

INVESTMENT NOTE

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**HERMES: GAMBLING ON GROWTH
A POSTCARD FROM MACAU**

Kunjai Gala, Senior Analyst, Hermes Emerging Markets, recently paid a visit to Macau's Cotai strip where construction is in full swing as operators try to tempt back their dwindling premium customers and cater to a steadily growing mass market. Kunjal met with several casino operators to find out how companies are adapting to a changing market and what the future holds for China's offshore gambling resort.

The evolution of Macau's gaming sector continues, and after a period of severe underperformance, the prospects for growth once again look appealing in a sector where we first invested in late 2012. There are parallels between the current environment and that of 2012, when gaming revenue growth was decelerating and the junket operations and VIP segments were coming under pressure. Now, as then, we are seeing green shoots of recovery, and we are again prepared to take a contrarian stance towards this out of favour sector, via our position in Galaxy, whose share price rose four-fold and then halved all in the space of 3 years, like the casino it is.

The changes in business dynamics for Macau's casino operators are easily visible. Premium customers are a rare breed nowadays, following the crackdown on corruption, and their spending is lower. The low-hanging fruit from the high-end segment is now fully monetized, and the growth engine has moved from these high rollers to the mass market, where bets are lower but margins are higher, due to the absence of the junket operators taking their cut. Visitors to Macau are also demanding a more sophisticated experience, with increased emphasis on high quality non-gaming facilities – good hotel rooms, luxurious dining and entertainment facilities. This fits with the preference of policymakers, who would like to reduce the economy's reliance on gambling and ensure the sustainable development of Macau. Improved access via high speed rail links into mainland China, and the completion of the Macau-Hong Kong bridge will both drastically reduce travel time for visitors, sustaining the inflow of new customers on a long term view.

Construction along the Cotai strip is in full swing, the standout development being the Galaxy Macau Phase 2, opened in May 2015 and doubling its capacity on completion, which blends in seamlessly with the existing Phase 1 structure and stands opposite its re-opened Broadway Macau mass market casino. Phases 3 & 4 of the same project will add growth and continuity over the next 3 to 5 years, helping Galaxy capture both visitor growth and margin expansion as its mix shifts towards the mass market, transitioning from its previous VIP-centric model. Our 2012 investment thesis for Galaxy of diversification into the mass market boosting both revenue and profitability remains broadly intact, and its potential to expand its non-gaming operations into the neighbouring Hengqin Island is well aligned with the government's policy and social objectives, namely alleviating issues relating to land shortage and over-crowding.

The base mass market is where we see the highest multi-year growth potential in Macau, and we believe that visitor and spending levels will continue to rise in this segment, which is less affected by President Xi's crackdown on corruption than the VIP or Premium mass markets. That is not to ignore the headwinds to growth that have surfaced in the past 18 months; tightening transit visa arrangements, curbing the usage of cross border Union Pay card machines, and imposing a smoking ban on public floors. Share prices have factored in the negative impact on growth from these changes, and the subsequent drop in spending and visitor levels in the high end segment. Macau gaming revenue is back to 2010-11 levels, models have adapted and expectations have been reset.

Our recent visit to Macau showed us the first signs of an upturn. The HK-Macau ferry was fully booked, and the mass market floors we visited were enjoying a constant inflow of tourists. The lower limit tables and slot machines were seeing most of the action, contrasting with only limited activity at the high limit tables. Operators we met are optimistic that the gaming market has now stabilised, and voiced confidence in the mass market, though less so in VIP. This view is reinforced by the sequential improvement in May gaming revenue and comments from Galaxy. Competition seems rational, with

each operator focusing on its preferred segment; Sands on the volume mass market with significant non-gaming operations, Melco Crown on the niche premium mass market, Wynn Macau on the high end VIP customers, and Galaxy transitioning to the mass market. All six operators are well-capitalized and generating sufficient cash flow to fund growth. Planned capacity additions to 2018 by both Galaxy and the competition are well spaced and should allow for newly launched properties to ramp up without irrational pricing.

Where we see most risk is on regulation, as there remains speculation that authorities will cap the yearly visitation to Macau at 21m (flat on 2014). This is a risk to growth, though would be counterproductive for the Macau government budget, so to some extent the interests of regulators and operators are aligned. Pressure from increased marketing and promotional activities must also be monitored as the casinos look to attract a broader visitor base – tourists taking the HK-Macau ferry are greeted by the image of David Beckham, now poster boy for Sands. Similarly, the increased focus on non-gaming facilities may mean higher investment at lower returns if execution is poor.

Macau has experienced significant growing pains as it moves from a pure gambling hub to a diversified entertainment and tourist destination. As the outlook stabilizes we are ready to add exposure on our normal, long-term horizon, going against consensus in a sector where expectations remain firmly negative. Galaxy remains our vehicle of choice to capture market growth, mix shift to the mass market and the non-gaming opportunity, delivering on Macau's potential to become an accessible destination for a new generation of mainland Chinese visitors.

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Notes to Editors:

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