

Wynn Macau: 4Q 2016 Earnings Are Tellingly Weak

Wynn Macau (1128 HK) reported 4Q 2016 **adjusted property EBITDA grew +28% QoQ and +41% YoY**. At a cursory glance, the numbers suggest a strong recovery. But on deeper investigation of the fundamentals, we concluded that they are weak and stronger headwinds may emerge up ahead. In our first paper under the “Show Me the Fundamentals” series, we analyze why Wynn Macau’s 4Q 2016 fundamentals are tellingly weak.

Firstly, investors must take into account that Wynn Palace, the US\$4.4bn new casino on the Cotai strip, was opened on 22 August 2016. Therefore the Q4 number includes 2 casinos. On a YoY basis, we’re comparing 2 casinos with 1 property a year ago—an inaccurate and meaningless comparison. The QoQ comparison is again meaningless because the new casino operated for only about 40 days in 3Q 2016.

The 4Q 2016 results can only be correctly understood by looking at the operating performance of the 2 casinos separately. The older Peninsula property’s 4Q 2016 gross gaming revenues (GGR) declined -10% when the industry GGR grew +10% (refer to Exhibit A4 in the appendix). This suggests that it lost market share and the new casino may have had a cannibalization effect.

Wynn Palace was a disappointment too as it did not benefit from the ‘new casino novelty factor’. The Palace’s 4Q 2016 adjusted property EBITDA was only 41.8%¹ of Wynn’s full-year forecast of US\$740mm on an annualized basis. On a recurring operating profit basis, Wynn Palace’s return on invested capital (ROIC) was negative²! For a US\$4.4bn investment, is this something to be optimistic about? Perhaps it should not come as a surprise that Wynn’s co-President reportedly departed³ a few months ago. Palace was built on a plan and optimism that VIP business will boom endlessly given China’s 1.3bn population and growing affluence. But by the time it was completed, VIP business had contracted sharply for 3 straight years. As soon as the Palace was opened in August 2016, renovations had to be made to reflect the new reality that VIP numbers fell significantly short of the company’s forecasts. Yet, Wynn’s investor day forecast in April 2016 did not reflect the new environment.

If the short-term fundamentals look worrying, think about the long-term structural problems.

Bad Timing: Huge Supply Increasing Amid Intensifying Anti-Corruption Measures and Capital Controls

Casino ROICs worldwide have declined with increased supply. In Macau, invested capital of a **whopping US\$22 billion**⁴ is being deployed from 2015-2018 at a time when GGR had already declined for 3 straight years from 2014-2016. Investors seem rather relieved that GGR might recover by +10% in 2017 although this number looks a little high after a disappointing +3% increase in January despite

Source: Company filings, sell-side research, CapitalIQ, public sources

¹ Based on Q4 adjusted EBITDA of US\$77.5mm and US\$740mm 2017 full year guidance for Wynn Palace at April 2016 Investor Day

² Wynn Palace Q4 2016 operating loss of -\$8mm for Wynn Palace and estimated US\$-40mm net loss for Q4 2016

³ <http://www.cnn.com/2016/09/30/wynn-stock-trips-after-key-macau-exec-behind-palace-departs.html>

⁴ Openings from 2015-2018 include Galaxy Phase 2 (US\$2.5bn), Studio City (US\$3.2bn), Wynn Palace (US\$4.4bn), Sands Parisian (US\$2.9bn), MGM Cotai (US\$3.2bn), SJM Grand Lisboa (US\$3.9bn), Louis XIII (US\$1.6bn). Galaxy Phase III & IV would be incremental and not factored into the US\$22bn supply.

the addition of Wynn Palace and Sands Parisian to the new casino supply. Be that as it may, we would argue that a +10% rise in GGR, assuming that the optimists are correct, is dreadful for an industry which had ploughed in so much more additional capital.

In the US gaming market, ROICs have persistently declined from 23.8% in the 1990s to 13.6% in the following decade and eventually to 3.1% for the last 16 years! (Refer to Exhibit A2). In Macau the ROIC issue is even more worrying because **supply has grown much faster than in the US**.

In Macau, for every single quarter except 2 since 4Q 2014, GGR has contracted between -9% to -37% YoY (refer to Exhibit A4). When all's said and done, Macau casino operators will have to contend with huge capacity increases that have arrived at a time when the market is facing sluggish to stagnant growth. In addition, the industry has to grapple with **China's persistent anti-corruption measures** and occasionally capital controls. President Xi Jinping is said to frown on gambling.

License Renewals in 2022

ROIC declines and oversupply are merely shorter-term worries. In the longer term, casino concessions are up for renewal in 2022. In an interview in Aug 2016⁵, **Steve Wynn** acknowledged the risk of license uncertainty: "You can ask me what the process of concession renewal will look like but neither me nor, as far as I am aware, any of the other concession holders, are in a position to answer you because we don't know. I have talked extensively with the Macau government on the issue but find myself in the position where planning ahead is difficult."

No analyst we spoke with knows how much the concession renewals will cost. In theory, the government can choose not to renew the licenses. But the likelihood will be a public tender where existing owners will have to bid to retain their concessions. There is already chatter that several state-owned enterprises (SOEs) are envious of the huge profits that the casinos made in the initial years. One casino made back its invested capital in just 10 months! This was possible because the licenses were dished out almost free of charge. Is it a wonder that operators rushed to build more casinos in the last 5 years, which turned out to be untimely given the subsequent policy headwinds?

In Wynn Macau's case, its gaming concession will come up for renewal in June 2022. That's only 5 years away. Yet, Wynn Macau built its new US\$4.4bn casino with nearly 100% debt and has paid out most or all its earnings as dividends. As a result, the company's equity stood at only US\$270mn as of 1H 2016. Is Wynn gambling with the bank's capital—heads we all win but tails, the bank and minority shareholders stand to lose?

We have argued that a high ROIC is critical for investors of Macau casinos today. Some large blue-chip long-only investors chose not to invest in Macau casino stocks because their earnings models have to take into account the license renewal uncertainty in 2022. When the concession expires, the company will have to make cumulative cash flows equal to its market cap of US\$9bn for today's shareholders to break even. Given today's valuation and GGR, we can't see how shareholders will make any return. With every passing year shareholders' anxiety can only increase with respect to this uncertainty of concession renewal. If the license is renewed, there would almost certainly be a meaningful sum of money involved, either in the form of a one-time payment or higher taxes, which means lower cash flows.

⁵ <http://www.scmp.com/news/hong-kong/economy/article/2004948/poised-open-us42-billion-resort-macau-casino-tycoon-steve>

Dividends at Risk

As of 4Q 2016, Wynn Macau has US\$4.15bn of debt⁶ with a shareholders' equity of only US\$270 mm⁷, making it highly leveraged at 15 times. Its market cap stands at US\$9.4bn as of 15 Feb 2017. Its parent company, Wynn Resorts which owns 72% of Wynn Macau, has a market cap of US\$9.95bn and carries a larger debt burden of US\$10.13bn.

Given the parent company's debt-servicing load, there may be a compelling need for it to require its Macau subsidiary to **upstream as much dividends** as possible. The policy and country risks make it even more necessary to do so.

However, banks are likely to be cautious about extending much more credit to the company because of the 2022 license renewal uncertainty. Therefore the company can only pay healthy dividends if it can generate strong free cash flows. The financial situation up till 2022 does not look sanguine and hence it was not a surprise that the parent company's rating was recently downgraded by Moody's to Ba3.

In Exhibit 1 below, we look at the **ability of Wynn Macau to pay dividends purely through its FCF** in i) **2016**, ii) **2017-2019** and iii) **2020-2021**. EBITDA estimates are based on consensus⁸ estimates from 4 brokers, GS, MS, UBS and CLSA.

Exhibit 1: Wynn Macau FCF estimates for funding dividends⁷

US\$ in millions, unless specified	2015A	2016E	2017E	2018E	2019E	2020E	2021E
EBIT	391.2	291.8	498.5	616.6	682.7	725.4	812.9
D&A	129.1	207.9	365.7	367.5	367.6	370.5	365.8
EBITDA	520.3	499.7	864.2	984.1	1,050.3	1,095.9	1,178.7
Net finance cost	(72.8)	(130.0)	(149.3)	(149.3)	(145.4)	(128.2)	(57.5)
Capex	(1,640.0)	(1,000.0)	(232.1)	(153.2)	(153.2)	(153.2)	(153.2)
FCF	(1,194.5)	(632.0)	480.7	679.4	749.4	812.4	966.2
(Debt repayment)/ new borrowings	1,652.8	109.0	-	-	(285.4)	(962.7)	(2,901.9)
FCF after (debt repayment)/new borrowings	458.3	(523.0)	480.7	679.4	464.0	(150.2)	(1,935.7)
Dividend paid assumed (60c HK\$ @ 5.2bn shares)	(702.8)	(402.2)	(402.2)	(402.2)	(402.2)	(402.2)	(402.2)
FCF after dividend payment	(244.4)	(925.2)	78.5	277.1	61.8	(552.5)	(2,338.0)
DPS (HKD)	0.60	0.60	0.60	0.60	0.60	0.60	0.60
Dividend yield		4.4%	4.4%	4.4%	4.4%	4.4%	4.4%

Source: EBIT, D&A and capex consensus forecasts are based on Goldman Sachs, Morgan Stanley, UBS and CLSA.

- **2016 full year:** In 2016, Wynn Macau is expected to generate negative FCF i.e. it should have a weak cash position. The ability to pay a HKD 0.60 dividend (same as 2015) without debt facilities is questionable.
- **2017 – 2019:** Wynn Macau has none to limited debt principal repayment during these years, which gives the company headroom to pay dividends in 2017 and 2018. In 2019, FCF is just enough to

⁶ Company filings. As of 4Q 2016 earnings release

⁷ As of 1H16 earnings release.

Source: Company filings, sell-side research, CapitalIQ, public sources

⁸ EBIT and D&A forecasts using average forecasts from four brokers, GS, MS, UBS and CLSA where forecasts are available. Debt repayment of credit facility (HK\$17.9bn) repayable in graduating installments of between 2.5% to 7.33% of principal amount on quarterly basis commencing Dec 2018, with final maturity repayable in Sept 2021.

cover the dividend payment (assuming a HKD 0.60 dividend) as Wynn has debt repayment kicking in from 2019.

- **2020 – 2021:** Wynn Macau may struggle to pay dividends from FCF because it has debt payments of nearly US\$1bn and US\$3bn coming due in 2020 and 2021. This is not taking into account the funds needed for the **concession renewal** in 2022. Yes, the company could potentially do a debt refinancing, but banks and investors will ask for stringent covenants for the uncertainty of the concession renewals.

In short, **investors expecting handsome dividends** similar to what they received in the past may be very disappointed in the future.

“Adjusted” Property EBITDA Is a Misleading Metric

The Macau gaming operators and sell-side analysts like to use adjusted property EBITDA to measure the operating performance of casinos and we would like to suggest to our investors that it is a misleading metric. Our reasons are as follows:

By definition, adjusted EBITDA should exclude non-recurring items. But for Macau casino operators, adjusted items recur every quarter (refer to Exhibit A1), which suggests they are not one-off. These include stock-based compensation, property charges, corporate expenses and management fees. As Warren Buffett said of EBITDA⁹: **“Does the tooth fairy pay for capital expenditures?”** Adjusted EBITDA takes the issue further.

Some excluded items are **significant contributors to a quarterly consensus beat**. These adjusted figures are not covered by **external auditors’** opinion. At Wynn Macau, 4Q 2016 expenses “adjusted” out of EBITDA have been the biggest since 1Q 2014. Property charges, management and license fees, corporate and stock-based compensation totaled US\$53 mm in 4Q 2016 (+69.7% YoY). Therefore, 4Q 2016 “adjusted” property EBITDA was 30% above EBITDA excluding adjusted items.

Investors relying on adjusted property EBITDA can get an unexpected shock when critical business licenses are due. These include **gaming concession renewal and land lease renewal**, which last for approximately 20-25 years. If the concession isn’t renewed at favorable terms, the costs can be significant, as explained above.

The consensus view is that Wynn Palace has ramped up nicely, with adjusted EBITDA for the property up **3x QoQ** from US\$25.5mm to US\$77.5 mm. But when we look at operating income, **Palace made an operating loss of –US\$8 mm in 4Q 2016**. We estimate Palace made a 4Q 2016 net loss of over -US\$40mm and our analysis suggests a net loss in full-year 2017 assuming 4Q 2016 EBITDA run rate. This is significant when Palace was constructed at a cost of US\$4.4 bn¹⁰—entirely debt-funded. As the “the most luxurious” property in Macau, Palace should have benefited from the *novelty* factor. Yet, Palace’s average daily hotel room rate in 4Q 2016 fell -5.2% QoQ to US\$272, which is disappointing as 3Q16’s rate of \$287 was already low compared the older Peninsula property’s average daily room rate.

⁹ <http://www.forbes.com/sites/brentbeshore/2014/11/13/ebitda-is-bs-earnings/#7c9bef47494c>

¹⁰ As of 30 Sept 2016, the total investment into Wynn Palace was US\$4.4 bn. This reflects a US\$300 mm increase to the guaranteed maximum price (GMP) under the GMP contract.

Conclusion

The current optimism over Macau casino stock valuations, including Wynn Macau, is unjustified. We have argued that the fundamentals are less rosy when analyzing ROICs and free cash flows *even if* GGRs were to grow until 2022, the year of concession renewals. Given the current valuations and headwinds discussed above, most casinos—Wynn Macau in particular—will very likely not see healthy enough ROIC by 2022 to justify their significant invested capital. All things considered, can investors expect to make money from capital gains and dividends in the future?

It is also not to Beijing's political advantage to see Chinese flocking to Macau to gamble. Since Xi's administration took office 4 years ago, we have not found compelling evidence in the political leaders' speeches to encourage gambling. Instead, the law enforcers have thus far made it difficult for Chinese to gamble in Macau. Chinese policies have provided support for struggling industries from time to time but this is highly unlikely for the casino industry.

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The Founder and CIO, Wong Kok Hoi, has over 35 years of investment experience, including CIO at Cititrust Japan, Senior PM at Citibank HK, and Senior Investment Officer of GIC. He was the recipient of the prestigious Mombusho Scholarship in Japan, and graduated with a Bachelor of Commerce (Honors) degree from the Hitotsubashi University (1981). Mr. Wong also graduated from the Investment Appraisal and Management Program at Harvard University (1990).

Appendix

Exhibit A1: Adjusted Property EBITDA, US\$ in '000

Wynn Macau (1128 HK) Adjusted Property breakdown	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016
Wynn Macau Adjusted Property EBITDA breakdown:			Reclassified	Reclassified				-3.9%
Operating income	130,946	93,347	105,762	107,891	100,552	84,963	99,461	95,622
Pre-opening costs	9,499	11,041	-	-	26,258	39,338	-	-
Depreciation and amortization	34,201	34,357	27,954	24,284	29,810	31,111	24,687	23,997
Property charges and other	234	1,461	890	1,983	1,366	1,261	1,758	1,291
Management and license fees	27,057	23,876	22,368	20,970	22,763	24,373	20,018	18,846
Corporate expense and other	5,988	5,291	3,049	2,182	6,403	5,523	2,751	4,643
Stock-based compensation	4,417	4,018	2,799	2,758	4,093	3,820	2,334	4,467
Equity in loss from unconsolidated affiliates	-	-	-	-	-	-	-	-
Adjusted Property EBITDA	212,342	173,391	162,822	160,068	191,245	190,389	151,009	148,866
YoY growth %	-44.7%	-43.5%	-50.0%	-33.6%	-9.9%	9.8%	-7.3%	-7.0%
QoQ growth %	-12.0%	-18.3%	-6.1%	-1.7%	19.5%	-0.4%	-20.7%	-1.4%
Wynn Palace Adjusted Property EBITDA breakdown:								
Operating income	-	-	-17,940	-24,875	-	-	-79,226	-8,035
Pre-opening costs	-	-	13,688	20,830	-	-	65,548	-1,371
Depreciation and amortization	-	-	4,252	4,045	-	-	31,561	64,722
Property charges and other	-	-	-	-	-	-	8	243
Management and license fees	-	-	-	-	-	-	6,554	16,510
Corporate expense and other	-	-	-	-	-	-	847	4360
Stock-based compensation	-	-	-	-	-	-	255	1060
Equity in loss from unconsolidated affiliates	-	-	-	-	-	-	-	-
Adjusted Property EBITDA - Palace	-	-	-	0	-	-	25,547	77,489
Wynn Total - Adjusted Property EBITDA:	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016
Operating income (1)	130,946	93,347	83,050	78,912	100,552	84,963	15,351	84,832
Pre-opening costs (2)	9,499	11,041	13,688	20,830	26,258	39,338	65,548	-1,371
Depreciation and amortization (3)	34,201	34,357	32,943	29,064	29,810	31,111	57,150	89,849
Property charges and other (4)	234	1,461	890	1,983	1,366	1,261	1,766	1,534
Management and license fees (5)	27,057	23,876	22,368	20,970	22,763	24,373	26,572	35,357
Corporate expense and other (6)	5,988	5,291	6,172	4,755	6,403	5,523	8,784	10,647
Stock-based compensation (7)	4,417	4,018	3,711	3,554	4,093	3,820	1,385	5,507
Equity in loss from unconsolidated affiliates (8)	0	0	0	0	0	0	0	0
Total Adjusted Property EBITDA	212,342	173,391	162,822	160,068	191,245	190,389	176,556	226,355
YoY growth %	-44.7%	-43.5%	-50.0%	-33.6%	-9.9%	9.8%	8.4%	41.4%
QoQ growth %	-12.0%	-18.3%	-6.1%	-1.7%	19.5%	-0.4%	-7.3%	28.2%

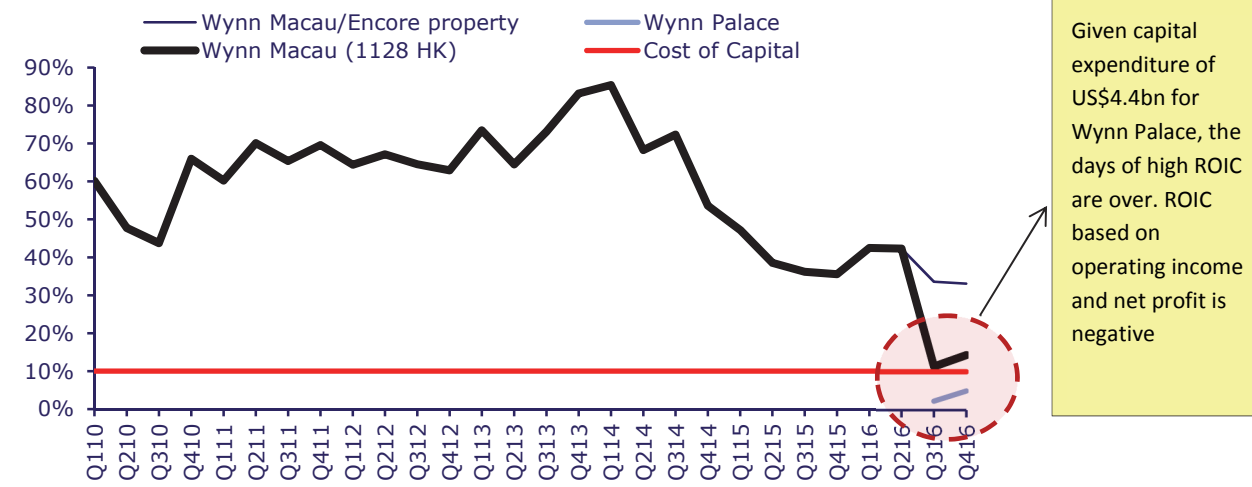
Source: Company filings, analyst estimate

Exhibit A2: US casinos' ROIC decline despite smaller supply than Macau, US\$ in mm

US\$ in millions, unless specified		First Full	First	Total		Rooms	Cost		
Property	Owner / Operator	Year of	Full Year	Invested	EBITDA	at	per	2014	Current
		Operation	EBITDA	Capital	Return	Open	Room (\$m)	EBITDA	EBITDA
Post-2000 Projects									
Cosmopolitan	Deutsche Bank	2011	(\$22)	\$4,100	-0.5%	1,998	2.05	\$155	3.8%
CityCenter	MGM	2010	37	8,500	0.4%	6,785	1.25	329	3.9%
Encore	WYNN	2009	109	2,400	4.6%	2,034	1.18	223	9.3%
Palazzo	LVS	2008	168	2,500	6.7%	3,066	0.82	136	5.4%
Wynn	WYNN	2006	331	2,800	11.8%	2,716	1.03	298	10.6%
Sum / Avg			\$623	\$20,300	3.1%	16,599	1.22	\$1,141	5.6%
1999-2000 Projects									
Venetian	LVS	2000	\$183	\$1,300	14.1%	3,000	0.43	\$178	13.7%
Mandalay Bay	MGM (MBG)	2000	121	1,000	12.1%	3,643	0.27	176	17.6%
Paris Las Vegas	Harrah's	2000	112	785	14.3%	2,914	0.27	N/A	N/A
Bellagio	MGM (Mirage)	1999	260	1,900	13.7%	3,005	0.63	416	21.9%
Sum / Avg			\$676	\$4,985	13.6%	12,562	0.40	\$771	15.5%
1990-1997 Projects									
New York - New York	MGM (MGM Grand)	1997	\$136	\$470	28.9%	2,024	0.23	\$93	19.8%
Monte Carlo	MGM (Mirage / Mandalay)	1997	92	363	25.5%	3,002	0.12	71	19.6%
Treasure Island	MGM (Mirage)	1994	99	435	22.7%	2,891	0.15	N/A	N/A
MGM Grand	MGM (MGM Grand)	1994	179	1,005	17.8%	5,005	0.20	234	23.3%
Luxor	MGM (Mandalay)	1994	90	405	22.2%	2,526	0.16	70	17.3%
Excalibur	MGM (Mandalay)	1991	90	310	29.0%	4,030	0.08	176	56.9%
The Mirage	MGM (Mirage)	1990	205	750	27.3%	3,030	0.25	116	15.4%
Sum / Avg			\$891	\$3,737	23.8%	22,508	0.17	\$761	20.4%

Source: sell side research. Based on original investment, excludes further capex.

Exhibit A3: Wynn Palace's ROIC is below cost of capital



Source: Sell-side research. Company cost of capital assumed 10%

Exhibit A4: Industry GGR vs Wynn Macau's old Peninsula property YoY growth

This table highlights that Wynn's older property in the Peninsula has witnessed more GGR declines for 8 out of the last 9 quarters relative to industry GGR

YoY Growth	Macau industry				Wynn Peninsula property			
	GGR	VIP	Mass and slot		GGR	VIP	Mass and slot	
Q414	-25%	-32%	-10%		-35%	-42%	-16%	
Q115	-37%	-47%	-19%		-41%	-52%	-12%	
Q215	-37%	-46%	-25%		-38%	-41%	-31%	
Q315	-34%	-45%	-21%		-40%	-45%	-31%	
Q415	-27%	-40%	-10%		-30%	-41%	-8%	
Q116	-13%	-23%	-3%		-16%	-21%	-9%	
Q216	-9%	-21%	3%		4%	4%	4%	
Q316	1%	-6%	8%		-10%	-6%	-15%	
Q416	10%	9%	11%		-10%	-2%	-19%	

Source: Company filings, analyst estimates.

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