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Crown

13/09/2011 FAT-AUS-540

CWN

AUD \$7.85

Core

MED.



**All in**

Gaming businesses are big, flashy and glamorous by nature. The business of gaming, when well run, can be just as enticing for investors. We are adding Crown to the Fat Prophets portfolio as we believe this company is undervalued. In addition, the multi-year capital expenditure program is close to completion and Crown is about to enter a period of very strong cash generation.

***“Macau is far from a mature market even though it is easily the largest gaming centre on the planet today”***

Support is indicated at \$7.78, followed by the August intraday low of \$7.45 in the near term. Should prices firm at current levels, we would expect a rotation higher to follow. The upside target is towards the confluence of the 50 and 200 day moving averages at \$8.50.



Crown can be thought of as three distinct gaming businesses: (1) Crown Melbourne (2) Burswood and (3) Macau. The first two are Australian domestic casino businesses while the Macau business is comprised of two major casinos – Altira Macau and the City of Dreams – plus growth options.

We looked at Crown a year ago (FAT490) and liked what we saw as the long term prognosis for this business. The Australian casinos in Melbourne and Perth were having large amounts of cash spent on new and improved facilities – work that is continuing – and its investment in Macau was under-appreciated and under-valued.

Our conservative valuation at the time of \$8.90 per share was ahead of the share price at \$8.50 but we held back from recommending the stock on the basis that consumer caution was potentially going to squeeze profits in the near term.

Crown reported its full year earnings for 2011 recently which showed normalised net profit after tax had increased 18% to \$340.3 million. Even though this was mildly below consensus, it was still a good outcome in what had been a turbulent year for stocks that are reliant on discretionary spending.

Operationally, the Crown and Burswood casinos performed adequately with Crown's operating earnings (EBITDA) ahead by 6.5% on last year and Burswood down 8.6% delivering an aggregate increase of 1.2% to \$664.9 million.

The results need to be read in the context of not only the cautious consumer environment but also the significant amount of capital spending that has occurred at both properties. Crown has spent \$1.5 billion over the last four years and still has a further \$540 million to spend in FY12.

Whenever there is large scale work being carried out on the gaming facilities there is always an element of business disruption that must be managed. Crown's management has always proven very adept in this regard, in our view, so the result we have seen in the last year or two have been commendable in the circumstances.

The flip side to this is of course that the building work doesn't go on forever, and Crown is now close to the point in time when it will be fully operational with world class facilities in Melbourne and Perth.

In May, the company updated the market as to what remains of its current capital expenditure plan. A variety of projects are spread across each property such as developing the 'West End' of Crown Melbourne to accommodate an increased number of table games. The main gaming floor at Burswood is another key project that will allow for new gaming product and various hotel related projects at both venues.

A good deal of attention has been paid to the non-gaming facilities as well, and visitors to both properties will have a greater choice of upmarket restaurants and bars as well as entertainment. This is a trend seen at most big casino resorts around the world where the emphasis has shifted towards a more balanced offering of gaming and non-gaming activities.

As a guide, Crown Melbourne's revenue in FY11 was split between gaming (\$930.7 million, 54% of total), VIP gaming (\$418.2 million, 24%) and non-gaming (\$365.2 million, 21%).

Crown's VIP (high roller) business is a very important part of the group's earnings. We like to think of the VIP business across all three locations (Melbourne, Perth and Macau) as the small number of customers requires intensive nurturing to keep them within Crown's walls. By offering alternative gaming experiences at different

properties, Crown has an advantage over Echo Entertainment Group's Star casino in Sydney and is highly competitive with the major gaming groups established in Macau.

Crown has felt some impact from the honeymoon effect of the two new casino resorts in Singapore but this is now tapering off.

In Australia, Crown has milked the lack of VIP competition over several years and generated approximately \$40 billion of last year's \$60 billion in high roller turnover. Star will have its work cut out to take back any of the ceded market share as Crown has a big lead in the customer relationship game that is crucial to this business.

VIP play has been the cornerstone of the Macau gaming industry to date, but is increasingly opening up to the mass market. The growth of gaming in Macau has returned to the heady days of two years ago, interrupted partly by the GFC but just as much by the Chinese government clamping down and controlling the flow of visitors from the mainland.

Macau is far from a mature market even though it is easily the largest gaming centre on the planet today. Crown's 33.4% stake in the Nasdaq listed Melco Crown Entertainment (MCE) provides it with a big seat at the table.

MCE owns two major properties in Macau. The Altira Macau is the smaller of the two and caters mainly for high roller and junket players. MCE has an established share of this market at approximately 16% and is quickly growing its share of the mass market through the much larger City of Dreams casino.

In its most recent results, the breakdown of MCE's revenue showed the City of Dreams at approximately 61% of the total, with Altira at 36% and the Mocha gaming machine business at 3%.

MCE owns a sub-concession in Macau which is equivalent to a casino licence in Australia. The number of such concessions is limited to six and no further concessions are to be granted.

After several years of reported losses as the businesses were built and established, MCE is now also on the cusp of making rapidly increasing contributions to Crown's earnings.

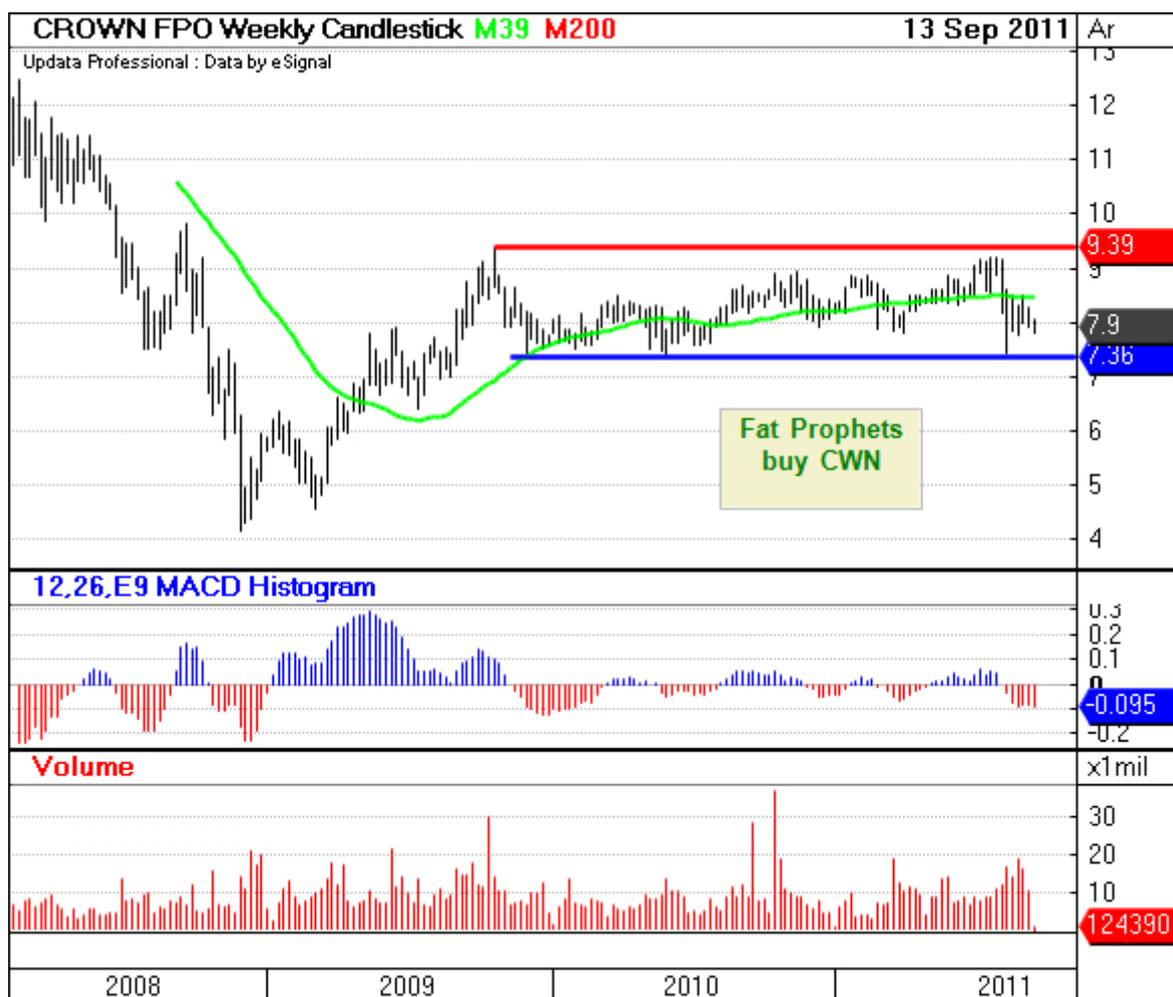
Despite the heavy schedule of capital spending in recent years, Crown's balance sheet is impressively robust. FY11 net debt to EBITDA of just 1.3 times and a further \$959 million of undrawn bank facilities suggests the chief financial officer is sleeping well at night.

In a surprise move, the company announced a \$240 million share buyback representing approximately 4% of the issued capital. This will help to underpin the share price to some degree.

It is interesting to note that Crown's major shareholder, James Packer, has also been buying more shares over the last year. Most recently, he acquired a further 6 million shares at an average price of \$8.07 per share. That brings his total ownership of Crown to 43.8%.

As part of the separation of Tabcorp's casino business (Echo Entertainment Group) from its wagering and gaming business this year, it emerged that Crown was a shareholder of Tabcorp at the time. Crown currently owns 4.9% of Tabcorp and 4.9% of Echo Entertainment Group. The news sparked immediate talk that Crown might initiate a takeover move on Echo Entertainment Group which owns the Star City casino in Sydney as well as three casinos in Queensland. Crown was quick to dispel such talk but remains on the register of both companies for now.

With reference to the weekly chart, prices are largely contained within a broad consolidation between support at \$7.36 and resistance at \$9.39. A sustained break above the upper range of the consolidation, would likely result in a strong boost of upward momentum into the longer term.



### Valuation and Summary

We have applied a more realistic valuation multiple of 9x to our estimate of Crown’s FY12 operating earnings and added the market value of MCE and other investments to reach a valuation of \$10.70 per share.

We think that Crown’s operational outlook and diminishing capital expenditure profile will be the basis for significant free cash flow over the next few years.

We are aware of the steady but unspectacular trading conditions for now, but the market cannot continue to ignore the huge growth emanating from Macau.

On our valuation approach, investors are buying the Australian casinos at a discount and getting the Macau investment for nothing at the current share price.

**We are adding Crown to the Fat Prophets Portfolio and recommend members buy the shares at the current price of \$7.85.**

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## Snapshot CWN

### Crown

**Latest Closing Price: \$7.85**

Crown Resorts operates and manages gaming (gambling) and entertainment facilities. The company opened its major expansion project in Macau in June 2009, the City of Dreams casino.

**Market Capitalisation:\$5,923m**

	FY1	FY2
Price to Earnings	14.8	12.3
Dividend Yield (%)	4.7	4.7
Price to Book	1.79	1.69
Return on Equity (%)	12.0	13.5

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