

SKYCITY

Stacked Hand; Upgrade to OUTPERFORM

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OUTPERFORM

We believe SKC now offers a favourable risk/reward proposition, following recent share price weakness, and upgrade our rating to OUTPERFORM. SKC's share price has fallen ~20% since the emergence of coronavirus (COVID-19), with the market cap decline equating to ~3x annual profit. While we see some risk to near-term domestic visitation, current valuation metrics more than compensate for this. SKC has an attractive asset base, defensive (primarily domestic exposed) earnings and offers a healthy cash dividend yield of c. 6%. There has been no shortage of challenges and earnings fade through history and valid questions remain about return on capital from major projects – however none of these are new issues. Valuation levels are attractive against peers, our valuation and the NZ market, while its land value and sustainable yield also provide downside protection.

NZX Code	SKC	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$3.21	NPAT* (NZ\$m)	173.0	122.5	124.4	143.5	EV/EBITDA	7.5	9.4	8.8	8.2
Target price	NZ\$3.80	EPS* (NZc)	25.6	18.2	18.1	20.6	EV/EBIT	10.2	13.8	13.2	12.2
Risk rating	Medium	EPS growth* (%)	0.9	-29.0	-0.3	13.3	PE	12.5	17.7	17.7	15.6
Issued shares	667.2m	DPS (NZc)	20.0	20.0	20.0	20.0	Price / NTA	6.1	13.3	14.3	14.8
Market cap	NZ\$2,142m	Imputation (%)	100	100	100	100	Cash div yld (%)	6.2	6.2	6.2	6.2
Avg daily turnover	696.6k (NZ\$2,669k)	*Based on normalised profits					Gross div yld (%)	8.7	8.7	8.7	8.7

Valuation and yield attraction

Following the material recent share price decline, we now see valuation attraction on both a fundamental and relative basis. SKC is trading at the lower of global gaming peers, NZ defensive stocks, below historic averages and at its widest discount to the NZ market in the past 15 years. It also now offers investors a cash yield of ~6.2%, attractive in today's low interest rate environment.

SKC is a defensive, grind business, with medium-term earnings upside (and an improved free cash flow profile) post the completion of its major projects. It is a 'sin' stock and we do see downside risk to FY20E, however we now believe valuation metrics more than compensate for this. At current pricing, investors are effectively getting its International Business (IB) segment and post-project earnings upside for free, in our opinion.

COVID-19 – fear vs reality

SKC's exposure to inbound tourists is moderate, predominantly through IB, although it has some exposure in hotels and a small exposure on the main gaming floor. While we acknowledge there is some risk to near-term domestic visitation, in addition to the impact on IB already flagged by SKC, the sharp correction in its share price this year appears dislocated from the risk.

Near-term downside risk to earnings, albeit medium-term upside

A myriad of complexity (including asset sales, project accounting, NZICC fire, construction disruption) has overshadowed recent results. Stepping back from this there are a number of topical areas in the short to medium-term, presenting net downside risk to near-term earnings, albeit upside risk in the medium-term.

SKYCITY Entertainment Group Ltd (SKC)

Priced as at 05 Mar 2020 (NZ\$)						3.21						
12-month target price (NZ\$)*						3.80	Spot valuations (NZ\$)					
Expected share price return						18.4%	1. DCF					3.58
Net dividend yield						6.2%	2. Sum of the parts (current)					3.54
Estimated 12-month return						24.6%	3. Sum of the parts (w project upside)					4.08
Key WACC assumptions						DCF valuation summary (NZ\$m)						
Risk free rate						2.00%	Total firm value					2,825
Equity beta						0.99	(Net debt)/cash					(368)
WACC						8.1%	Less: Capitalised operating leases					0
Terminal growth						1.5%	Value of equity					2,457
Profit and Loss Account (NZ\$m)						Valuation Ratios						
Sales revenue	2018A	2019A	2020E	2021E	2022E	2018A	2019A	2020E	2021E	2022E		
Normalised EBITDA	998.6	1,011.6	864.9	946.1	1,003.2	EV/EBITDA (x)	7.4	7.5	9.4	8.8	8.2	
Depreciation and amortisation	(94.4)	(89.9)	(91.4)	(105.7)	(113.2)	EV/EBIT (x)	10.3	10.2	13.8	13.2	12.2	
Normalised EBIT	243.8	252.8	196.4	213.0	230.5	PE (x)	12.6	12.5	17.7	17.7	15.6	
Net interest	(12.5)	(10.2)	(23.9)	(40.3)	(31.1)	Price/NTA (x)	6.6	6.1	13.3	14.3	14.8	
Associate income	0	0	0	0	0	Free cash flow yield (%)	-0.3	-4.9	-8.2	3.1	2.5	
Tax	(61.5)	(69.6)	(50.0)	(48.4)	(55.8)	Net dividend yield (%)	6.2	6.2	6.2	6.2	6.2	
Minority interests	0	0	0	0	0	Gross dividend yield (%)	8.7	8.7	8.7	8.7	8.7	
Normalised NPAT	169.8	173.0	122.5	124.4	143.5	Capital Structure						
Abnormals/other	(0.3)	(28.4)	253.1	0	0	Interest cover EBIT (x)	19.5	24.8	8.2	5.3	7.4	
Reported NPAT	169.5	144.6	375.5	124.4	143.5	Interest cover EBITDA (x)	27.1	33.6	12.1	7.9	11.0	
Normalised EPS (cps)	25.4	25.6	18.2	18.1	20.6	Net debt/ND+E (%)	27.2	30.3	42.6	45.6	48.7	
DPS (cps)	20.0	20.0	20.0	20.0	20.0	Net debt/EBITDA (x)	1.3	1.5	2.4	2.4	2.5	
Growth Rates						Key Ratios						
Revenue (%)	2018A	2019A	2020A	2021A	2022A	2018A	2019A	2020E	2021E	2022E		
EBITDA (%)	6.9	1.3	-14.5	9.4	6.0	Return on assets (%)	9.6	9.9	7.8	8.3	9.2	
EBIT (%)	5.6	1.3	-16.0	10.8	7.8	Return on equity (%)	14.7	15.0	12.9	13.5	15.8	
Normalised NPAT (%)	8.2	3.7	-22.3	8.5	8.2	Return on funds employed (%)	11.9	11.1	8.4	9.2	9.6	
Normalised EPS (%)	10.5	1.9	-29.2	1.6	15.4	EBITDA margin (%)	33.9	33.9	33.3	33.7	34.3	
Ordinary DPS (%)	8.5	0.9	-29.0	-0.3	13.3	EBIT margin (%)	24.4	25.0	22.7	22.5	23.0	
Cash Flow (NZ\$m)						Operating Performance						
EBITDA	2018A	2019A	2020E	2021E	2022E	2018A	2019A	2020E	2021E	2022E		
Working capital change	338.2	342.7	287.8	318.8	343.7	Total revenue (incl gaming GST)	2018A	2019A	2020E	2021E	2022E	
Interest & tax paid	72.8	19.1	(5.3)	2.7	2.0	Auckland	584.60	606.60	596.31	624.14	653.10	
Other	(157.4)	(147.2)	(95.9)	(98.6)	(109.0)	Hamilton	60.70	61.80	66.04	67.69	69.39	
Operating cash flow	253.6	214.5	186.5	222.9	236.7	Other NZ	13.00	13.20	14.15	14.43	14.72	
Capital expenditure	(261.0)	(320.1)	(361.5)	(156.0)	(183.0)	Adelaide (A\$)	149.00	148.70	148.53	165.24	186.00	
(Acquisitions)/divestments	(47.3)	224.9	129.0	0	0	Darwin (A\$)	110.80	83.30	0	0	0	
Other	0	0	0	0	0	IB	160.30	190.50	121.50	163.08	169.08	
Funding available/(required)	(54.7)	119.3	(46.0)	66.9	53.7	Revenue (incl gaming GST)	1,101.02	1,118.96	953.62	1,042.91	1,103.92	
Dividends paid	(85.1)	(127.1)	(134.7)	(137.2)	(139.7)	EBITDA breakdown						
Equity raised/(returned)	0	(37.3)	(20.0)	0	0	Auckland	260.70	267.90	261.25	271.51	289.61	
(Increase)/decrease in net debt	(139.8)	(45.0)	(200.7)	(70.3)	(86.0)	Hamilton	26.90	26.90	28.52	29.24	29.97	
Balance Sheet (NZ\$m)						Other NZ	2.10	2.30	2.65	2.70	2.76	
Working capital	2018A	2019A	2020E	2021E	2022E	Adelaide (A\$)	22.50	21.00	22.74	28.28	35.75	
Fixed assets	(161.7)	(172.4)	(167.0)	(169.8)	(171.8)	Darwin (A\$)	25.10	19.00	0	0	0	
Intangibles	1,498.6	1,436.3	1,541.5	1,606.3	1,542.1	IB	32.60	41.70	15.52	31.69	33.25	
Right of use asset	831.8	798.4	784.5	769.9	754.6	Corporate costs	(33.00)	(34.70)	(38.00)	(39.90)	(41.90)	
Other assets	0	0	0	0	0	Other	(2.84)	(3.96)	(6.00)	(6.18)	(8.00)	
Total funds employed	107.2	220.0	115.1	115.1	115.1	Total EBITDA	338.2	342.7	287.8	318.8	343.7	
Net debt/(cash)	2,275.9	2,282.3	2,274.0	2,321.5	2,239.9	NZDAUD	0.92	0.94	0.95	0.95	0.94	
Lease liability	433.0	504.3	704.9	775.2	861.2	Capitalised interest	22.90	30.32	22.03	10.00	22.00	
Other liabilities	0	0	0	0	0							
Shareholder's funds	684.8	622.0	621.8	621.8	472.4							
Minority interests	1,158.0	1,156.0	947.2	924.4	906.3							
Total funding sources	0	0	0	0	0							

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

Value Attraction; Upgrade to OUTPERFORM

We upgrade our rating on SKC to OUTPERFORM, with a 12m target price of NZ\$3.80 (prior NZ\$3.70).

SKC's share price has declined ~21% over the past month and ~16% over the last 12m, underperforming peers and the NZ market – we now see valuation attraction, with current levels offering a favourable risk/reward.

SKC has an attractive asset base (long dated, quasi monopolistic licenses), defensive (primarily domestic exposed) earnings and offers an attractive yield. There has been no shortage of challenges and disappointments through history, and valid questions remain about return on capital from major projects – however, none of these are new issues. The company has been transparent in priority areas and is delivering to plan, however, cost inflation, a slowing / volatile macro backdrop and various disruption has constrained any upside. The myriad of complexity in recent results, and recent weakness in IB / VIP, has likely overshadowed robust underlying trends for the core value driver, Auckland (pre fire gaming growth of +6%). While it is unlikely to be smooth sailing, we believe valuation metrics more than compensate for the risks. The company's land value and dividend yield also provide downside protection.

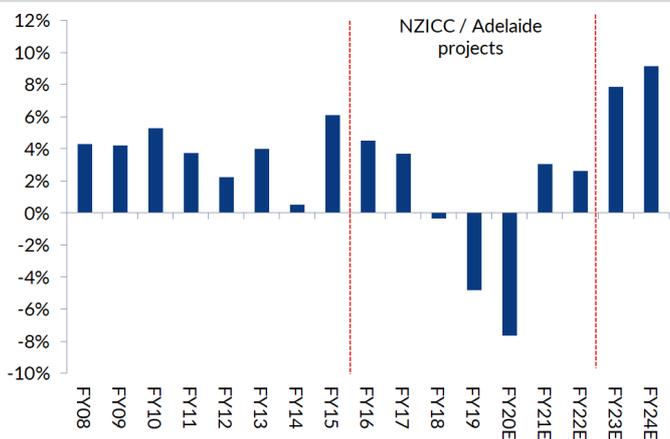
Coronavirus (COVID-19) – fear vs reality?

There is no escaping COVID-19 in daily media currently and accordingly we acknowledge there is some risk to domestic visitation in addition to the impact on IB already flagged. Media / sentiment tends to overreact to risk and the market appears no different. SKC's share price is down -21% since our first research commentary on COVID-19 with the market cap decline implying ~3 years of profit. Looking at this differently we assess the market is currently implying no value for its IB segment into perpetuity, no upside from capital projects and a >-5% hit to domestic earnings in perpetuity. Reality in our view will be considerably different. We expect any impact would be short-term in nature and thereby shouldn't be capitalised in a valuation. It is likely too early to draw firm conclusions but we have moderated our FY20 expectations slightly to account for weaker visitation and a more conservative view on IB (FY20 EBITDA revised -3% to NZ\$288m).

Three key issues explored in this report

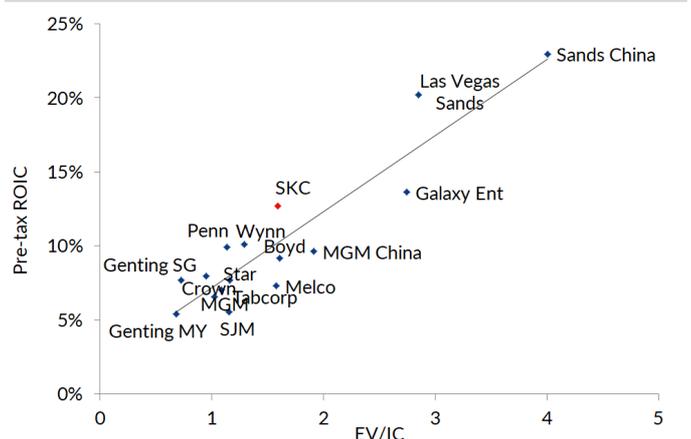
- Valuation attraction:** Recent share price weakness means SKC is now trading at attractive levels (~NZ\$3.20 implies an EV/EBITDA ~8.7x) relative to a number of benchmarks including peers, history, the NZ market and our valuation. It is also now trading below land value and only modestly above the multiple SKC received for its underperforming Darwin casino (EV/EBITDA of 8x).
- Healthy dividend yield:** SKC has committed to a minimum 20cps dividend, offering a cash yield of 6.2%, attractive in today's low interest rate environment. We believe this is sustainable, with upside risk post its major projects given the anticipated earnings lift and balance sheet headroom, although we expect at least some of this will likely be invested in other new projects.
- No shortage of complexity; issues broadly balanced between positive/negative:** We see upside risk from its Adelaide project in the medium-term (beating a low base of expectations), any move to regulate the online market, Adelaide regulatory change and the Auckland Level 8/9 capital project (which will enable more machines back on the floor). Key downside risk areas are: temporarily lower domestic visitation from COVID-19, Adelaide in the near-term (disruption, higher opex leading up to opening and initial lack of carparking), Auckland rebuild disruption and pressure in hotels.

Figure 1. Free cash flow yield (assumes no new major projects)



Source: Forsyth Barr analysis, Company reports

Figure 2. Return profile versus EV/IC



Source: Forsyth Barr analysis, Bloomberg

(1) Valuation attraction

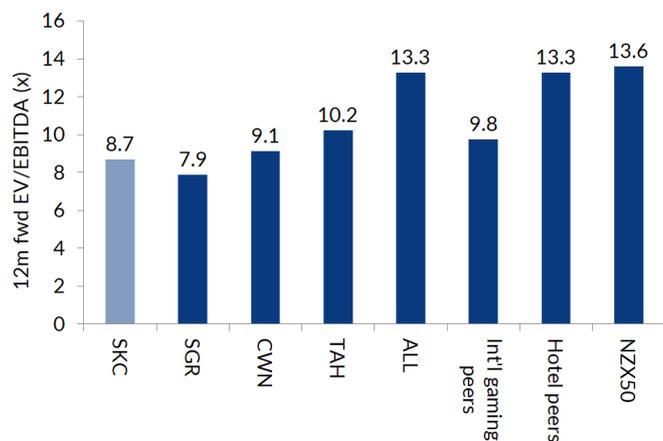
SKC is trading at ~NZ\$3.20, implying a market cap of NZ\$2.1bn and EV/EBITDA of 8.7x – attractive against a number of benchmarks including:

- **Fundamental value:** Our spot DCF valuation is NZ\$3.58.
- **Peers:** SKC is trading at the lower end of gaming peers and NZ defensive stocks, below the historic average, and well below the NZX50.
- **NZ market:** Regardless of the time horizon (1m, 1yr, 5yr, 10yr) SKC has underperformed the NZX50. Current multiples offer relative value with SKC trading at its widest discount to the NZ market in the past 15 years.
- **Land value:** SKC is now trading below land value. The company has an asset base of ~NZ\$2.2bn in market value.
- **Sum-of-the-parts:** Following recently improved disclosure from SKC (on hotels), our revised sum-of-the-parts is NZ\$3.54, or NZ \$4.08 including risk-adjusted, time-weighted upside from its major projects (Auckland hotel and Adelaide).
- **Recent divestment multiple for Darwin:** SKC recently divested its underperforming Darwin casino for 8x pro-forma FY19 EBITDA.

Since COVID-19 was first discussed, SKC's share price has materially fallen – out of step with valuation risk in our view. SKC has also underperformed its Australian casino peers despite lower tourist exposure.

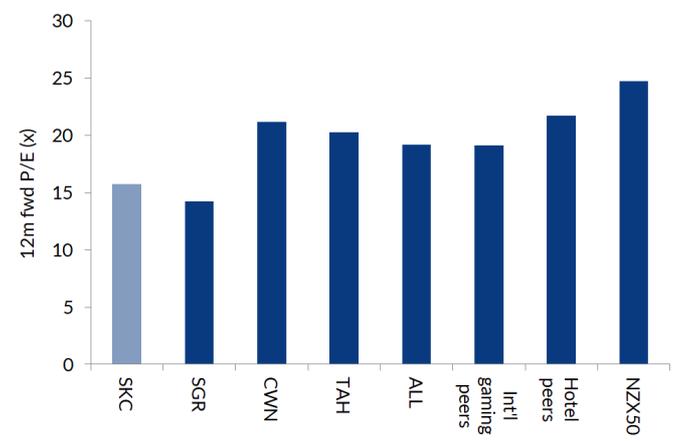
Valuation vs comparatives in pictures

Figure 3. SKC EV/EBITDA vs gaming and hotel peers



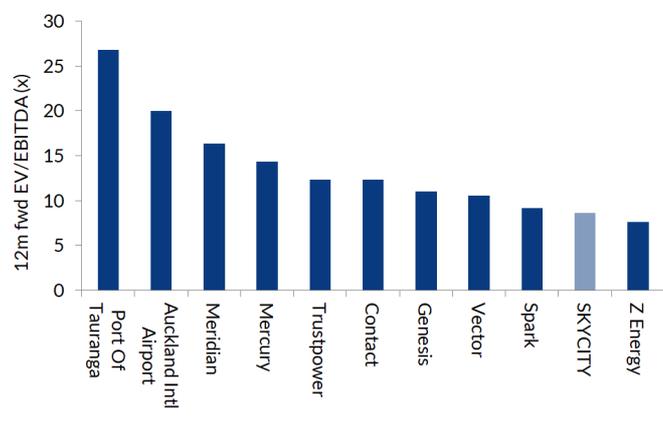
Source: Forsyth Barr analysis, Bloomberg

Figure 4. SKC P/E vs gaming and hotel peers



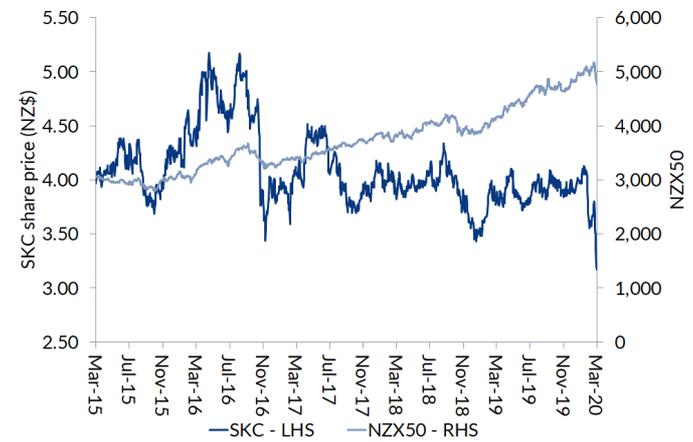
Source: Forsyth Barr analysis, Bloomberg

Figure 5. SKC EV/EBITDA vs defensive peers



Source: Forsyth Barr analysis, Bloomberg

Figure 6. SKC share price vs NZX50



Source: Forsyth Barr analysis, Bloomberg

Breaking down sum-of-the-parts

Recently improved disclosure from SKC on its hotel business allows us to better assess value. Our revised sum-of-the-parts approach breaks EBITDA out by asset class, in addition to geography. We derive a sum-of-the-parts valuation of NZ\$3.54, which is lifted to NZ\$4.08 to include the present value of project upside (risk-adjusted).

Domestic gaming is the key value driver, making up 75–80% of EBITDA and EV, driven by the key Auckland casino. Hotels make up ~11% of our valuation albeit set to lift to ~17% as new hotels are completed, helped by global hotel peers trading at a materially higher multiple vs gaming companies. While IB can drive significant earnings volatility, it represents a small portion of our assessed value reflecting a material discount applied to peer multiples (to factor in the volatility) and not helped by FY20 earnings under pressure from coronavirus (FY20E EBITDA of NZ\$16m is at five year lows and well below the 5yr average of c. NZ\$32m).

Figure 7. Updated sum-of-the-parts valuation

NZ\$m	FY20E EBITDA	Discount applied to compcos	EV/EBITDA used	EV
AKL - gaming	215.4	0%	9.5x	2,046
Adelaide - gaming	22.9	-10%	8.6x	196
Hamilton - gaming	27.2	0%	9.5x	258
Queenstown - total	2.7	-25%	7.1x	19
Hotels	28.5	-10%	11.7x	335
IB	15.5	-40%	5.7x	88
Non-gaming	19.8	-15%	11.1x	219
Corporate	-44.0		9.8x	-432
TOTAL	287.8			2,729
Debt				-368
Equity value				2,361
Shares				667
Per share (NZ\$)				3.54

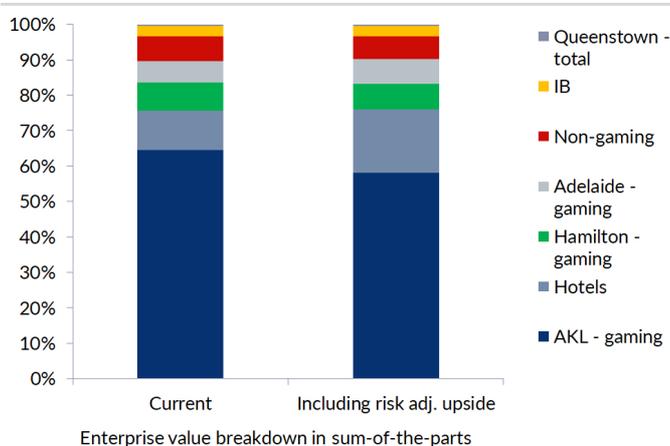
Source: Forsyth Barr analysis

Figure 8. Upside quantified

	EBITDA	EV/EBITDA	EV	Yrs to discount	Risk adjustment	Present value of EV (risk adj.)
AKL - Horizon Hotel	20.0	11.7x	234.9	4	0%	172.0
Adelaide project						
Hotel	10.0	11.7x	117.5	3	0%	93.0
Domestic Gaming	15.0	8.5x	127.1	3	-25%	75.5
IB	7.5	5.6x	42.4	3	-50%	16.8
Total						357.3
Per share						0.54

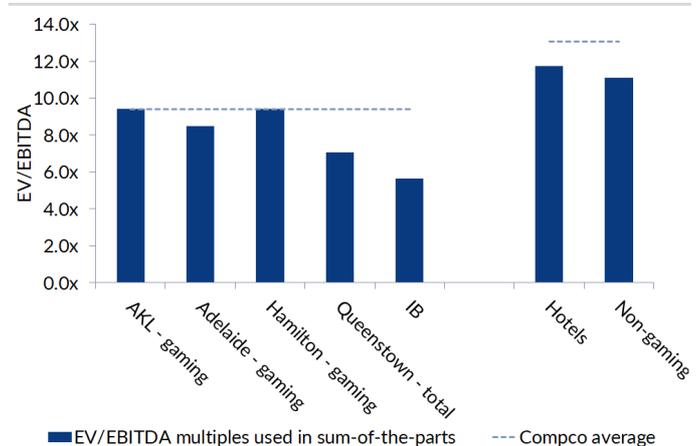
Source: Forsyth Barr analysis

Figure 9. EV breakdown in sum-of-the-parts



Source: Forsyth Barr analysis

Figure 10. EV/EBITDA multiples by segment



Source: Forsyth Barr analysis

Global comparative companies
Figure 11. SKC compcos - global gaming peers, NZ market and hotel peers

	Market cap	12m forward	12m fwd (at 31 Dec 19)	12m forward	Cash	Net debt
	US\$bn	EV/EBITDA	EV/EBITDA	PE	Yield	to EBITDA
SKC	2.1	8.7x	10.0x	17.8x	6.2%	1.1x
<u>Aus casinos</u>						
Star	3.4	7.8x	9.1x	14.2x	5.5%	3.0x
Crown	6.7	9.1x	10.3x	20.4x	6.0%	0.3x
Average		8.5x	9.7x	17.3x	5.8%	1.6x
Median		8.5x	9.7x	17.3x	5.8%	1.6x
<u>Casinos - Asia</u>						
Genting Malaysia	15.4	7.0x	7.9x	14.1x	5.5%	1.4x
Genting Singapore	9.7	5.9x	6.4x	18.0x	5.0%	-3.1x
Wynn Macau	79.7	12.2x	12.0x	19.2x	6.5%	2.3x
Sands China	283.9	12.3x	13.6x	17.8x	5.7%	1.1x
SJM Holdings	49.8	12.2x	11.2x	22.9x	3.4%	-0.1x
Galaxy Entertainment	220.4	13.5x	13.4x	20.6x	1.6%	-1.1x
MGM China	38.3	9.9x	9.6x	26.7x	2.4%	2.9x
Melco Resorts	8.5	9.0x	9.5x	27.5x	3.7%	2.4x
NagaCorp	47.8	8.0x	9.9x	10.4x	5.7%	0.3x
<u>Casinos - North America</u>						
Las Vegas Sands	42.7	10.7x	12.3x	17.8x	5.7%	1.7x
Wynn Resorts	11.0	11.0x	n/a	32.1x	4.1%	5.3x
MGM Resorts	11.5	8.2x	9.3x	25.3x	2.5%	2.5x
Penn National	3.0	5.5x	5.4x	11.1x	n/a	8.0x
Boyd Gaming	2.8	6.7x	7.4x	12.0x	1.1%	4.9x
Global casino - average		9.3x	9.8x	19.4x	4.3%	2.0x
Global casino - median		9.1x	9.6x	18.6x	5.0%	2.0x
NZ market		13.6x	13.9x	25.4x	3.3%	
<u>Hotels</u>						
Accor	9.0	11.8x	13.8x	20.7x	3.3%	1.3x
InterContinental Hotels	7.8	12.6x	14.9x	17.3x	2.4%	3.5x
Hilton Worldwide	25.9	13.7x	16.0x	21.4x	0.7%	4.1x
Marriott International	37.1	12.9x	15.9x	17.7x	1.7%	4.8x
Hyatt Hotels	7.6	10.9x	12.9x	48.7x	1.1%	1.5x
Shangri-La Asia	25.4	17.3x	16.0x	31.4x	2.4%	9.5x
New World Development	101.5	17.1x	17.7x	11.6x	5.2%	6.3x
Choice Hotels	5.1	15.3x	17.1x	21.0x	1.0%	2.3x
Wyndham	3.5	5.9x	7.0x	6.3x	4.7%	3.2x
Average		13.1x	14.6x	21.8x	2.5%	4.1x
Median		12.9x	15.9x	20.7x	2.4%	3.5x

Source: Forsyth Barr analysis, Bloomberg

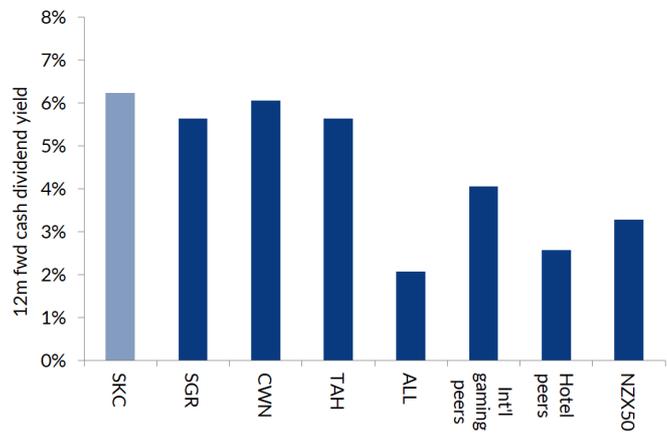
(2) Attractive yield – 20cps committed with medium-term upside

SKC has been clear on its commitment to its dividend policy – 80% payout ratio subject to a minimum of 20cps. We forecast dividends of 20cps over the medium-term, with risks skewed to the upside as earnings come through from its major capital projects. SKC dividends are fully imputed, offering a gross yield of 8.7% and cash yield of 6.2%. This is attractive in the current low interest rate environment and against other NZ defensive stocks and gaming peers.

SKC yield versus peers

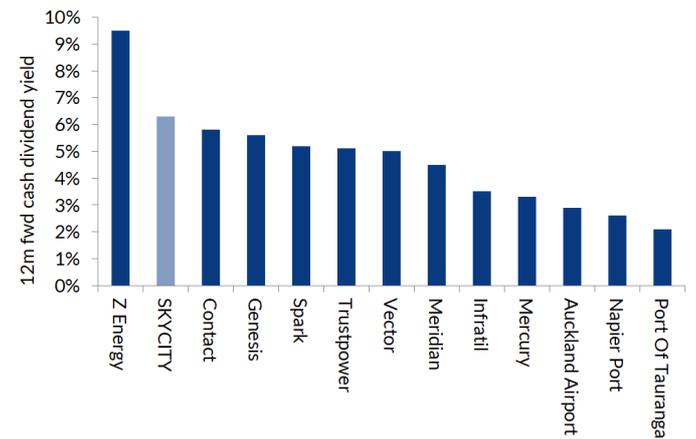
SKC offers an attractive cash yield vs gaming peers, the NZ market and more specifically its defensive peers (acknowledging a different risk profile) – refer Figure 12 and 13.

Figure 12. Cash yield – SKC vs gaming sector peers



Source: Forsyth Barr analysis, Bloomberg

Figure 13. Cash yield – SKC vs NZ defensive stocks

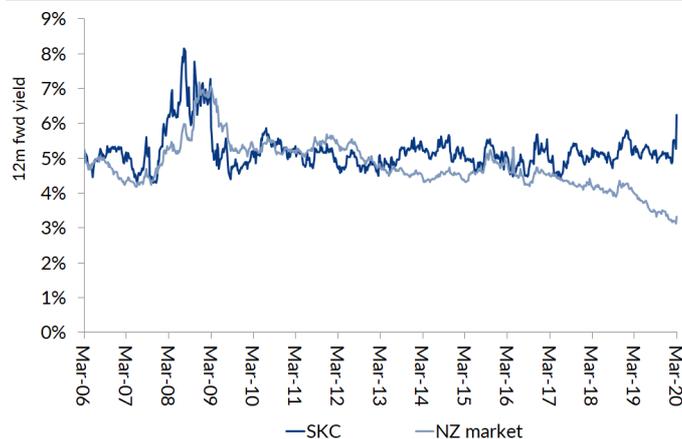


Source: Forsyth Barr analysis, Bloomberg

Balance sheet capacity post major projects

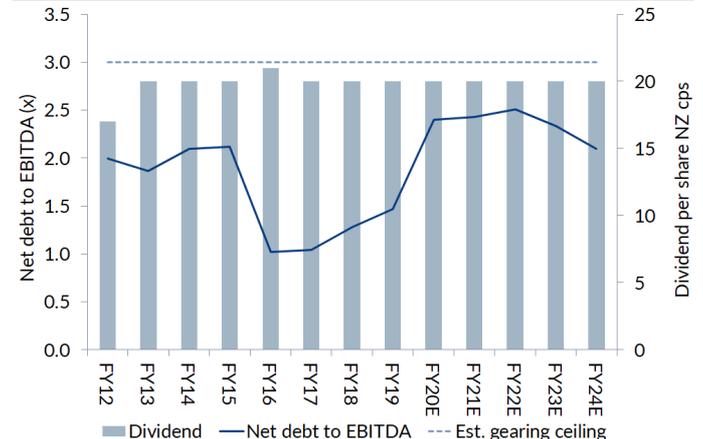
Gearing is expected to peak in FY21/FY22 (somewhat dependent on re-build timeline for NZICC). Casinos are cash-generative businesses and thereafter we see ample balance sheet capacity which provides options. This, combined with the earnings uplift anticipated from major projects, provides upside risk to yield expectations. The casino sector has a tendency to find new 'growth' projects, with a continual desire to diversify and refresh its offering to retain relevance / visitation in what is a fairly mature industry. Accordingly we expect at least some of the capacity will be invested in other projects.

Figure 14. SKC vs NZ market



Source: Forsyth Barr analysis, Bloomberg

Figure 15. Gearing and dividend payments



Source: Forsyth Barr analysis, Company reports

(3) No shortage of complexity – issues broadly evenly skewed

Recent results have been complex and there remain a number of issues for investors – all of which mask underlying trends. We currently see the range of key issues broadly balanced between positive/negative.

- **Upside risk:** Adelaide project upside in the medium-term (beating a low base of expectations), any move to regulate the online gaming market in NZ, Adelaide regulatory change and the Auckland Level 8/9 capital project (which will enable more machines back on the floor).
- **Downside risk:** domestic casino visitation weakness from coronavirus, near-term disruption and initial lack of carparking in Adelaide on new project opening, Auckland NZICC rebuild disruption, and pressure in hotels.

Accounting complexity – cash is king

SKC's 1H20 result had no shortage of complexity, with multiple adjustments for asset divestments and accounting implications from the NZICC fire. This is unlikely to change near-term. Forecasting NPAT over FY21–22E is difficult, not helped by uncertainty on revised completion timing for the NZICC and Horizon Hotel. We expect the first clean year (i.e. first period post its major capital project completion and the associated material step up in depreciation and net interest) for SKC's P&L to now be FY23E.

In the interim we view EBITDA and cashflow as preferred metrics to monitor, with the majority of complexity unlikely to have cash (or valuation) implications.

Major projects

The time for debating the merits or otherwise of SKC's two major capital projects is past. The key near-term focus and most material from an earnings perspective is Adelaide.

Adelaide on track to open October 2020

Adelaide is on track to open October 2020; to schedule and budget. It is well known that the Adelaide Casino is under-penetrated in terms of EGM win per unit and market share vs. peers (Figures 17 and 18) due to historical disadvantages – with steps being made to reduce this gap. SKC has been transparent in its expectations for EBITDA post the project, targeting an uplift of c. NZ\$30–35m initially (c. 2 years), including NZ\$10m from the hotel, NZ\$5–10m from IB and NZ\$15m from local gaming, with more ambitious targets thereafter.

Our medium-term forecasts factor in EBITDA upside of ~NZ\$25m from Adelaide (a sub-WACC return), with upside risk if SKC's targets become reality. We expect market expectations are also conservative given a broadly sceptical consensus view on SKC's ability to deliver value accretion from the project. The project is in its most disruptive phase over the next 6 months and there is risk of higher cost investment upfront given SKC's desire to hit the ground running on day one. The lack of carparking for the first ~6m post opening will also add some constraint to the immediate upside.

Auckland – timing up in the air still, earnings uplift unlikely until FY22/23

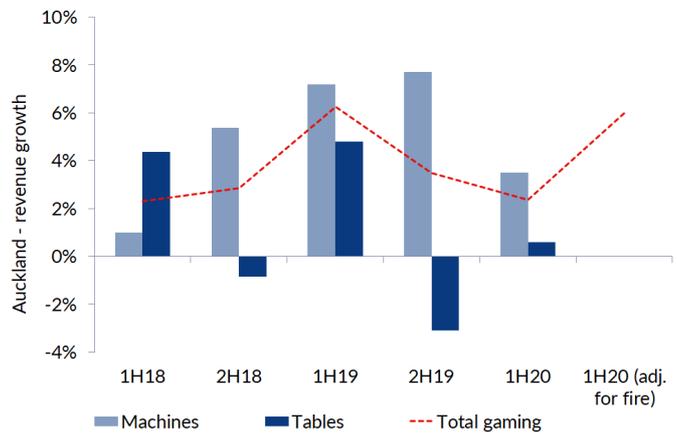
The fire at the NZICC site on 22 October 2019 has been, and will likely continue to be, disruptive for Auckland. The key remaining earnings contributors for SKC from the project are (1) hotel earnings, (2) anticipated uplift in visitation to its precinct with ~1m incremental visits estimated vs current visitation of ~6m per annum. The NZICC itself is not expected to make any material earnings contribution. A revised completion timeline has yet to be provided – we have assumed 30 June 2021 for the hotel and 30 June 2022 for the NZICC. There is likely to be at least some disruption during the re-build and risk of additional costs to open the hotel earlier than the NZICC (although we expect at least some will be covered by insurance).

Other gaming areas of note

- **Recent gaming trends:** Growth has been particularly encouraging in high margin products (EGMs and ATGs), despite challenges, disruption and less parking availability (Figure 16). A +/- 1% change in gaming growth forecasts impacts group EBITDA by c. +/-2% given modest operating leverage.

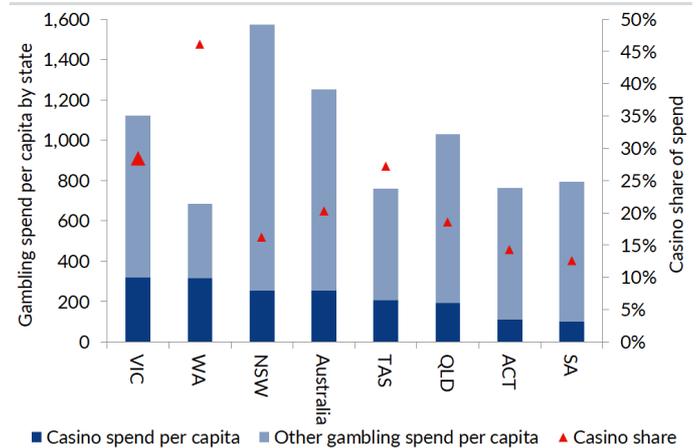
- **Cost creep:** SKC has been lifting investment in regulatory costs and harm minimisation including supporting technology such as facial recognition. We expect investment in this area to continue to increase. Wage inflation will also remain an area of pressure.
- **Auckland Level 8/9:** An upgrade is underway, due to be completed in the short-term. While this improves the customer experience, most importantly it should lift capacity and support gaming growth. With an estimated ~130 machines to re-introduce to the floor in areas which typically deliver higher revenue per machine, we estimate this offers EBITDA upside of c. +2% (acknowledging some cannibalisation).
- **Adelaide regulatory review:** This has been a slow process but any change provides upside risk. SKC has flagged potential for note acceptors on EGMs across Adelaide by the end of FY20, following the completion of a regulatory review bill under consideration by SA Parliament and there is also potential for TiTo to be introduced. Distant precedent has suggested upside of c. +10% for EGMs from note acceptors, or c. +1% upside to group EBITDA.

Figure 16. Auckland gaming growth in recent results



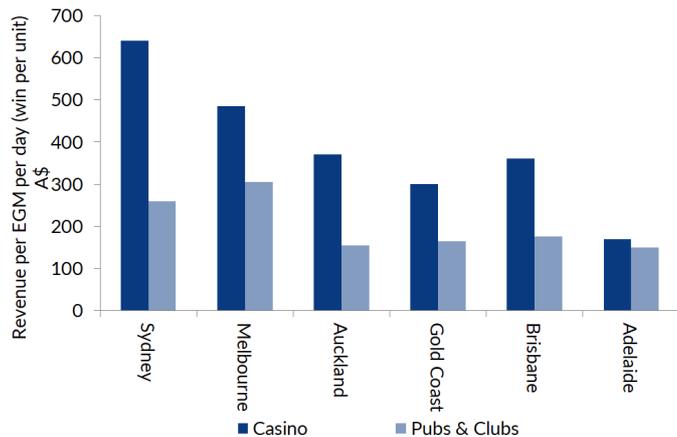
Source: Forsyth Barr analysis, Company reports

Figure 17. Australian gambling spend per capita by state



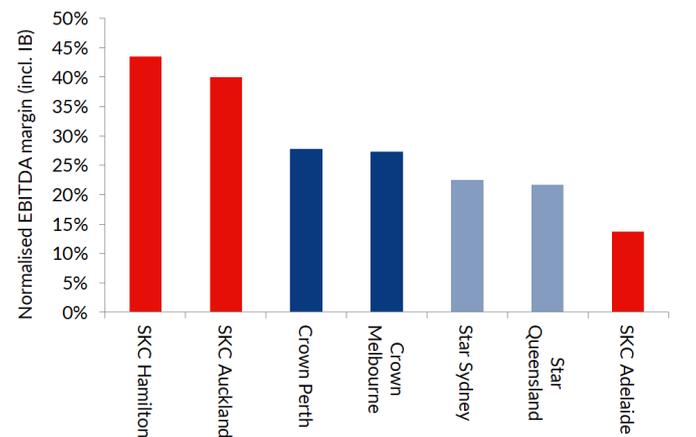
Source: Forsyth Barr analysis, various gaming data and company disclosure

Figure 18. EGM win per unit for key Australasian markets



Source: Forsyth Barr analysis, various gaming data and company disclosure

Figure 19. Normalised EBITDA margins – Australasian casinos



Source: Forsyth Barr analysis, Company reports

Land optionality

SKC has a material land base surrounding its key precincts, offering ample optionality particularly for further accommodation, hospitality and general entertainment. This includes:

1. Auckland: ~2,500sqm of land is available for development around Victoria/Federal St. Given the scale, this would require development partner(s), with the key area of upside for SKC being increased visitation to the precinct.
2. Hamilton: potential for a hotel on the carpark site neighbouring the casino. Capital commitment is likely moderate although reliant on casino licence extension and ideally successful product mix change (currently under review to substitute 3 tables for 60 EGMs).
3. Queenstown: 1ha of lakefront property. Any development is reliant on regulatory change (casino licence extension and relocation) and a healthier VIP market.

Online – can it move the dial?

Yes – we believe online can move the dial, if regulation is addressed in NZ. There is a wide range of potential outcomes, however our scenario suggests EBITDA risk from online gaming for SKC of 0% to +10%. Using an array of assumptions, should NZ regulate (and SKC get a licence) we estimate EBITDA upside of +10% is feasible.

Already readily available in NZ

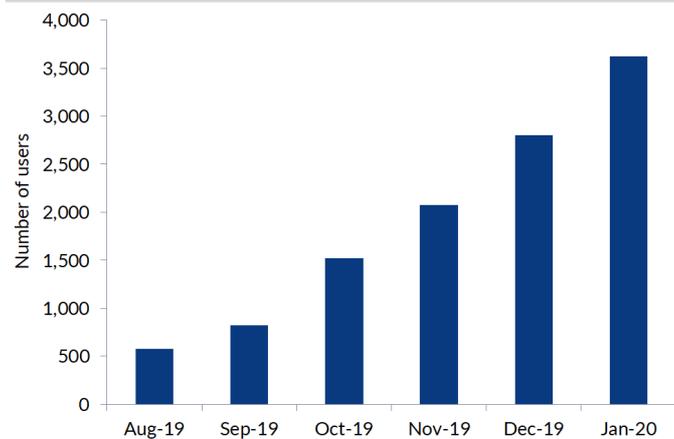
Current legislation allows for offshore operators to address the NZ online gaming market, but not local operators. There is no doubt online casino platforms are already easily accessible (evidenced by a quick Google search). SKC launched its own site via a Malta-based subsidiary in August 2019. This market is currently unregulated which in most instances means (1) limited / no host responsibility mechanisms, (2) no tax / levies returned to the community and government, (3) limited prevention for under-age and problem gamblers, (4) limited recourse to protect players.

Our previous estimates (based on other markets) have suggested a market size of c.NZ\$200m, although recent updates and market anecdotes suggest it is likely materially higher than this (wide range of suggestions from NZ\$250-600m vs land-based casino market revenue of ~NZ\$600m).

Key features of online gambling

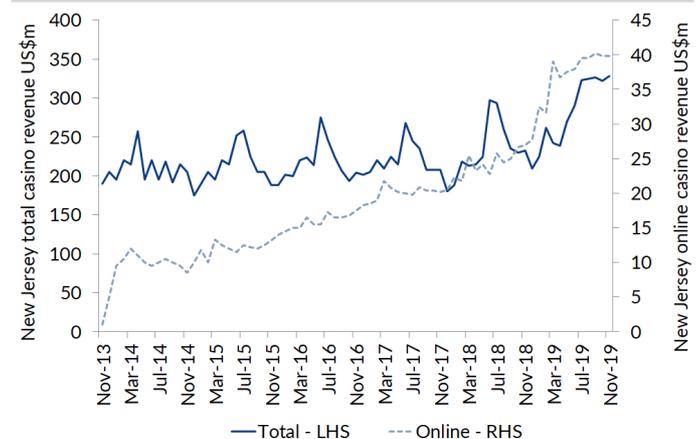
- **Fast growing channel:** Data from permissible domestic online gambling formats in Australasia (Lotto, TAB) and offshore data shows strong growth, outpacing land-based offers. The global online gambling market is forecast to grow at +9.7% CAGR (2018-2023).
- **Attractive attributes:** The online channel has a number of attractions, including (1) data rich – showing spending patterns/habits, player dynamics and how this is evolving (2) well supported by younger demographics – studies show online gamblers are more likely to be male and younger versus their land-based gambling counterparts.

Figure 20. Appetite there, with registrations for SKC's site despite highly conservative (self-imposed) approach to market



Source: Forsyth Barr analysis, Company reports

Figure 21. New Jersey example – no obvious cannibalisation, with land-based growth CAGR of +8% post online regulation



Source: Forsyth Barr analysis, Play NJ.com, SKC

Regulatory change seems likely, at some point

Regulation of online gambling is a growing trend globally, particularly in developed economies. The NZ government (via the DIA) launched a public discussion document 'Online Gambling in NZ' in 2019. Public commentary from Minister, Tracey Martin, appears to support regulation (online gambling "could be far more dangerous to New Zealanders than [gaming machines] have ever been because it is unregulated") and the submission from the Problem Gambling Foundation also agrees change is required.

Pre-empting regulatory policy or views is difficult; however, it appears likely we will see some form of regulatory change to address the online market. When and what that looks like are the key unknowns and it will likely take time. However, with NZ in an election year it looks unlikely to be changed near-term.

What happens if regulation changes?

Of those countries which have regulated in recent years, there have been no obvious signs of cannibalisation for land-based casinos or traditional gaming. This aligns with the view the market already existed but it wasn't being captured in official statistics. There is no doubt (in our view) that the market is already sizeable in NZ. Any move to address regulation (ban or regulate) is net positive for SKC. Using a number of scenarios (based on offshore examples) we see upside risk to EBITDA ranging from 0% to +10%.

Figure 22. Summary of scenarios to assess materiality – online platform

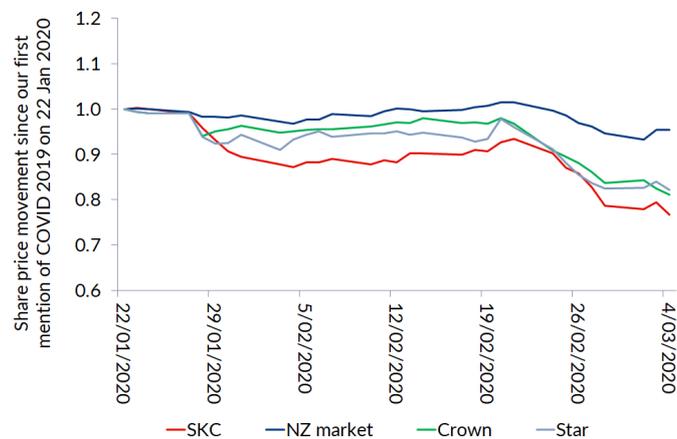
Scenarios	EBITDA upside	Key assumptions/details
1. Status quo	1.6%	15% market share; 50:50 JV; 15% 'tax' paid ; offshore margins
2. Ban online	7.2%	Redistribution of current online revenue; assumes 10% reaches the casino
3. Regulate online	9.9%	Local online platforms licenced; SKC is successful and captures market share of c. 30%
4. Regulation; SKC not a player	0.0%	Assumes no cannibalisation of existing market over and above what is already occurring

Source: Forsyth Barr analysis

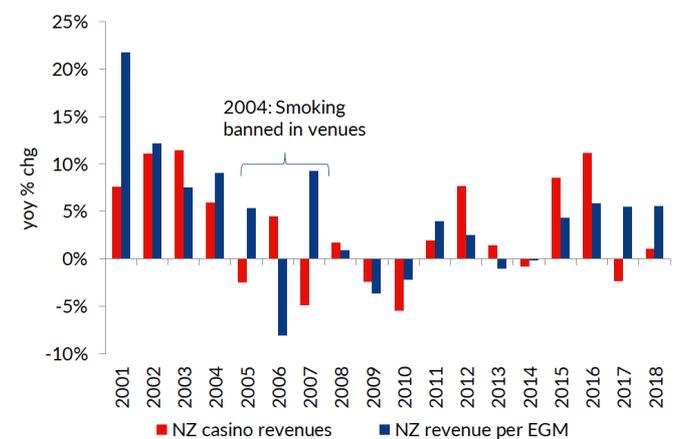
COVID-19 –tourism exposure modest, risk if situation in NZ escalates

SKCs key exposure to tourists is IB, with some exposure through its hotels and low exposure on the main gaming floor. The company has estimated <5% of group normalised EBITDA (excluding IB) is from China-based customers, which lifts to ~10% in FY20E including the (already impacted) IB segment. At 1H20, SKC noted a slight reduction in visitation in its domestic business with some softness in tables, while no discernible impact on EGMs.

The key risk for SKC is if the situation in NZ escalated and impacted domestic consumer behaviour, particularly in Auckland, for any period of time. It is likely too early to draw firm conclusions but we have moderated our FY20 expectations slightly to account for weaker visitation levels to its properties following the heightened media and sentiment currently (with examples of stockpiling at supermarkets). We expect any impact would be short-term in nature and thereby shouldn't be capitalised in a valuation. As a guide a -5% reduction in FY20E revenue would impact EBITDA by c. -12.5% and our DCF by c. -1%. This magnitude has only been seen during the GFC and smoking bans in venues, with gambling revenue broadly resilient through the cycle.

Figure 23. Share price movement since 22 Jan 2020


Source: Forsyth Barr analysis, Bloomberg

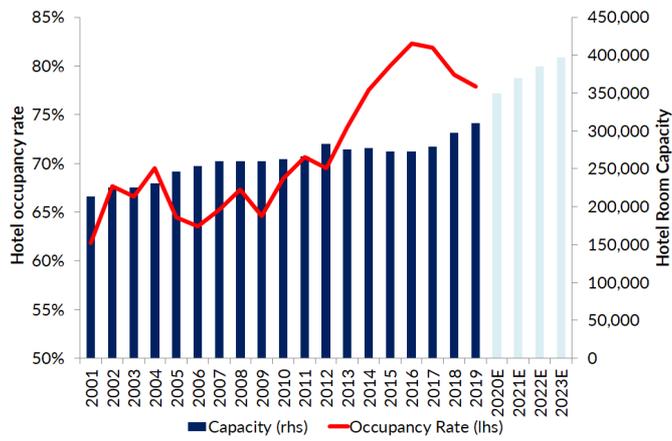
Figure 24. Gambling revenue YoY growth through the cycle


Source: Forsyth Barr analysis, DIA

Hotels under pressure, not helped by NZICC supply/demand timing imbalance

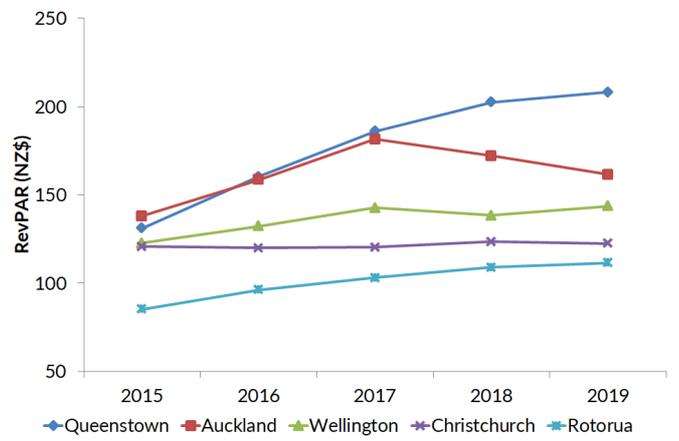
Hotels are showing some signs of pressure in Auckland, with occupancy rates and RevPAR both declining over the past 12m. SKC's 1H20 result also saw RevPAR down -6% and EBITDA down -11% given material fixed cost in a hotel business. Supply has increased in Auckland and the current pipeline is strong. We expect Auckland is seeing some supply/demand timing imbalance due to the continued delay to the new convention centre (NZICC) which was anticipated to materially lift demand, in addition to the softening tourism backdrop. We expect pressure to remain in the sector at least until the NZICC is operational. Hotels are long-dated assets and this weakness should be temporary, with the longer-term demand outlook for well-located accommodation still healthy.

Figure 25. Auckland hotel supply and occupancy



Source: Forsyth Barr analysis, Colliers

Figure 26. RevPAR in key cities



Source: Forsyth Barr analysis, Colliers

Investment Summary

SKYCITY (SKC) is one of the largest gaming operations in Australasia. Earnings and valuation are driven by Auckland, which makes up ~70% of group EBITDA. SKC has two major growth projects underway in Auckland and Adelaide which are large, complex, and challenging, but directly relate to its core expertise. Valuation levels are attractive, more than compensating for the risks, with its land value and attractive yield also providing downside protection. **OUTPERFORM.**

Business quality

- Monopoly assets: SKC has a casino monopoly in all its markets and significant term on its exclusive casino licences.
- Increasingly capital intensive platform, given a fairly mature industry and a need to continually diversify and refresh its offering to retain relevance and drive visitation.

Earnings and cashflow outlook

- Earnings outlook: EBITDA and cashflow are our preferred metrics to monitor, with complexity through NPAT given the project and NZICC fire accounting. We expect a lacklustre near-term underlying EBITDA profile, with upside as major projects are completed. We see near-term downside risk to market expectations but medium-term upside risk.
- Project execution: Two major capital projects are underway in Auckland and Adelaide. Achieving a satisfactory return on capital is the challenge given the substantial capital being spent. Adelaide in particular raises questions given perennial disappointment from the property through history.

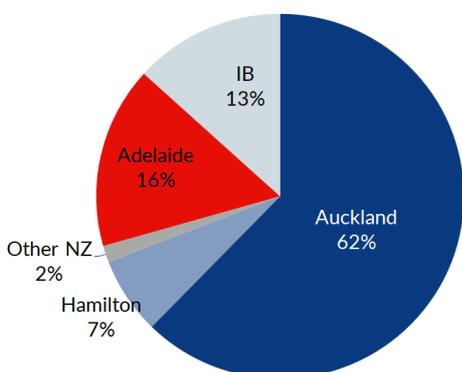
Financial structure

- Gearing: SKC has committed to a BBB- credit rating and efficient capital allocation is a key strategic priority. Gearing is expected to peak in FY21/FY22 (somewhat dependent on re-build timeline for NZICC). Casinos are cash-generative businesses and thereafter we see ample balance sheet capacity which provides options, albeit expect at least some to be used for other growth projects.
- Solid yield: SKC offers a solid dividend yield, which we view as sustainable (with upside risk after project completion).

Risk factors

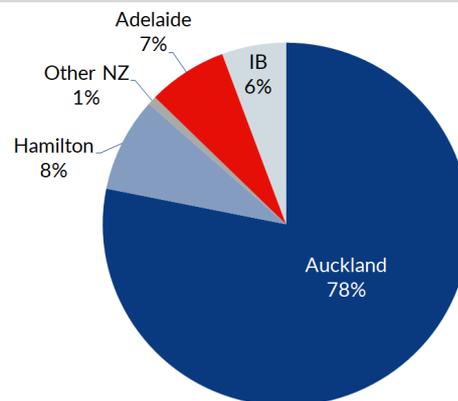
- Gaming regulation: Unexpected regulatory and taxation changes.
- Mature local gaming market: The local grind gaming market is not only mature but vulnerable to changing entertainment spending patterns.

Figure 27. Revenue breakdown (FY20E)



Source: Forsyth Barr analysis, Company reports

Figure 28. EBITDA breakdown (FY20E)



Source: Forsyth Barr analysis, Company reports

Figure 29. Price performance


Source: Forsyth Barr analysis

Figure 30. Substantial shareholders

Shareholder	Latest Holding
Sumitomo Mitsui Trust Holdings	10.0%
Lazard	8.5%
Commonwealth Bank of Australia	8.2%
BlackRock Investment Management	7.1%
Investor Mutual	7.1%
Colonial First State	5.4%

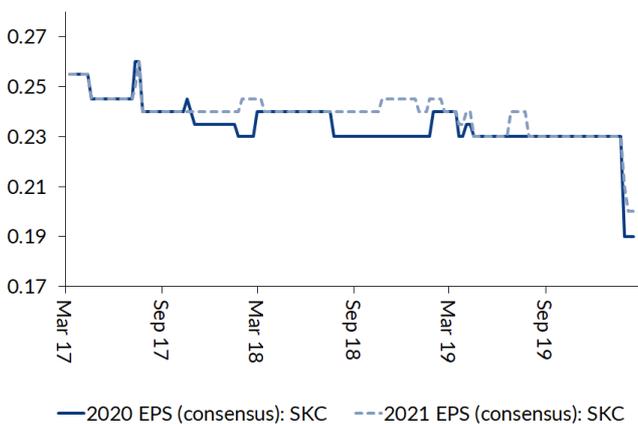
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 31. International valuation comparisons

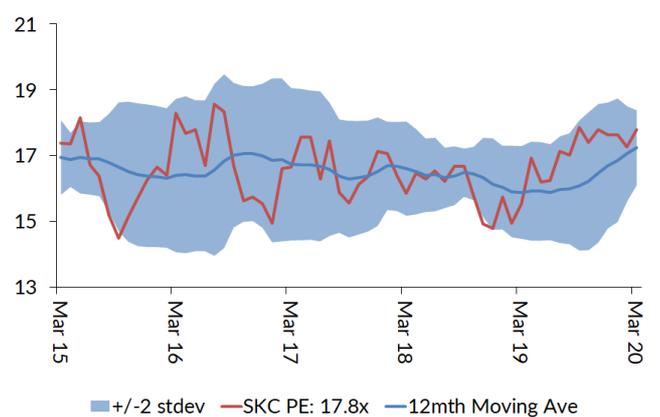
Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
(metrics re-weighted to reflect SKC's balance date - June)										
SKYCITY	SKC NZ	NZ\$3.21	NZ\$2,142	17.7x	17.7x	9.2x	8.3x	13.5x	12.4x	6.2%
CROWN RESORTS	CWN AT	A\$9.86	A\$6,677	21.5x	19.9x	9.7x	8.8x	15.9x	14.5x	6.1%
TABCORP HOLDINGS	TAH AT	A\$3.71	A\$7,514	20.1x	19.4x	10.3x	10.1x	15.5x	15.2x	5.7%
STAR ENTERTAINMENT GRP/T	SGR AT	A\$3.60	A\$3,302	14.2x	14.0x	7.9x	7.7x	12.4x	11.8x	5.8%
GENTING MALAYSIA BHD	GENM MK	RM2.75	RM15,542	13.1x	13.4x	7.1x	6.9x	12.0x	11.8x	5.6%
KANGWON LAND INC	035250 KS	KRW23650.00	KRW5,059,693	14.5x	12.4x	6.5x	5.9x	6.8x	6.4x	4.1%
Compcpo Average:				16.7x	15.8x	8.3x	7.9x	12.5x	11.9x	5.5%
SKC Relative:				6%	12%	11%	5%	8%	4%	14%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcpo metrics re-weighted to reflect headline (SKC) companies fiscal year end

Figure 32. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 33. One year forward PE (x)


Source: Forsyth Barr analysis

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