

Asia Entertainment & Resources

AERL US

For VIP access only

- AERL has pure exposure to Macau's dominant and fast-expanding VIP-gaming segment
- It operates an asset-light model and uses working capital to generate VIP rolling-chip turnover
- Based on management's profit guidance, AERL is trading currently at a 2011E PER of 2.3x

Target price: **n.a.**

Up/downside: -

Share price (16 May): **US\$6.00**

■ Not Rated



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■ Background

Asia Entertainment Resources (AERL) is an investment-holding company engaged mainly in Macau's VIP-gaming-promoter business. Through its wholly-owned subsidiaries, it receives 100% of the profit made by its VIP-gaming promoters.

VIP gaming accounted for 72% of Macau's 2010 gaming revenue, which rose by 58% YoY to US\$23.5bn, four times greater than that of the Las Vegas Strip for the same period.

Leveraging its own and its agents' relationships, a gaming promoter brings VIP customers to the casinos and receives a rebate (from the casinos) based on the amount of rolling-chip turnover or revenue generated. In return, it pays its agents for the business they bring in.

While junket commissions are capped at 1.25% of rolling-chip

turnover, the share of revenue (table wins) for the junket operators varies and is usually 40-45%.

AERL's VIP-gaming promoters operate rooms at *StarWorld*, *Venetian Macau*, *Galaxy Macau* and *MGM Macau* (MGM). While they operate on a commission-based structure at the first three properties, they are paid on a revenue-sharing basis by MGM.

■ Highlights

For 1Q11, AERL recorded a revenue increase of 103% YoY to US\$51m, helped by the VIP operation at the *Venetian Macau*, acquired in November 2010.

AERL operates an asset-light model, and puts its capital into working capital, including credit provisions to facilitate gaming turnover.

The company's biggest cost item is the commission it pays its agents, which accounted for 61% of its 1Q11 revenue. It recorded an operating-profit margin of 30% for 1Q11. As at the end of 2010, cash and receivables accounted for 61% of its total assets, (or 93% of total assets excluding goodwill and intangibles), and it had no third-party debt.

The company has been expanding, both organically and through

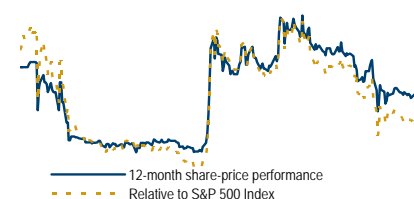
acquisitions. It has just opened a VIP room with up to 12 tables at the *Galaxy Macau*, the integrated resort that opened in Cotai on 15 May 2011.

■ Valuation

Taking the mid-point of management's 2011 guidance range for the profit before amortisation of intangible assets and the change in the contingent consideration's (ie, EBITDA as defined by the company) fair value of US\$62-68m, AERL is trading currently at a 2011E EV/EBITDA multiple of 2.1x.

In the absence of depreciation, debt, and profit tax, we calculate that the stock would trade at a similar PER of 2.3x for 2011E, excluding the impact of a change in the value of the contingent consideration.

Share price performance



12-month range	5.00-11.82
Average daily turnover (US\$m)	1.07

Source: Bloomberg, Daiwa

Financial summary

■ Profit and loss (US\$m)

Year to 31 Dec	2008	2009	2010
VIP gaming operation	51	60	127
0	0	0	0
Others	0	0	0
Total revenue	51	60	127
Other income	0	0	0
COGS	(25)	(40)	(78)
SG&A	(5)	(5)	(11)
Other op. expenses	0	0	(1)
Operating Profit	20	16	37
Interest income	0	0	0
Interest expense	0	0	0
Net interest inc./(exp.)	0	0	0
Assoc/forex/extraord./others	(20)	(16)	(4)
Pre-tax profit	0	(0)	33
Tax	0	0	0
Min. int./pref. div./others	0	0	0
Net profit	0	(0)	33
EPS (USD)	0.000	(0.002)	2.325
DPS (USD)	0.000	0.000	0.000
EBIT	20	16	37
EBITDA	20	16	38

■ Cash flow (US\$m)

Year to 31 Dec	2008	2009	2010
Profit before tax	0	(0)	33
Depreciation and amortisation	0	0	1
Tax paid	0	0	0
Change in working capital	6	4	(112)
Other operational CF items	(5)	0	2
Cash flow from operations	1	4	(76)
Capex	0	0	0
Net (acquisitions)/disposal	0	0	(9)
Other investing CF items	0	0	0
Cash flow from investing	0	0	(9)
Change in debt	0	0	0
Net share issues/(repurchases)	0	0	36
Dividends paid	0	0	0
Other financing CF items	(0)	(4)	63
Cash flow from financing	(0)	(4)	99
Forex effect/others	0	0	0
Change in cash	0	(0)	14
Free cash flow	1	4	(76)

Source: Company

Financial summary continued ...

■ Balance sheet (US\$m)

As at 31 Dec	2008	2009	2010
Cash & short-term investment	n.a.	0	14
Inventory	n.a.	0	0
Accounts receivable	n.a.	4	11
Other current assets	n.a.	2	120
Total current assets	n.a.	6	145
Fixed assets	n.a.	0	0
Goodwill & intangibles	n.a.	0	75
Other non-current assets	n.a.	0	0
Total assets	n.a.	6	220
Short-term debt	n.a.	0	0
Accounts payable	n.a.	5	10
Other current liabilities	n.a.	3	87
Total current liabilities	n.a.	8	97
Long-term debt	n.a.	0	0
Other non-current liabilities	n.a.	0	38
Total liabilities	n.a.	8	135
Share capital	n.a.	0	0
Reserves/R.E./others	n.a.	(2)	85
Shareholders' equity	n.a.	(2)	85
Minority interests	n.a.	0	0
Total equity & liabilities	n.a.	6	220
Net debt/(cash)	n.a.	(0)	(14)

■ Key ratios (%)

As at 31 Dec	2008	2009	2010
Sales - YoY %	n.a.	18.5%	110.0%
EBITDA - YoY %	n.a.	-23.0%	145.3%
Operating Profit - YoY %	n.a.	-23.0%	139.9%
Net Profit YoY%	n.a.	n.a.	n.a.
EPS - YoY %	n.a.	n.a.	n.a.
Gross-profit margin %	50.3%	34.4%	38.9%
EBITDA margin %	39.6%	25.7%	30.0%
Operating margin %	39.6%	25.7%	29.4%
ROAE (%)	n.a.	n.a.	78.5%
ROAA (%)	n.a.	n.a.	33.0%
ROCE (%)	n.a.	n.a.	88.8%
ROIC (%)	n.a.	n.a.	106.9%
Net debt to equity (%)	n.a.	net cash	net cash
Effective tax rate (%)	n.a.	n.a.	0.0%
Accounts receivable (days)	0.0	n.a.	21.8
Payables (days)	0.0	n.a.	21.2
Net interest cover (x)	n.a.	n.a.	n.a.
Net dividend payout (%)	n.a.	n.a.	0.0%

Source: Company, note: balance sheet information only available from 2009

■ Company profile

Asia Entertainment Resources (AERL) is an investment-holding company principally engaged in the gaming-promoter business in Macau. Via itself or its agents it brings VIP customers to the casino, provides working-capital financing as necessary to generate rolling-chip turnover, and receives in return commissions from the casinos. At present, AERL operates VIP rooms at *StarWorld*, *Venetian Macau*, *MGM Grand* and *Galaxy Macau*.

For VIP access only

Taking the largest chunk of the world's biggest VIP-gaming market

A sweet spot

AERL is engaged in Macau's VIP-gaming promoter business. Macau's gaming revenue has been on a continual upward trend over recent years and the outlook for the industry remains strong, with VIP-gaming accounting for more than 70% of the total gaming revenue. For VIP gaming, we estimate that in Macau, gaming promoters and their agents account for more than 90% of the segment's revenue.

Macau gaming momentum is strong

Macau's gaming revenue expanded at a CAGR of 28% for the 2004-10 period, since the opening of the first non-SJM Holdings (SJM) (880 HK, HK\$17.20, 1) casino in 2004. Gaming-revenue-growth momentum accelerated further for 2010 (revenue rose by 58% YoY). Macau's gaming revenue increased by 43% YoY for the first four months of 2011.

Macau: gaming revenue (MOP m)



Source: DICJ

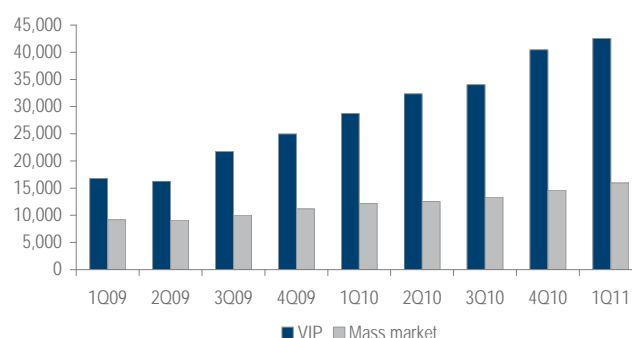
VIP-gaming: Macau's dominant segment

VIP-gaming accounted for 72% and 73% of Macau's gaming revenue for 2010 and 1Q11, respectively. As we

envisage the opening of more mass-market-focused integrated resorts in Macau and the expansion of catchment areas for this mass market, we think mass-market growth could see stronger momentum over the next few years, but that VIP-gaming should remain a dominant segment.

The outlook for the VIP segment is likely to depend on the following factors, in our view: liquidity in China, relative returns vis-à-vis other asset classes, and junket and casino cash flows. We believe these factors continue to look favourable.

Macau: VIP and mass-market gaming revenue (MOP m)



Source: Macau Gaming Inspection and Coordination Bureau (DICJ)

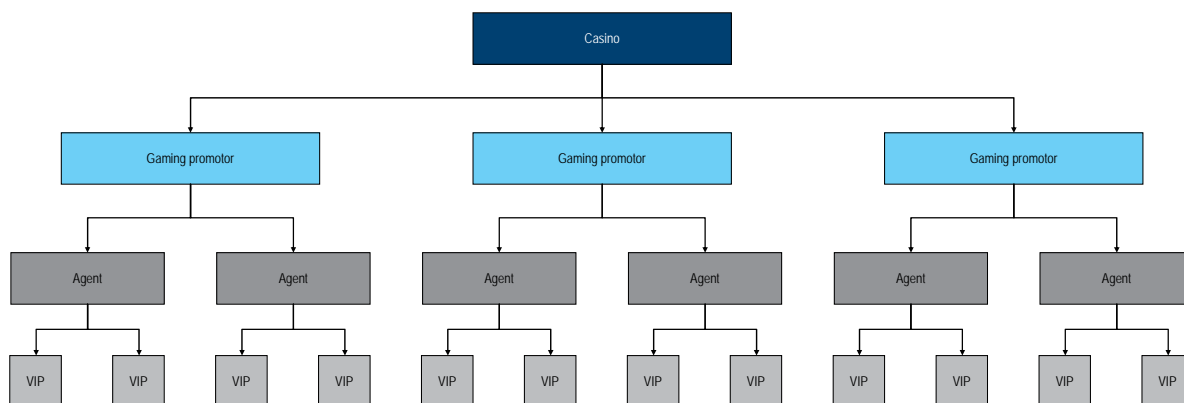
Junkets dominate Macau's VIP gaming

VIP-gaming in Macau is operated mostly through the junket system, where the junket operators and their agents own their relationships with VIP customers. These junket operators and agents provide a number of functions that the casinos outsource:

1. marketing and the solicitation of business,
2. currency exchange,
3. providing working capital, and /or
4. credit collection (and bearing credit losses, if any).

Functions 2-4 have arisen due to: a non-free-market Renminbi exchange system, the illegal status of gambling in China, which means casinos cannot enforce the collection of gambling debt via the courts, and the lack of credit information on individuals in China, in turn making credit assessments on VIP customers a difficult and imprecise task for the casinos.

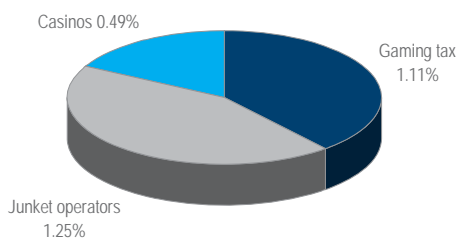
■ **Gaming-industry structure: casino and their VIP agents**



Source: Daiwa

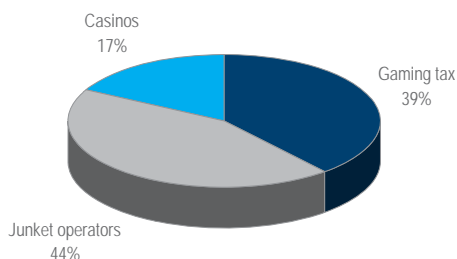
Junket operators are rebated either on the rolling-chip volume generated by their customers at the gaming tables, or by sharing the winnings the casinos make from this gaming volume. Assuming a 2.85% win rate for VIP Baccarat, the main game played in Macau's VIP rooms, a 1.25% commission on rolling-chip turnover would be equivalent to a 44% share of the table wins.

■ **AERL: rebate scheme – rolling-chip-turnover basis**



Source: Daiwa

■ **AERL: rebate scheme – revenue-sharing basis**



Source: Daiwa

The regulatory commission cap of 1.25% of rolling-chip turnover applies to rolling-chip commission. However, there is no regulation governing the revenue-sharing split between junket operators and the casinos. We believe the junket operators usually share 40-45% of table wins.

AERL operates in MGM, Galaxy and Venetian Macau

AERL operates VIP rooms in Macau, including at *StarWorld*, *MGM*, and the *Venetian Macau*. Also, it has just opened a room at the *Galaxy Macau* – the newest addition to Macau's integrated-resort portfolio, after the *Venetian Macau* and the *City of Dreams*.

■ **AERL: number of VIP tables**

Operator	Casino	Tables
Galaxy	<i>StarWorld</i>	12
MGM China	<i>MGM</i>	6
Sands China	<i>Venetian Macau</i>	5
Galaxy	<i>Galaxy Macau</i>	12

Source: Company data

While these rooms operate on a commission-based structure at *StarWorld*, *Galaxy Macau*, and the *Venetian Macau*, they are on a revenue-sharing rebate structure at *MGM*.

According to AERL, about 80% of its total revenue came from a rolling-chip-based scheme before its VIP room in *Galaxy Macau* opened. The *Galaxy Macau* is on a rolling-chip-based scheme as well.

The rolling-chip-based scheme, which frees the VIP-room operators from having to bear the brunt of win-loss ratios with the casinos, means less earnings volatility than that seen generally with revenue-sharing schemes.

Asset-light model

AERL receives commission from casinos and pays its agents, usually keeping 0.45% out of the 1.25% as operating profit before general and administrative (G&A) expenses. While its business model means its puts its money into working capital, there is no fixed-asset requirement. The company finances its working capital via shareholders' equity and loans, and was debt-free at the end of 2010.

Working-capital basis

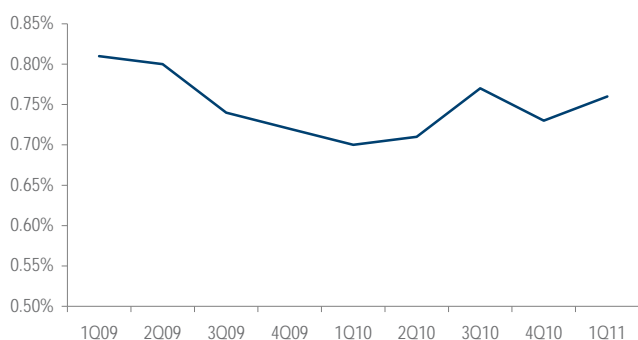
The gaming-promoter business operates on a working-capital basis. By providing credit to their agents and customers (in AERL's case it only extends credit to customers brought by the major shareholders themselves), the gaming promoters facilitate the rolling-chip volume, receiving rebates from the casinos in return.

AERL also gives its agents rebates, usually 0.9-1.1% of the rolling-chip turnover they bring in, depending on whether these agents require credit from the gaming promoter. For eight consecutive quarters (2Q09-1Q11), AERL has paid a commission to its agents at about 0.70-0.81% of the rolling-chip turnover they have brought in.

We note that this ratio has been, and should continue to be, subject to changes in:

- the mix of revenue between commission-based income and revenue sharing (in revenue sharing case it is subject to varying win-rates),
- the level of credit required by the agents (the less credit required, the higher the commission rate), and/or
- the amount of revenue from direct customers (in which case there is no agent commission).

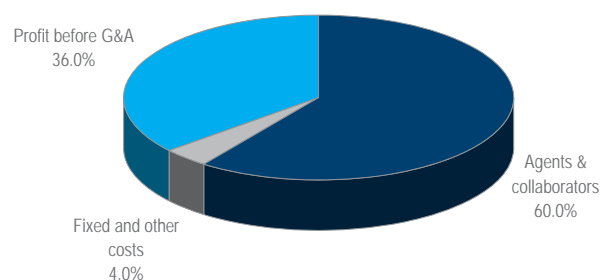
■ AERL: agent commission as a % of revenue



Source: Company

Agent commission is AERL's biggest cost item, and based on management's guidance it usually keeps 0.45% of the 1.25% commission received from the casinos as operating profit before G&A. Effectively, this would mean a 36% operating-profit margin before G&A expenses.

■ AERL: operating-profit margin before G&A expenses



Source: Company

While AERL has not had any bad-debt charges so far in its reported financials, the company's major shareholders have guaranteed to absorb personally any credit costs, should they arise.

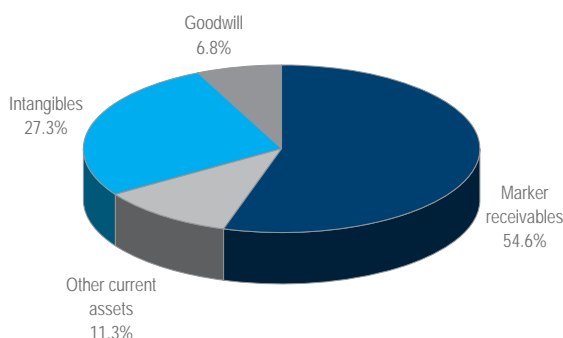
In our opinion, the credit quality of agents is usually better than that of VIP customers, as the agents have multiple customers, and hence there is a lower concentration risk. As such, we believe it makes good sense for individual agents to absorb the credit costs of one or two individual customers, while maintaining their working relationships with the gaming promoters.

From what we understand from management, AERL extends credit to agents but not to customers directly, except for those VIP customers sourced directly from the company's major shareholders.

No fixed-asset investment

Inherent in AERL's business structure is the minimal requirement to invest in fixed assets. In AERL's balance, its asset base comprises primarily market receivables that are used to generate rolling-chip turnover, and hence revenue.

■ **AERL: composition of assets (31 December 2010)**



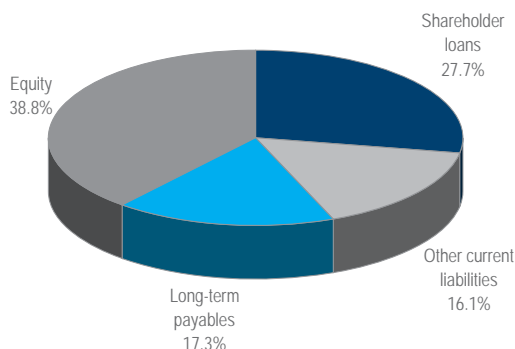
Source: Company

Excluding the goodwill and intangibles created by the prior acquisitions of VIP-room operations, marker receivables would make up 83% of the company's current asset base, and cash 10%.

Zero third-party debt as at end-2010

On the other side of the balance sheet, the company's assets are funded largely by shareholders' funds and loans. It had no third-party debt on its balance sheet as at the end of 2010.

■ **AERL: composition of liabilities and equity (31 December 2010)**



Source: Company

Only limit: lack of capital

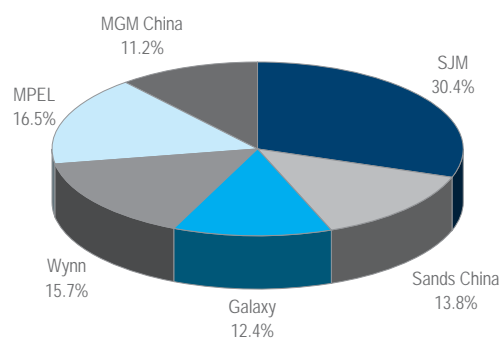
Given the currently strong growth-momentum of VIP-gaming in Macau, AERL sees ample business-growth opportunities, especially at the casinos where it does not operate rooms. However, as its cage capital is already running at a 90% utilisation rate and the utilised cage capital is generating a 10.4x rolling-chip turnover a month (for April), there have been occasions when AERL has had to turn away business given its limited capital position.

Opportunities ahead

Based on AERL's recorded rolling-chip turnover for January to April 2011, and our forecast of the industry's 2011 total rolling-chip turnover, we calculate a 2.5% market share for the gaming promoter in Macau's VIP space.

Currently, AERL operates VIP rooms in properties of three (out of six) licensed gaming operators, and we estimate that these three operators accounted for a combined 37% of Macau's VIP-gaming revenue for January-April 2011.

■ **VIP-gaming market shares by operator (Jan-Apr 2011)**



Source: DICJ, Daiwa estimates

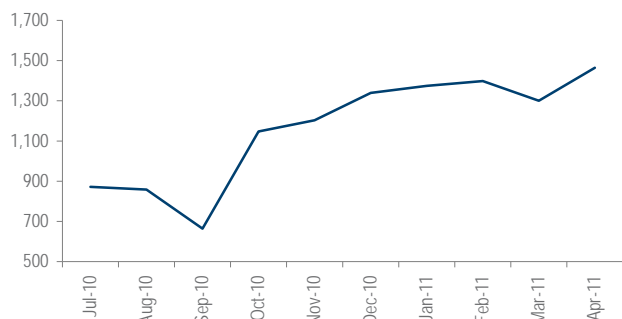
Management believes that as VIP customers usually move between casinos to try and improve their luck and/or environment, it would be strategically sound for AERL to expand its presence to the other major casinos in Macau, in addition to pursuing organic growth of its existing VIP rooms.

Cage capital: utilisation rate

AERL generated a rolling-chip turnover of US\$5.5bn for the first four months of 2011, and recorded a high of US\$1.464bn for April.

As at the end of 1Q11, the gaming promoter recorded a cage capital of US\$157m. According to management, the cage capital was running at a 90% utilisation rate in April, and this suggests to us a 10.4x turnover of the utilised cage capital (to generate a rolling-chip turnover of US\$1.464bn) for the month. This turnover ratio is already at the high end of the Macau Gaming Sector's average.

■ **AERL: rolling-chip turnover (US\$m)**



Source: Company

Valuation

Based on management's guidance, we calculate that AERL is trading currently at a 2011E EV/EBITDA multiple of 2.1x. In the absence of depreciation, debt and profit tax, we calculate that it would trade at a similar PER, of 2.3x for 2011E, excluding the impact of a change in the value of the contingent consideration in relation to its acquisition of the VIP-room operations at the *Venetian Macau*.

From EBITDA to net profit

Management's guidance for the profit before the amortisation of intangible assets and the change in the fair value of the contingent consideration (EBITDA as defined by the company) is US\$62-68m for 2011.

Taking the mid-point of management's 2011 guidance range and in consideration of:

- no depreciation as there are no fixed assets,
- an annualised 1Q11 amortisation cost of US\$5m,
- no interest expenses, given zero debt,
- no profit tax applicable (a special rolling tax has been absorbed above the EBITDA line),

we calculate a 2011 net profit of US\$60m, excluding the change in the value of the contingent consideration in relation to the company's acquisition of the VIP-room operations at the *Venetian Macau*.

2011E EV/EBITDA multiple of 2.1x; 2011E PER of 2.3x

Based on these calculations, we calculate that AERL would be trading currently at a 2011E EV/EBITDA multiple of 2.1x. There is no direct comparison available for other gaming promoters. While we note that the casinos and VIP-gaming promoters have different business models and structures, for reference

we have provided the valuations for the Macau gaming operators we cover in the following table; the average 2011 EV/EBITDA for the Macau casino operators is 15.9x at current share prices and based on our forecasts.

Similarly, based on the assumptions discussed earlier, we calculate a 2011E PER of 2.3x for AERL. This compares with an average 2011 PER of 33.2x for the Macau casino operators (24.7x if we exclude Melco Crown Entertainment [Melco Crown]) based on our EPS forecasts.

■ **AERL and Macau gaming operators: valuation data**

Company	Ticker	Rating	Market cap (US\$)	Share price (local ccy)	2011E EV/EBITDA multiple (x)	2011E PER (x)
Galaxy	27 HK	1	7,399	13.94	17.8	29.6
Melco Crown	MPEL US	1	5,208	9.73	13.3	66.9
Sands China	1928 HK	1	22,160	21.4	16.2	27.9
SJM	880 HK	1	12,559	17.72	13.5	18.5
Wynn Macau	1128 HK	2	17,421	26.1	18.5	22.9
Macau casino average					15.9	33.2
Asia Entertainment & Resources	AERL US	NR	135	6.00	2.1	2.3

Source: Bloomberg (for AERL), Daiwa forecasts (for all other companies)

Note: data is based on share prices as at 16 May 2011

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