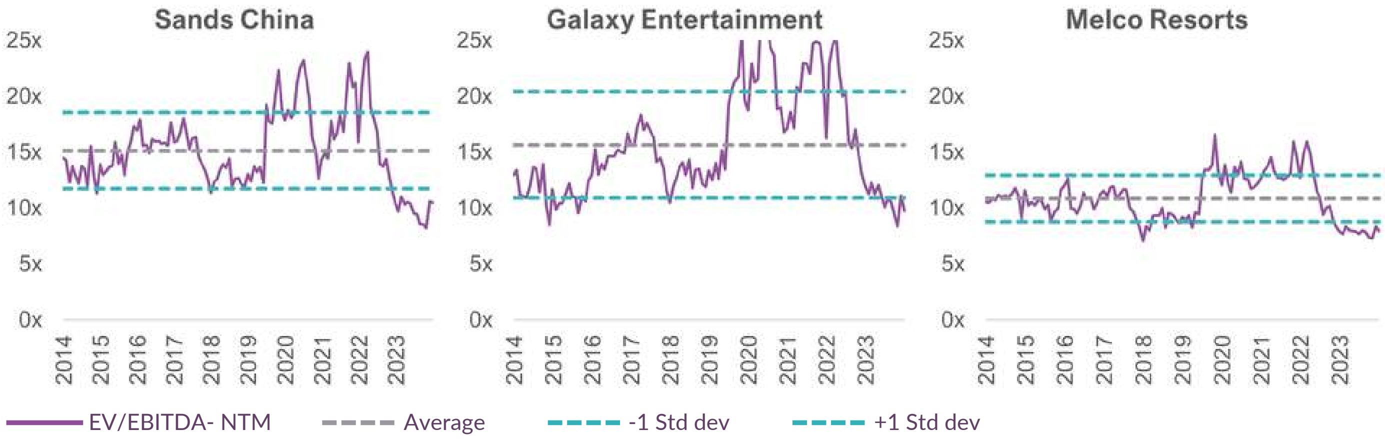
Source: tripadvisor.com

Offering attractive value

EV/EBITDA is the more commonly applied valuation metric used for valuing the Macau gaming stocks because it allows for effective comparability between peers without being skewed by factors such as varying debt levels. It enables investors to assess a business' success by what it earns from its main activities, compared to the total price tag someone would pay to own it. Furthermore, these businesses are highly cash generative, so EBITDA is an effective metric to reflect the cash that comes in the door from operations.

Macau valuations including our preferred picks remain undemanding, with share prices trading at more than 1x standard deviation below their historic mean [Figure 9]. Put differently, the share prices could rise on average by 40% and would still only trade at their mean-reverted pre-Covid multiples, without any earnings upgrade. More fundamentally, our analysis suggests that **free cashflows** will grow double-digits per year from this point and we also expect that dividends will return to their historic levels. This is a contrarian view as the market currently believes that earnings will fall over the next few years. We gain confidence in our view from the fact GGR continues to improve month over month and operating margins are expanding despite the China headwinds. In fact, October's GGR was the highest since the pandemic began, with mass GGR—the main profit driver—reaching a record high in Macau's history.

Figure 9: Valuations of our preferred picks as of 30 October 2024

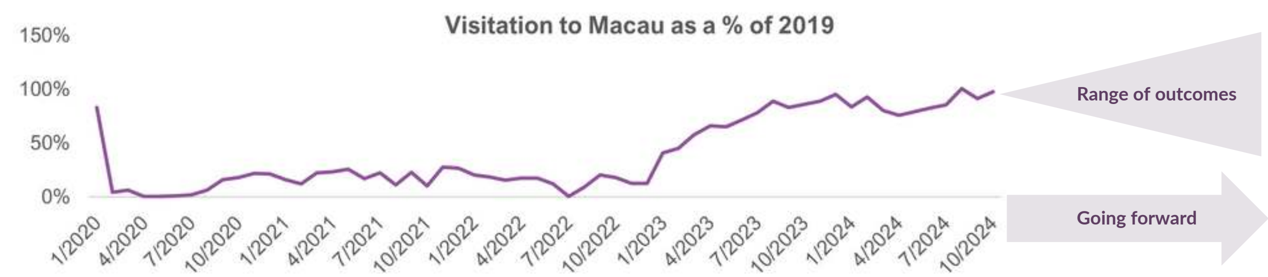


Source: Factset, Perpetua Research

Our concluding thoughts

The investment case relies heavily on the continued recovery of visitation and tourism spend to Macau. Whilst we are positive on the current trends, the future is not guaranteed so as investors it is important to stress-test what happens to profitability and cashflows in scenarios where the recovery is below our expectations and what it does to the valuation of the company. This ensures that we have an acceptable **margin of safety** before investing [Figure 10].

Figure 10: Monthly visitation to Macau as % of the corresponding month in 2019 as of 30 October 2024



Source: dataplus.macaotourism.gov.mo, Perpetua Research

In summary, we are optimistic about Macau's long-term gaming prospects and the operators' growth potential. Positive structural shifts, a strong recovery, enhanced capacity, and attractive valuations create a compelling investment case with significant risk-adjusted upside. We're confident our top picks are poised to deliver exceptional returns for long-term investors.

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