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BARRON'S COVER

Fold 'Em

Casinos' incredible streak of Macau-inspired, winning hands just ended. Should you take the bulls' advice and double your bets?

By KOPIN TAN

THE FIRST THING YOU LOSE in Las Vegas is your sense of scale. It begins with the four-mile strip of blinding bling, continues with the grand halls and vast lounges, and builds to a nightly climax, for \$350 a pop over at Caesars Palace, with Celine Dion's energetic mauling of the American Songbook. Everything is designed to make your life back home seem small and dull, and persuade you to prolong your pleasurable -- and profitable -- stay.

Macau is trying to do bigger even better than Vegas. Blessed with proximity to China's teeming masses (and their allegedly genetic predilection for baccarat), the tiny offshore enclave is gleefully erecting a shrine to the kind of recreational gambling the Chinese government won't allow on the mainland. In just three years, the number of casino tables has quadrupled to 4,622, while available hotel rooms jumped 11-fold to 8,901.

But frenzied construction all over Macau suggests the boom is just beginning. This summer, for example, **Las Vegas Sands** (ticker: LVS) opened its newest behemoth there. The Venetian Macao boasts the world's biggest casino, 3,000 suites, 48 gondolas prowling three Grand Canals, a one million square-foot "baroque" mall, a water park, a stadium nearly as big as Madison Square Garden, and a 27-hole rooftop golf course -- all billed, with towering immodesty, as the "eighth wonder of the world."

In such a grandiose context, Wall Street's clamor for U.S. casinos with Macau toeholds can seem almost...restrained. Las Vegas Sands, which opened Sands Macao in 2004 before it upped the bombast with the Venetian, has seen shares surge 173% over the past two years. **Wynn Resorts** (WYNN), which opened Wynn Macau last year, is up 140% over the same period. Even **MGM Mirage** (MGM), which has joint ventures there but isn't considered a big Macau play, is up 127%.

Yet the bulls are betting their winning streak will resume after a recent pullback in the shares. After all, Macau's gaming revenue recently overtook Vegas' and is growing at a 50% year-over-year pace, far outstripping the 3% rate in the profitable but mature Vegas market. China won't issue new licenses to build in Macau until at least 2010, and available land is scarce, so those chasing the boom see few options but to lunge at LVS and Wynn.

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Macau's rise will continue, since a burgeoning middle class in China desperately needs its licentious outlets. But near term, stock buyers will be disappointed. Over the next three years, the number of Macau tables will

double to about 10,000, while hotel rooms will more than triple to 31,017, by Deutsche Bank's count. In fact, the building boom will add 20.2 new rooms a day. Even if pent-up demand keeps revenue rising, the supply onslaught will escalate competition for business. One casualty: the stellar profits that shareholders have come to expect.

"Some investors seem to think high margins are perpetual and are disappointed when they find out otherwise, but you're starting to see margins pressured as supply gets saturated and competition increases," says Wahid Chammas, a senior analyst at Janus Capital. Two years ago, Chammas advocated betting on Macau while the public wavered (see "[High Stakes in Macau](#)"¹," Dec. 19, 2005), but he is more circumspect today. "The story has been discovered."

THERE ARE NOW AT LEAST 26 casinos in Macau, with 18 controlled by Hong Kong billionaire and casino-king Stanley Ho, and another five owned by Hong Kong-based Galaxy Entertainment. While Wynn and LVS have upped Macau's wow factor, nearly everyone is building and renovating. Cash-flow margins of around 30% will come under pressure with competition, possible discounting, and as all-important junkets -- which bring tourists to Macau and hence control customers -- lobby for a bigger slice of the take.

On Nov. 1, LVS reported third-quarter adjusted Ebitda (earnings before interest, taxes, depreciation and amortization) of \$128 million, well short of the \$180 million forecast. Margins fell short of targets. Surprised investors dumped the stock, which is off 22% from its late-October peak. Wynn, which reported insufficiently spectacular numbers, also lost ground and is off 25%.

But investors tempted to double down right now ought to remember: This pullback may be just the start. Another correction of 25% to 30% would merely take LVS and Wynn to levels they were at in July, and they'd still be richer than their peers on most valuation measures.

Today, even after the recent declines, LVS and Wynn sport enterprise values that are 34 and 22 times their respective 2008 Ebitda. To put that in perspective, **Harrah's Entertainment** (HET), which has no Macau casinos, is being acquired by buyout firms at a comparable 9.9 times multiple.

"Betting on these stocks is like betting on the winning horse after the race," says David Trainer, president of the independent stock-research firm New Constructs. He thinks LVS and Wynn are overvalued. "Their current market valuations imply huge future cash-flow growth."

CASINOS ARE FAMOUSLY capital-intensive enterprises, and over time they find it difficult to earn returns far exceeding their cost of capital. Early profits from Macau are strong, but forecasts for this to continue fail to consider the impact of over-building and maturation.

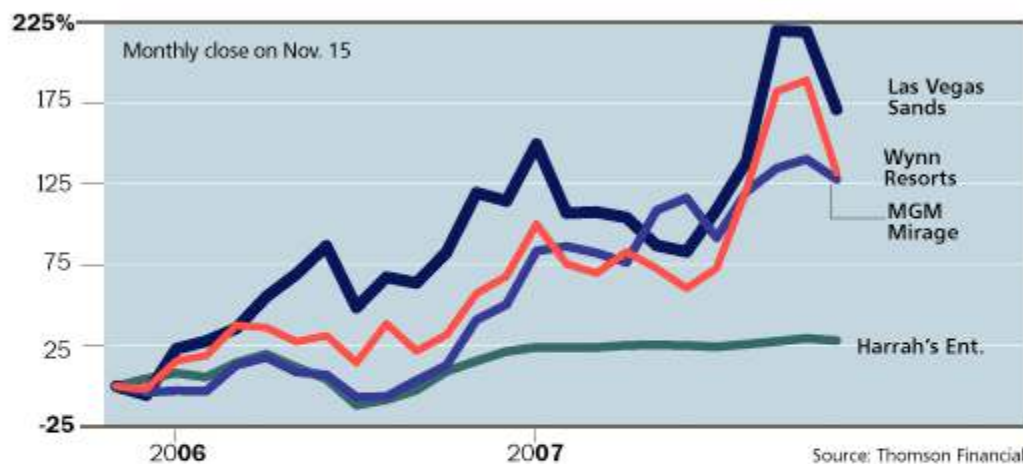
Management of LVS and Wynn, which did not return *Barron's* repeated calls for comment, isn't complaining. Letting others overvalue your hand -- bluffing in poker -- is shrewd business, since a rich stock price helps raise capital to construct the kind of buzz-worthy properties that, in turn, justify a rich stock price.

LVS has made a name building scale-distorting, "market-changing properties," says Jefferies analyst Lawrence Klatzkin. "It's why every time there is a new market, LVS has a good shot at getting the deal." It is one of just two companies given the nod to build in Singapore, and besides its Sands and Venetian properties in both Vegas and Macau, it has a full pipeline. Whenever talk surfaces of another country -- say, Slovenia -- mulling a casino project, LVS shares tend to pop the most.

Wynn's empire is smaller but haughtier. Charismatic leader Stephen Wynn has managed to persuade guests to pay a market-leading \$311 a night for his extravagant thread counts in Las Vegas, where the average room goes for \$134.33. Besides the Wynn Macau, the company is developing a high-end hotel in Macau slated for 2010, and the Encore in Vegas.

...But Their Shares May Have Reached Wretched Excess

The Las Vegas Sands and Wynn Resorts, with big Macau properties, have seen their stocks race to big price-earnings premiums over MGM Mirage, which has a lesser stake, and the casino sector. U.S.-focused Harrah's is selling out for a much more modest price than any of these players now fetch.



Company/Ticker	Recent Price	% Change YTD	Earnings/Share 2007E	Earnings/Share 2008E	P/E 2008E	EV/Ebitda* 2008E	Free Cash-Flow Yield	Debt To Capital
Las Vegas Sands/LVS	\$114.55	28%	\$1.07	\$2.38	48.1	34	-5.8%	73%
Wynn Resorts/WYNN	130.35	39	2.87	3.22	40.5	22	-0.5	56
MGM Mirage/MGM	87.60	53	2.39	2.79	31.4	13	-0.6	76
Harrah's Ent/HET	87.42	6	3.51	3.89	22.5	10	-2.8	65
Casinos & Gaming	1515.38	-2	57.53	63.93	23.7	-	-	38

E=Estimate *Enterprise Value to Ebitda.

Sources: Thomson Financial; Bear Stearns; New Constructs

But will Wynn be as successful if the U.S. economy slows? Klatzkin sees the stock as overvalued, given the company's thin two-hotel roster.

Of course, Wynn had created Vegas landmarks like the Mirage and Bellagio before he sold that company, Mirage Resorts, to MGM Grand in 2000. MGM is transforming itself from a casino operator into a high-end hotel developer. A Macau joint venture, MGM Grand Macau, opens Dec. 18, and MGM will develop three hotels in Abu Dhabi that will earn revenue on properties wholly owned (and risks fully borne) by the government there. Its stock, near 87 today, has downside support at 84, given a Dubai state-owned investment group's agreement to buy up to 28 million shares at that price (as the two jointly develop the 76-acre City Center in Vegas).

Yet MGM shares trade at just 31 times 2008 earnings, compared to 48 times for LVS and 40 times for Wynn. That discount persists even though MGM earned more than the other two combined in 2006.

Don't believe that's a sign of a Macau bubble? Then look at **Melco PBL Entertainment (MPEL)**, a casino developer that lost money in 2006 and 2007 but recently opened Crown Macau and is planning the heavily touted "City of Dreams" in 2009. Billed, correctly, as a "pure play on Macau," Melco's Nasdaq-listed American depositary shares fetch 164 times 2008 earnings.

U.S. Casinos Put the Vegas Wow in Macau...

China's designated-gambling den pushes Las Vegas garish to a new extreme. For U.S. gaming firms, having a casino there has been akin to hitting the jackpot.



Cover Story -- Part II²

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