

The Last Resort

Lisboa Palace won't open until 2017 at the earliest—the final splash of Cotai's next wave—and it promises to be worth the wait

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The company founded by Stanley Ho to take his gaming empire forward in the post-monopoly era is still the best-known among players and probably the most respected. But its Hong Kong-listed stock consistently lags the competition in valuation, the much smaller peninsula operations of Wynn Macau and MGM China included. Sands China has outstripped it in terms of hotel rooms and floor space. In February, the Sands juggernaut on Cotai dethroned it from its longstanding position as the market leader in gaming revenue.

"SJM's only problem is it has only ever been a gaming company," says David Green, who heads Macau-based industry advisors Newpage Consulting. "It is a company so ingrained in gaming," as he recently put it to Reuters, "that it could be a limiting factor."

"Ambrose So, a protégé of Stanley Ho's going back more than three decades and chief executive of SJM Holdings, the company's publicly traded parent, acknowledged as much in his remarks at a ceremonial groundbreaking for Lisboa Palace on 13th February.

"Ten years back the main thing for [the customers] was really gaming-centric. They just wanted to go to the casino and were glued to the tables. We have seen there is a gradual change.

"Change is what is driving the company's thinking on Cotai. "We are mindful," Mr So said, "this is a new area we have come into in which we compete with the other operators.

"So SJM has something to prove with the multibillion-dollar Lisboa Palace, and it plans to do just that.

Grant Govertsen, a principal of Las Vegas-based boutique brokerage Union Gaming Group and founder of the firm's Macau office, was among the numbers guys who came away from the groundbreaking a fan.

"We believe that the Lisboa name has exceptionally high namerecognition with mainland visitors to Macau and should result in a natural attraction to the site," he stated in a client note issued the same day. He would have been "disappointed," he said, if SJM hadn't brought the brand to Cotai.

He likes the overall design, too, the fanciful recreation of a palace in the grand style of Versailles—"certainly not the only new project with a French theme being constructed on Cotai," he wrote, but "We think the theme resonates well with mainland consumers. Ultimately, mainland consumers view Europe in general and France in specific as very aspirational destinations.

"It doesn't get any more aspirational for China's nouveau riche millions than Versace, and their participation as a hotel brand—a 270-room "Palazzo Versace" will be one of two six-star hotels at the resort—is part of what stands the project apart from the rest of the lavish competition that will already be up and running when Lisboa Palace opens in 2017 as the last of the six new Cotai megaresorts.

Karl Lagerfeld is lending his cachet to the other ultra-luxe room tower. The Karl Lagerfeld Hotel, containing around the same number of rooms as Versace's, is the famed Chanel designer's first foray into hospitality.

Plans for a third tower, SJM's own "Lisboa Palace," call for 1,450 five-star rooms.

MASS MARKET SHARE

	2013	Jan'14
Sands China	29.7%	30.8%
Galaxy Entertainment	16.0%	15.7%
Wynn Macau	7.6%	7.0%
SJM	26.7%	25.5%
Melco Crown	12.9%	13.2%
MGM	7.0%	7.9%

Figures may not total 100% due to rounding

Source: DICJ, company data

SLOT MARKET SHARE

	2013	Jan'14
Sands China	31.2%	30.5%
Galaxy Entertainment	12.2	11.8%
Wynn Macau	13.5	14.4%
SJM	10.0%	9.8%
Melco Crown	17.5%	18.0%
MGM	15.5%	15.5%

Figures may not total 100% due to rounding

Source: DICJ, company data



In total the resort will encompass 521,000 square meters knit together by rooftop gardens under a glowing dome that will be visible inside and out. High-end retail covering 34,000 square meters and a luxury spa, musts for a 21st century destination, will help round out the offering. There will be swimming pools indoors and out. SJM's reputation for good food will be on ample display (36,000 square meters of restaurant and entertainment space is contemplated). A further romantic touch is planned in the form of a "wedding pavilion" richly detailed with symbols (dragons, the phoenix, the lotus) associated in Chinese lore with love and marital harmony.

The design has been 18 months in the making, according to architect Perry Brown, senior vice president of Southern Californiabased WATG and the firm's partner in charge of the project, which will come together as a three-way collaboration involving also a sister firm of WATG's, Beverly Hills-based Wimberly Interiors

The selection of WATG, creators of The Venetian Las Vegas and Atlantis Paradise Island in the Bahamas, is emblematic of SJM's commitment to achieving what Mr Brown calls a "total experience".

"It's taking it to that next level," he explains. "It's what's going to make this a unique destination.

"WATG has designed resorts from Dubai to the Maldives, from Palm Desert, Calif., to Orlando, Fla., from Uncasville, Conn., to Egypt's Red Sea coast, but few have been more satisfying for him as a work in progress than this one. "SJM, they set the vision, they're clear with it, they continue to pursue it," he says. "They respect the quality of design. They value it. That's rare with clients. They really want to see it through. We enjoy that."



The Home Team

It may be good public relations to expound the fact, as SJM does, that it is the only operator with historical roots in south China. But there is history to back it up.

Stanley Ho's grandfather was a stepbrother of Sir Robert Ho Tung, the Hong Kong businessman and philanthropist who financed the Xinhai Revolution of Sun Yat Sen that established the Republic of China. Sir Robert was one of the few Chinese to live on colonial Hong Kong's Victoria Peak and was twice knighted by British monarchs. He founded a library in Macau on the site of a mansion where he'd taken refuge when the Japanese invaded Hong Kong in the Second World War.

Stanley Ho, was born in Hong Kong in 1921 and planned to attend the University of Hong Kong on a scholarship, but his education and his stay in his native city were similarly cut short by the invasion. He also fled to Macau, where it's reputed he made his first fortune smuggling luxury goods to the mainland during the war. One of his early partners in Sociedade de Turismo e Diversões de Macau, the private company he founded in the early 1960s to run Macau's last casino monopoly, was Hong Kong tycoon Henry Fok, a native of Guangzhou who had also fled the colony ahead of the Japanese and who ran guns, steel and rubber to Mao's China during the Korean War. Renowned for his philanthropy, Mr Fok would serve as vice chairman of the National Committee of the Chinese People's Political Consultative Conference. Prior to his death in Beijing in 2006 he was viewed by many as possibly the most powerful Hong Konger in China politics. Since the handover, only three Hong Kong citizens have had their caskets draped in the national flag. He was one of them.

SJM will be wearing its patriotism on its sleeve on Cotai. This is what Perry Brown refers to when he talks about the intensity of SJM's engagement with the look and feel of Lisboa Palace, whose faux Gallic classicism will be informed by an aesthetic fancifully characterized as "Chinoiserie" but which will at some level, indeed on several levels, attempt to convey through its décor and via an attraction called "A Fantasy World of Sino-Western Cultural Interchange" a sense of Macau's significance as the first and still one of the more profound encounters between China and the West.

The company views itself as the guardian and promoter of a heritage, and it continues to devote a portion of its considerable resources to ensure the resorts it directly operates serve as repositories of it. Ambrose So is an active patron of education and the arts. He also is a noted practitioner of traditional Chinese calligraphy. His work has graced a set of stamps issued by the Macau Post Office and it's been exhibited in collections in Hong Kong and as far away as Princeton University and the US Library of Congress. It's an everyday thing in the lobby of the Grand Lisboa to see crowds of tourists from the mainland snapping photos of the many fine examples of the decorative arts displayed there, some of them genuine antiquities, like the bronze horse's head that Stanley Ho—the only living person to have a street in Macau named after him—donated to the Chinese government, part of a set of two he bought at foreign auction (the other a pig's head, now in Beijing) that formed a "water clock" of sculptures from the Chinese zodiac looted by Anglo-French forces when the Summer Palace of the Qing emperors in Beijing was razed in the Second Opium War.

The groundbreaking ceremony was all about how China influenced Europe (and vice versa) through the stylistic ethos of chinoiserie. Macau's Secretary of Finance and the Economy Francis Tam was in attendance. The horse's head was brought up from the hotel lobby for the occasion. A scale model of the resort was displayed for the press in a room at the Grand Lisboa decorated floor to ceiling with paintings, reproductions and artifacts elaborating on the theme, some on loan from the Macau Museum. Samples were shown of the fabrics and treatments WATG and Wimberly will employ. Guests were given an 18-page color brochure penned by historian and academic Fok Kai Cheong, dean of the faculty of arts of Macau Millennium College, where Mr So is an honorary professor and has served as a chancellor. Professor Fok wrote of the planned "Fantasy World" as something perceived by SJM—"the only indigenous corporation representing both local and national interests"—as a civic responsibility, "to extend [China's] global influence through cross-cultural communication by demonstrating to the world the excellence of China's cultural achievements in the past". This "historical art movement," as Mr Brown terms it, is "the unique overlay" to Lisboa Palace, and it was developed, he says, "at the urging of the SJM executive group". "That," he emphasizes, "is what the guest will experience."





Same-Store Blues

How all this translates into revenue is subject to calculations of an altogether different nature.

“Obviously what drives all these properties at the end of the day isn’t the look, it is the demand to play baccarat,” says analyst Philip Tulk of Standard Chartered in Hong Kong.

In line with the government’s desire to promote Macau as an all-around destination, gaming will occupy only about 10% of the public space at Lisboa Palace, as SJM reckons it. Plans call for a casino of 27,000 square meters the company wants to stock with as many as 700 table games. It’s not going to get them all. The government’s cap on new tables of 3% a year through the expiration of the current concessions precludes it. The other five resorts opening on Cotai between now and 2016 will deal with the same constraint.

Morgan Stanley’s Praveen Choudhary, for one, is “concerned about SJM getting a proportionate number of tables to help maintain the return profile,” especially if the company follows through with plans to expand the resort by another 180,000 square meters with adjoining land controlled by the youngest and last of Stanley Ho’s consorts, Angela Leong, who is an executive director of SJM and a major shareholder. However, only about half her parcel actually has been gazetted (officially approved, that is) for commercial purposes, and this may be complicating the negotiations to unite them, which no doubt have involved the government. The half that has been gazetted is not zoned for gaming. Mr Tam, moreover, has said there will be no more approvals for large-scale casino development. Grant Govertsen of Union Gaming Research Macau expects the site will add a “significant amount of non-gaming amenities” that could include “many thousands of hotel rooms, entertainment, etc.” Mr Choudhary, writing on the day of the groundbreaking, said it could amount to another HK\$30 billion in capex, which, as he notes, certainly would put pressure on returns in the absence of a gaming element.



The cap anticipates around 1,900 new tables in the market through 2023, or about 325 per concessionaire. Mr Tulk is not alone in believing this will be exceeded well before that date. He projects an average closer to 400-425, augmented by “bonus allocations” the government will conjure as a reward for investments in non-gaming.

Mr Choudhary uses 300 tables at Lisboa Palace to value an additional HK\$4.40 per SJM share (HKSE: 0880) into his forward price target. Mr Tulk values in \$5.80. It works out to only 20.9% of his target price, way less than the impact he assigns the Galaxy Macau Phase 2 and Studio City openings, which are much nearer on the horizon.

He’s skeptical of the 2017 opening date, for one thing. “I think it’s quite reasonable that it might not open until 2018,” he says. “That’s quite a long ways off.”

He’s not impressed with the location either, noting that it lies outside the radius of the city’s Light Rail as currently planned— although it’s possible that could change—and rather distant, in his view, both from Wynn Palace, which will be the closest resort, and the main Cotai action.

“It’s not that easy to get to,” he says.

Investors are more concerned near- to mid-term on the prospects of SJM’s existing operations, capacity constraints having emerged as perhaps the biggest issue, particularly as Cotai continues to ramp up for Melco Crown and Sands.

SJM enjoyed a 25% surge in share price toward the end of 2013—impressive but well below the competition, which doubled on average. After a year in which it led the market in gaming revenue its

share price entered 2014 trailing the median by triple digits, the multiples it commanded both in terms of price/earnings and enterprise value/EBITDA the lowest of its peers.

“A lack of space at core properties and an insufficient number of hotel rooms make it hard for SJM to compete for new business,” Mr Tulk wrote in a December note to investors.



VIP ROLLING CHIP TURNOVER (MOP millions)

	1Q13	2Q13	3Q 13	4Q 13	Market Share	Jan. '14
Sands China	278,177	281,231	288,997	329,963	15.6%	80,995
Galaxy Entertainment	340,374	361,349	378,831	439,492	20.1%	126,623
Wynn Macau	203,923	219,429	220,112	250,519	11.8%	69,840
SJM	487,042	489,348	520,472	589,094	27.7%	158,887
Melco Crown	256,304	259,932	228,171	247,965	13.7%	83,991
MGM	193,303	207,963	209,202	244,375	11.2%	62,869

Figures may not total 100% due to rounding | Source: DCL company data

As a consequence the company has become overly reliant, in his view, on cash rebates to lure higher-spending play to its mass-market tables, the prized segment known as “premium-mass,” a strategy that he sees knocking margins around by 12-15% compared with non rebated premium mass.



He expects management will be punching away with changes this year to Grand Lisboa’s mezzanine area involving the addition of more premium-mass tables (and less VIP). It’s also possible they could take back the remaining 80 tables from the company’s troubled Greek Mythology satellite on Taipa island, although he wonders whether there is enough space to “usefully” employ them. He notes

as another positive the reopening of the company's directly operated Casino Jai Alai (with 170 new hotel rooms) later this year.

A lot could depend on VIP. It's the heart of SJM's business, but it continues to weaken market-wide relative to mass. The fourth quarter of 2013 was the 10th in a row in which VIP revenue had fallen as a proportion of the whole. Not surprisingly, the number of mass tables has grown sequentially throughout this period while VIP's have remained roughly unchanged. In January, a month when SJM once again led all comers in rolling chip volume, VIP revenue market-wide dipped 1% year on year. SJM's share fell by 0.8%, mainly on poor luck. The sector's 60.6% of the market was its lowest share ever.

"In 2014, we see risk rising with limited new supply, tightening liquidity, and competition from premium mass," Mr Choudhary wrote on 24th February, two days before SJM released its results for the fourth quarter, in which the company would report a significant increase in EBITDA of 23% for the three months ended 31st December on a 13% increase in gaming revenue to HK\$23.7 billion, which was below the market's +19%. "We believe the outlook for SJM remains positive," Mr Govertsen responded in a client note, "and especially so at its flagship Grand Lisboa property, which we are currently modeling to grow GGR during 2014 at slightly under our market-wide growth rate."

Mr Tulk is bullish on Macau, forecasting growth of 16.7% versus current consensus of 15%, but he has SJM trailing the market by about two percentage points. He expects the company will underperform both in VIP (+11.2% versus +11.5% for the market) and mass tables (+22.5% versus a market-wide +30%).

As he states it, "They have much lower EBITDA margins. They have much less control over their operations because half their revenue goes through third-party operations. Their multiple today reflects what's going to happen tomorrow, and that includes Cotai. But Cotai is like four, five years away for these guys instead of one year for Galaxy, one and a half years away for Melco, and so on. It reflects all these things. It also reflects growth, that slower growth profile. They're growing, but they're not growing as fast as the market.



" Writing last month, Mr Choudhary took the converse view that investors should "overweight" on the shares: "We believe SJM is a value play on the Macau sector, which is growing at a very healthy rate driven by strong demand from mainland and benefits from oligopoly. ... With the Cotai project expected to start construction in 1Q14, stronger 4Q13 QoQ, moving 30 tables to Grand Lisboa (1H14), opening of Jai Alai hotel (by November 2014) and valuation discount versus peers, the stock price should move higher this year. " Analyst Kenneth Fong, writing for J.P. Morgan on the day of the groundbreaking, wondered if the ceremony later that day "may redirect market attention back to this underperforming name".

It didn't.

The stock has been trading, at any rate, at the upper range of its 52-week high of HK\$28. The release of Q4's results saw volume almost double at one point (on 27th February, the price jumped 2.4% before closing roughly at where it opened). Heading into March it was up all of 2.8% since Lisboa Palace was unveiled.