Weekly Credit Brief Sep 21 - Sep 27 2021

Macau casino operators face heightened credit risk as a proposed regulatory review casts a shadow on license renewal

by Amrita Parab

- **The NUS-CRI Agg PD of Macau Casino operators soars as the government begins review of regulations with an aim to increase oversight**
- **The NUS-CRI Forward PD demonstrates a worsening outlook for Macau casinos stemming from heightened risk related to licensing renewal and slowdown in the recovery**

On 15th September 2021, the local administration of Macau announced a proposal to modify Macau's gaming law in order to facilitate greater government oversight over casino operations. As the current gaming licenses of casino operators are set to expire in Jun-2022, the proposed changes to abolish the "sub-concession" framework[1], increase supervision over operations by increasing representatives at concessionaires, and expand non-gambling offerings bring in uncertainty regarding the future prospects of the 6 casino operators[2]. Concurrently, the NUS-CRI Aggregate (mean) 1-year Probability of Default (Agg PD) of Macau casino operators in Figure 1a showcases a jump in Agg PD in tandem with the announcement of a 45-day consultation period to implement new rules for the casinos. The Agg PD, which was already elevated in August amidst fresh COVID-19 related lockdowns, surpassed the PDiR2.0[3] BBB- upper bound in mid-September following the announcement. The NUS-CRI Forward 1-year PD (Forward PD[4]) (See Figure 1b) showcases increased short-term stress in the credit outlook of casino operators. The Sep-2021 Forward PD rises from 50bps to 70bps over the next 12 months before stabilizing, suggesting that should the casinos be able to navigate this period of regulatory uncertainty, their PD may stabilize going forward.

[1] Three operators – Sands China Ltd, MGM China Holdings, and Melco Resorts and Entertainment Ltd – hold their gaming rights (concessions) via sub-concessions spun off from the three original concessionaires selected via a 2002 public tender. The three original concessions under the 2002 process were Galaxy Entertainment Group Ltd, SJM Holdings, and Wynn Macau Ltd. The sub-concessionaires are almost identical to the three concessionaires in terms of their license contract terms.

[2] Macau Casino Operators in the sample - Sands China Ltd, MGM China Holdings Ltd, Galaxy Entertainment Group Ltd, SJM Holdings Ltd, Wynn Macau Ltd, Melco Resorts & Entertainment Ltd.

[3] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

[4] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

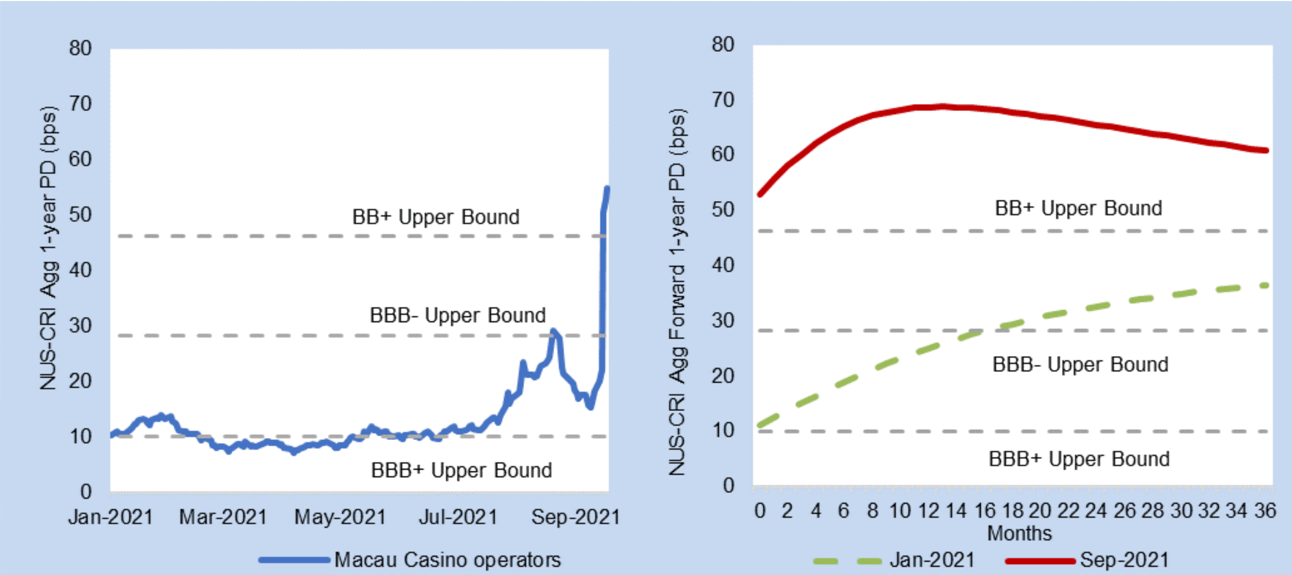

Figure 1a (LHS): NUS-CRI 1-year PD for Macau Casino operators from Jan-2021 to Sep-2021 with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Forward 1-year PD for Macau Casino operators in Jan-2021 and Sep-2021. *Source: NUS-CRI*

Currently, the proposed changes, which detail abolishing sub-concessions, have given no clarity about the number of licenses to be issued under the amended rules. As all the operators will be required to submit fresh bids after their licenses expire, the opacity around the number of licenses adds considerable uncertainty in the short term, as the possibility of losing gambling licenses threatens outlook. The regulatory review further pressurizes the credit profile of those casino operators with US parents - namely Sands China, Wynn Macau, and MGM China, as these entities pay out high dividends to their US parents. With the regulator's aim to reduce the outflow of capital to foreign shareholders, these operators may be in less favorable positions when bidding for the concessions, as shown by the increase in PD in Figure 2a. Furthermore, a special put option is present in the indentures of senior bonds currently outstanding. Under the option, the companies will be required to purchase bonds at par plus any accrued or unpaid interest if any changes in the gaming law substantially affect the operations of the company. As seen in Figure 2b, YTMs on casino operators' bonds increased due to the announcement. Additionally, some credit facilities of casino operators could be canceled as it contains a covenant regarding the execution of the put option. For example, Sands China has a covenant under their 2018 credit facility, which triggers repayment of all outstanding balances on the facility if the put option of the senior notes is exercised.

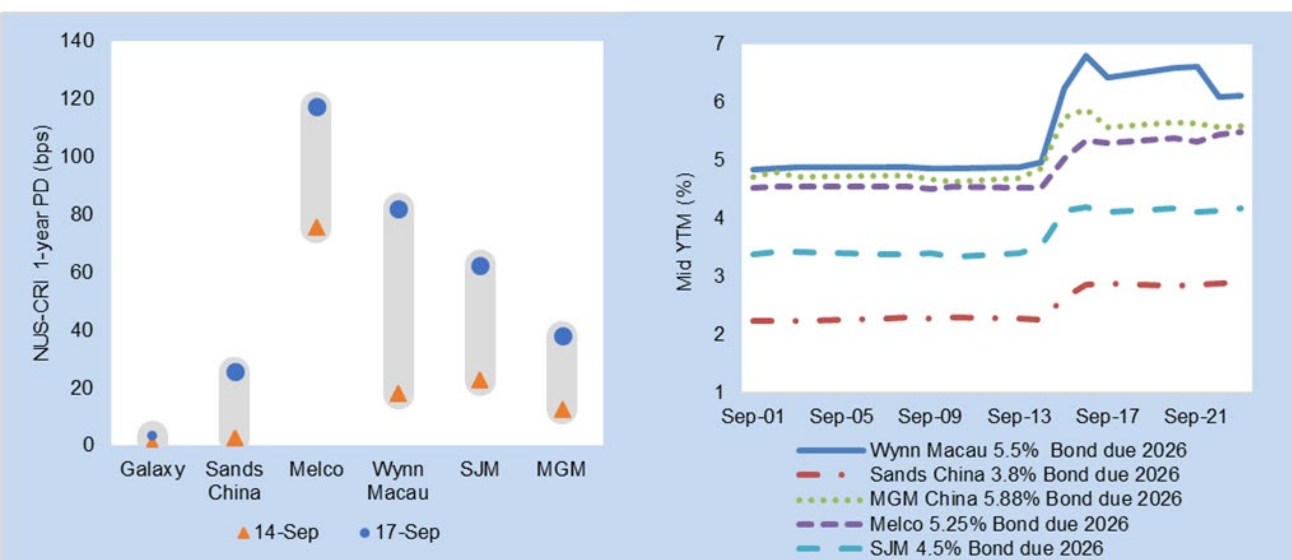

Figure 2a (LHS) : Change in PD of Macau casino operators from Sep 14 to Sep 17. Figure 2b (RHS): Comparison between Mid-Yield to Maturity (YTM) of select bonds of Macau casino operators. *Source: NUS-CRI, Bloomberg*

The regulatory review comes at a time when casino operators are struggling to recover from the impact of the pandemic, with gross gaming revenue[5] (GGR) down 80% from FY2019 (See Figure 3a). Visitors from Mainland China and Hong Kong are the main contributors to Macau's revenue, constituting 68% and 12% of total visitors in Q4 2019 respectively. Currently, only visitors from Mainland China are allowed to enter Macau, contributing to the slow pace of recovery.

The proposed changes also target capital brought in by patrons categorized in the “VIP segment”, putting further pressure on casino operators’ revenue-generating capabilities. This is especially so for Wynn Macau, Melco, and Galaxy as they continue to rely heavily on their VIP segment for generating revenues (See Figure 3b). The government has been progressively tightening regulations for the VIP segment as it tries to crack down on illicit capital inflows and money laundering thought to be facilitated by stakeholders related to this segment. Following suit, casino operators have also gradually tried to reduce revenue dependence on this segment over the past few years. The new amendments, which look to impose criminal penalties if cash deposits are taken for any purpose other than gambling, further complicate the recovery of this segment and raise questions about its sustainability in the future.

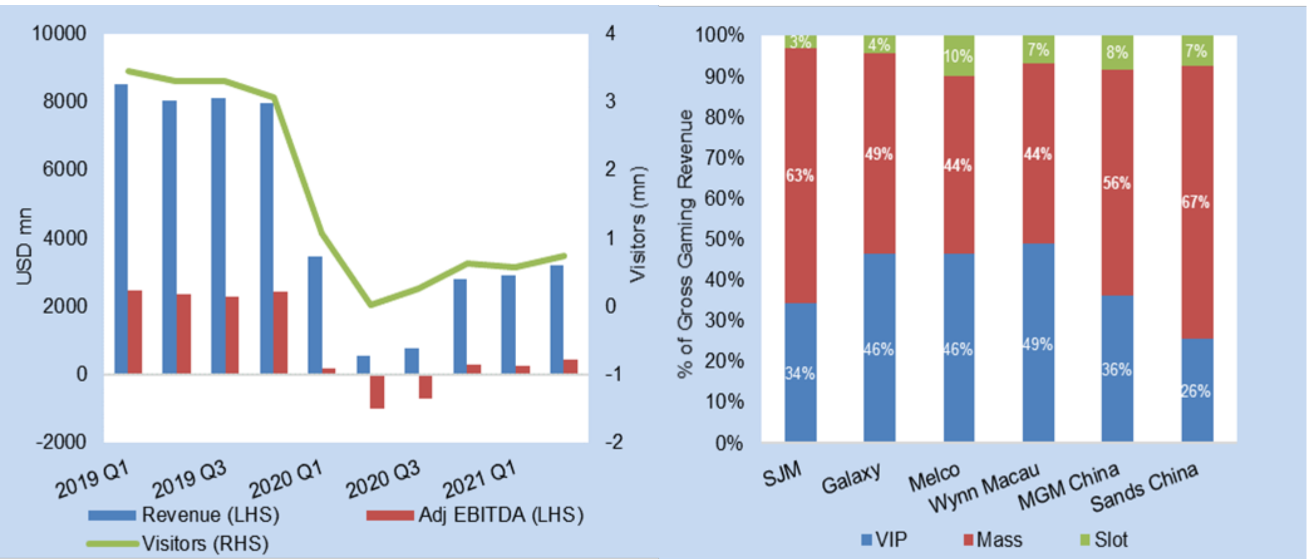

Figure 3a (LHS): Total Revenue and EBITDA (sum) of Macau Casino operators; Quarterly visitors (in mn) Figure 3b from 2019 Q1 to 2021 Q1(RHS): segment-wise breakup of gross gambling revenues of Macau casino operators as of FY2019. *Source: Bloomberg*

Depressed revenues coupled with high fixed costs such as rents, wages, and maintenance continue to impact the industry’s EBITDA margin. Anticipating a long-drawn recovery, casino operators took on significant leverage since Q2 2020 in an attempt to shore up their balance sheets to finance daily operations and to meet repayment obligations, causing their debt-to-capital ratios to reach 80.3% in Q2 2021 from 56% in Q2 2020. As a result, they are supported by strong liquidity stemming from available cash and revolving credit facilities. Among peers, Sands China has already announced a proposed refinancing of USD 1.8bn of its notes maturing in 2023, whereas, SJM’s new Grand Lisboa Palace resort is expected to drive its faster recovery, thus taking the pressure off their impending debt maturity. However, Wynn Macau faces higher risk driven by higher leverage with its debt-to-capital ratio currently at 118% and a difficult path to recovery, partially due to its higher exposure to the VIP segment. It is also vulnerable to changes in the license renewal process as its notes carry the special put option mentioned above. This could be why Wynn Macau’s bonds saw the highest jump in yield among the sector (See Figure 2b).

With the looming expiry of licenses, the casino operators will also have to give in to government pressures to expand their non-gambling business and increase corporate social responsibility commitments. With the operators currently struggling to turn cash flow positive, any initiatives to expand might have to be financed through debt. Companies have been investing heavily to build non-gaming segments to build their profiles before licenses expire in Jun 2022. Going forward, casino operators may need to focus on diversifying their revenue streams by overweighting mass-market and non-gaming segments in their revenue mix to protect themselves against regulatory headwinds faced in gaming operations.

[5] Gross Gambling revenue is the difference between amount wagered by players and amount won by players.It is a key metric used by casinos to gauge revenue/sales from gambling activities.

Credit News

Evergrande deadline sends chills through USD 400bn Asian debt market

Sep 23. Worries about Evergrande have sparked selling in the USD 428bn Asian debt market, illustrating how the property giant's crisis is impacting other assets Evergrande's future becomes more uncertain. An Evergrande offshore bond with an interest payment due on Thursday was trading at around $0.28 on the dollar, a sign of significant anxiety, as traders worried about the repercussions if the company started missing payments. However, the bond has a 30-day grace period for missed payments before considering it defaulted. Yields on US dollar-denominated bonds issued by riskier Asian borrowers rose to nearly 12% this week. If the USD 83.5mn interest payment is not made by Thursday, it would mark China's largest debt restructuring. After a tumultuous year that has already seen unprecedented limitations on the country's tech and education industries, Evergrande's liquidity crunch poses the newest regulatory danger for global investors in the world's largest developing market. Other developers with dollar debts also face refinancing fears. (FT)

Western investors bargain hunt in China bond rout

Sep 22. China Evergrande Group's recent crisis is hitting the offshore market of Chinese corporate bonds that totals around USD 750bn. Fears of Evergrande's default dragged down the bond prices of other Chinese property developers. The potential restructuring of Evergrande will close down the offshore market and leave other borrowers lacking access to foreign capital. For non-investment grade companies, they would face higher yield if prices continue to fall, adding pressure to their new refinancing endeavors. With its robust economy and relatively stable currency, China, on the other hand, has the option to dampen Evergrande's default. To counteract market turmoil, the People's Bank of China has been injecting liquidity into the banking system. Provincial authorities are also participating directly in Evergrande's restructuring process to reduce its political and economic consequences. (WSJ)

Bank of China, HSBC among first to trade on new bond link

Sep 24. The PBOC and Hong Kong Monetary Authority launched the new southbound Bond Connect scheme that allows Chinese investors to purchase debt overseas, potentially boosting the Chinese offshore bond market and bringing onshore and offshore yields closer. The launch came amidst Evergrande credit risk concerns, with the yield on Chinese junk bonds at the highest in a decade, while the yield on Chinese investment-grade bonds is at record lows. Major banks conducting trades in the new channel include HSBC, Bank of China, and Standard Chartered. Analysts expect that the southbound connect will grow into the primary channel for domestic banks and financial institutions to trade offshore bonds. (Bloomberg)

Venezuela debt swap breathes life into all-but-dead bond market

Sep 22. Venezuela's defaulted bond market is reviving, as investors believe that the government's decision to swap a share in a Caribbean refinery for payment of its debt might signal the start of more transactions. Although with small volumes as limited by US sanctions, the securities face strong demand when available in the market, mostly from risk-tolerant European funds. Over the past month, sovereign bonds have risen roughly 20%. The swap for the refinery is the first real sign that the Venezuelan government is prepared to start clipping away at the delinquent debts, which totals USD 80bn inclusive of interests. Moreover, the government and opposition representatives are negotiating with Mexico to end the years-long political stalemate, further boosting the prices. (Bloomberg)

Corporate-Buyout loans near highs of 2007

Sep 26. A slew of government policies, including easy money, low-interest rates, and a potential hike in capital gains tax, have driven a surge in leveraged buyout (LBO) deals. USD 120bn of leveraged loans have been issued to finance corporate buyouts year to date, the highest it has been since USD 124bn of loans were issued in the first nine months of 2007. The average LBO deal costs USD 2.5bn this year, surpassing the mean of USD 2bn in 2007. The LBO boom resembles the boom in the mid-2000s, with the difference being that the risk has now shifted to private equity firms specializing in credit instead of investment banks.

However, as purchase prices and debt burden rise, this fuels concerns that when economic growth slows, companies wouldn't be able to repay the debt used by private equity firms to acquire them. (WSJ)

Bond market gets reprieve from SEC rule that spooked traders (Bloomberg)

Investors see USD 20bn of high-grade bond supply on tap (Bloomberg)

Evergrande's EV unit admits there's no certainty it can pay debt (Bloomberg)

Regulatory Updates

Central banks turning slowly in ending pandemic's easy money era

Sep 26. Global monetary policy appears poised to remain ultra-easy into 2022 even as some central banks move closer to withdraw the emergency support. Facing potential stubborn inflation, the US Fed and Bank of England have indicated tightened policy. Norway has become the first developed economy to hike interest rates, likewise with borrowing costs in Brazil, Paraguay, Hungary, and Pakistan. There is also divergence, as the Bank of Japan showed no signs reducing stimulus and PBOC injected the most short-term liquidity in 8 months. While some central bankers in rich nations may plan to tighten their monetary policies and many emerging markets are already clamping down, ultra-loose monetary policy is expected to sustain globally for some time. (Bloomberg)

Turkey cuts interest rate to send lira tumbling as inflation soars

Sep 23. Despite inflation hitting 19.25% last month, the Turkish central bank unexpectedly lowered interest rates to 18%, causing the lira to fall to a record-low of TRY 8.80 against the USD. Sahap Kavcioglu, the central bank governor elected in March, had promised that he would keep rates above inflation levels so investors can benefit from lira-denominated assets, but has faced pressure from President Erdogan to reduce borrowing costs. Even though the Turkish USD 730bn economy expanded at the fastest rate in two decades this year, Erdogan aims to utilize rate cuts to drive growth and gain political capital. (FT)

Rishi Sunak set to tighten UK financial regulations after Greensill scandal (FT)

Taper warning signs flash to markets from India central bank (Bloomberg)

Published weekly by Credit Research Initiative – NUS | Disclaimer
Contributing Editors: Yao Xuan, Raghav Mathur