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Macau's coveted gaming license renewals will shape the industry landscape for the next decade

Given the massive media focus on China real estate over the past few years, one sector in the Asian High Yield market that is often overlooked is Macau gaming. It might therefore come as a surprise that bonds issued by Macau casino operators have grown to become the largest single industry sector for the whole Asian High Yield bond market. It is also a surprise that a crucial policy announcement to be made next month and that could have a profound impact on the fundamentals of the sector to the point that it could even affect its long-term viability is not making headlines.

The city state of Macau first legalised gambling in the mid-19th century while still under Portuguese rule. Even after Macau's sovereignty was transferred by Portugal to become a Special Administrative Region (SAR) of the People's Republic of China in 1999, gaming rules were unaffected. In 2002, the Macau government which had awarded in 1961 a gaming monopoly to the legendary Stanley Ho Hung-sun and his company STDM (Sociedade de Turismo e Diversoes de Macau), opened up the industry to foreign competition and issued three (later expanded to six) operating concessions. This has resulted in a massive expansion of the industry to become the world's largest gaming hub. As of 2019 (pre-Covid), Macau had 41 casino sites in operation under these six concessions generating a gross gaming revenue of approximately USD40 bn (compared to USD13.4 bn in Las Vegas and €240 million in Monaco). Casino operations accounted for approximately 50% of the Macau economy, 80% of all tax receipts and 10% of the working force.

Attracted by huge cash flow potential, foreign gaming giants Las Vegas Sands, Wynn Resorts and MGM Resorts have invested massively in mega integrated casino resorts in the city over the past two decades. Most of these investments were funded by debt. This has been the main driver of the huge growth of the Macau gaming High Yield bond sector which across six issuers has a total of USD21.8bn of USD issues outstanding. Indeed, while the China property sector (which used to account for half of the Asian High Yield AHBI index) has seen its weighting shrink to just 10.1% at present, Macau gaming operators in

contrast have increased their weighting to 10.2% currently. That percentage excludes the largest operator Sands China (BB+ rated) which is not included in the High Yield Index as all its bonds are callable. Adding Sands China's outstanding bonds, the Macau gaming sector's index weighting would increase to more than 15% making it larger than all High Yield bonds issued out of Indonesia, Thailand, Philippines, Singapore, Korea and Malaysia combined.

However, a series of headwinds emerged. Competition appeared from neighboring Pan-Asian countries including Australia, Philippines, Cambodia, and Singapore. A regulatory clamp down made it more difficult to obtain visas to enter Macau from China. And of course, travel restrictions due to the Covid pandemic have deeply impacted the sector and significantly crimped gaming revenues over the past three years.

Compounding these headwinds is the uncertainty surrounding the upcoming license renewal process for the existing six incumbents that have been operating under a 20-year concession since 2002 as these licenses all expire at the end of December 2022. Between now and then, the Macau government is expected to announce whether these licenses will be renewed. We already know that new licenses will only be granted for ten years. While there is a sweeping consensus among industry experts that the Macau government would likely just extend the license of the incumbents who have all invested billions of dollars in the sector, some surprises cannot be ruled out. Indeed, the unpredictability of Chinese government policy in recent years combined with rising geopolitical tensions between China (where Macau's gaming customers are largely coming from) and the US (where three out of six Macau's casino operators originate from) does complicate the process given that China will be highly influential on the Macau government's decision. Furthermore, the fight against corruption and the "Common Prosperity" priority set by Xi Jinping may be seen as incompatible with gaming activities.

Meanwhile the license renewal process comes at a precarious time for the Macau gaming industry as Beijing's strict border controls from their Covid-zero policy saw the city's tourist figures drop to only 7.7 million in 2021 from the pre-covid 39 million visitors recorded in 2019. Currently there is a travel bubble between Macau and neighboring Chinese province of Guangdong which has provided a small bump in terms of tourist figures. However, Chinese tourists from other provinces must apply for a visa in order to visit the gaming capital of the East. These measures are expected to persist longer given

the reiteration of China's Covid-zero policy by President Xi in the latest 20th National Party Congress. Admittedly the Macau gaming industry still managed to record USD10.1 bn of gross gaming revenue (GGR) in 2021 which is still larger than the sum of all the other Asian gaming cities including Singapore, Australia and Philippines put together. However, this is still a far cry from the USD40 bn pre-covid levels.

In addition to the impact of Covid, Macau gaming has also suffered from a tighter regulatory grip on the local gambling industry that targeted specifically China's high-rolling gamblers. The city's VIP gamers contributed more than 43% of the sector's earnings in 2019, which largely went through junket operators – middlemen who facilitate gambling for wealthy Chinese clients. These junket operators handled everything from their client's luxury travel and accommodation to offering credit to play with. They were known for mastering underground money transfer channels between Mainland China and Macau. However, when President Xi embarked on his push for "Common Prosperity" in 2020, China went on a crusade to crush the junket operator market. Last November, police arrested Alvin Chau, the head of the city's biggest junk operator Suncity Group Holdings on more than 200 charges involving illegally operating casinos, money laundering and running a criminal syndicate. Since his arrest, the Macau government has banned all dedicated junket rooms in casinos – signaling Beijing's tightening of the Macau gaming industry.

Fundamentally, the companies' depressed revenue figures have caused their debt and leverage ratios to pile up. Despite having ample cash buffers, the Macau gaming companies' cash positions continue to dwindle, and all operators have experienced credit rating downgrades over the past year. Meanwhile, gaming companies are beginning to exhaust the various sources of financing which has caused them to seek financing via their American parents – Sands China in July was able to tap a USD1 billion loan from controlling shareholder Las Vegas Sands.

September's bids for gaming licenses indicate that the largest casino operators are believers in Macau remaining the gaming capital of the world despite the regulatory headwinds facing the city. However, until Covid-zero policies are lifted and Macau truly opens its borders to tourists around the world, the industry outlook remains murky at the moment. Given the uncertainties surrounding the sector, we, at JK Capital, remain significantly underweight in our High Yield bond fund despite sell-side analysts and

private bankers' optimism as they describe Macau gaming as being a rotation play away from the battered China property sector.

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