UNION GAMING RESEARCH MACAU

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Company Research: NagaCorp (3918 HK)

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Buy / Price Target $7.50

2H14 results review; maintain Buy rating

2H14 results

Naga reported 2H14 results last night, which was followed by an analyst briefing this morning. The company continues to outperform its regional Asian peer group in terms of revenue, EBITDA and net income growth. However, 2H14 results came in slightly below our expectations due to what seems to have been a temporary mass slowdown late in 2H14, as well as a higher cost structure that's been put in place to handle the upcoming lift in revenue (both VIP and mass). Revenue of USD213mm (+10% y/y) was inline with our estimate, while EBITDA of USD89mm (-7% y/y) was below our expectations of USD94mm. Absent a one-time fee earned in 2H13, 2H14 EBITDA growth was approximately 10% y/y.

Maintaining Buy rating and lowering PT to HKD7.50 (from HKD8)

Across all of the primary gaming segments (VIP, mass, slots), NagaWorld continues to notably outperform its regional Asian counterparts. We also firmly believe that the company has and is putting the right things in place to continue to drive revenue across all of these segments over the next two years prior to the opening of Naga2. However, some of these initiatives are likely to come online later than initially expected (e.g. Bassaka Air, NagaCityWalk), suggesting that the offset to already-higher operating costs will come a bit later. As such, we have lowered our expectations for 2015 (EBITDA goes to USD212mm, from USD221mm), resulting in a new lower PT of HKD7.50 (from HKD8). Despite our lower earnings estimates in 2015, we think a risk to the upside exists in that one of the company's two largest 3rd-party slot machine operators will come off contract this year (followed by another in 2016), which could result in another notable one-time contract fee that would more than offset the difference between our old and new EBITDA and net income estimates. We also believe the initial very strong VIP results on the heels of just one China-centric junket operating at NagaWorld suggest the layering on of Suncity (and others) could result in upward consensus revisions over the coming quarters.

Estimates and Valuation (US$)	
2015 EPS (US cents)	7.20
2016 EPS (US cents)	8.08
2015 P/E	10.8x
2016 P/E	9.7x
2015 EBITDA ($m)	212.2
2016 EBITDA ($m)	250.9
2015 EV/EBITDA	7.9x
2016 EV/EBITDA	7.2x

Source: Union Gaming Research Macau

Issue Data (HK$)	
Last Price	5.95
52wk High (2/28/2014)	8.80
52wk Low (1/20/2015)	5.42
P/E (Trailing 12m)	12.9x
Dividend Yield	5.5x
Price to Book Ratio	2.8x
Price to Sales Ratio	4.4x
EV / Trail 12M EBITDA	8.8x
Shares Outstanding	2,270
Market Cap	13,733
Enterprise Value	12,151

Source: Capital IQ

For a description of important disclosures please see Appendix 1

2H14 results review; growth story intact; maintaining Buy rating but lowering PT to HKD7.50 (from 8)

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Segment review

VIP – explosive growth for this reinvigorated segment

During 2H14, NagaWorld's VIP rolling chip volume grew by 47% to USD3,763mm, which was well in excess of our 33% estimate. Of the total rolling chip volume, USD627mm came from approximately four full months of operations from Asian Nations junket, which brought Chinese players to the property. This one junket alone took the 2H14 growth rate from 22% to 47%.

Importantly, Suncity, which is Macau's largest junket by volume, has already signed an agreement with NagaWorld and is expected to start sending players beginning this month. In addition, Naga is in negotiations with other name-brand Macau junkets, as well as other junkets from SE Asia, which we hope will enter service later this year.

Our current expectations for 2015 call for nearly 70% growth in rolling chip volume, to a total of USD10.5bn. We believe the currently monthly run-rate (prior to the impact of SunCity, and prior to the anticipated impact of increased direct airlift on Bassaka Air), would suggest an annual rolling chip volume in excess of USD8bn. To fill the gap between the current run-rate of USD8bn and our expectations of USD10.5bn, we estimate that Suncity would only need to allocate 100bps to 200bps of its monthly rolling chip volume to NagaWorld. We think this is likely. Further, and given the benefits of airlift by mid-year, and additional Macau and SE Asian junkets, we believe that there is more upside risk than downside risk to our current expectations.

While we remain very excited about the VIP program at NagaWorld, we would point out that the associated margin story is lower. In fact, as a means to attract higher levels of rolling chip volume, the company pays a greater-than-regional-average revenue share to its junkets (an even higher share than previously). As such, and even though we have increased our 2015 rolling chip volume forecast to USD10.5bn (from USD8.7bn), we are maintaining our associated VIP gross profit estimate at around USD95mm. Over time, and as the company refines its programs, it expects to see some lift in margin. For the time being, we would prefer to be conservative and estimate further margin erosion (we are forecasting gross profit margin of 30% in 2015 vs. nearly 37% in 2014).

Mass market (public floor) table games

Mass market table games volume grew 10% y/y in 2H14, to USD230mm. This was below our estimate of 18% growth to USD245mm (and below the 3Q14 run-rate of 17%). It appears that December was an abnormally slow month on the mass floor, which was the primary contributor to the downside relative to our expectations. Management commentary would suggest that volume has picked up notably in January, and this, in our view, could be driven in part by increased airlift between Siem Reap and Phnom Penh.

We are currently modeling 16% growth in mass market volume in 2015, with 10% in 1H15 and 20% in 2H15. Our estimates are back-end loaded to afford NagaWorld a longer runway to ramp up its Chinese mass market initiatives, including the initiation of direct flights (hopefully mid-year) on Bassaka Air to/from mainland China in conjunction with China International Travel Service.

Slot machines / ETGs

NagaWorld's slot machin/ETG business finished the year on a strong note, growing volume 13% in both quarters of 2H14, having started the year at only +3% in 1H14. The growth story here is a combination of general tourism trends, as well as strength in the local economy, with GDP continually besting 7% growth.

We are currently modeling 11% volume growth in 2015, which we feel is a fair baseline going forward. This captures what tends to be double-digit tourism growth, in addition to high-single-digit GDP growth. In addition, the company expects to finally launch TITO (cashless slots) by 2Q15. This, if history is a guide, should result in a notable uplift in slot volume that we haven't factored in to our estimates. In addition, and as mentioned above, the contract of the second largest 3rd party slot provider at NagaWorld expires later in 2015, and we would look for the company to earn another notable one-time renewal fee (likely well in excess of the most recent slot deal done at USD15mm), which is also not in our current expectations.

Future initiatives and some delays

Noted above, there are a handful of initiatives that should drive business across all of NagaWorld's gaming segments that have been pushed out to some degree, which therefore resulted in our downwardly revised estimates for 2015.

Bassaka Air, which within the past couple of weeks has begun flying 2x daily service between Phnom Penh and Siem Reap is unlikely to start service to China/Macau until around May (vs. initial expectations of late 2014). While we should begin to see the daily Siem Reap flights bolster NagaWorld's mass floor with incremental Chinese tourists, we believe the real potential of Bassaka Air won't be felt until it starts flying international routes around mid-year. The reason for the delay relative to earlier expectations is due to incremental regulations imposed upon the airline.

Naga CityWalk, the retail experience that will eventually connect NagaWorld to Naga2, is now expected to come online in early 2016 (delayed by approximately 6 months). This project will be run by China Duty Free. Construction is moving slower than expected due to certain complexities related to some of the below-ground work that was seemingly causing cosmetic issues to existing facilities. While not a gaming component, we believe the addition of high quality retail should be a key driver of incremental volume to the property – especially for higher end mass and VIP customers.

The rooftop VIP pool deck should come online later this year, and will include an incremental 16 VIP tables (increasing VIP supply by 10%). This will augment several new VIP rooms that came online later in 2014.

Naga2 remains on track for a 2017 opening. In our view, this continues to be a transformational milestone for the company, as it will not only take them out of the single-asset mold, but that it will be the first high-end purpose-built space for the company.

At the airport, the company's private air terminal is still expected to open in 2016. In our view, all of these initiatives are essential elements to Naga's success in the VIP segment, and each should contribute to a critical mass that makes Naga all the more attractive to VIP junkets and customers alike (not to mention serving as a bridge until the purpose-built Naga2 opens).

Vladivostok

The company remains optimistic that they can break ground on an expected USD50mm Phase 1 by mid-2015. This right-sized Phase 1 would likely take two years to build, with 25% of capex in 2015, 50% in 2016 and the final 25% in 2017. We are waiting for the official ground breaking before adjusting our model to account for this capex and to give any valuation credit. Under the assumption that the Phase 1 project moves forward, we would not expect Naga to commit to any further phases until Phase 1 is operational and demand is sufficient to justify further development.

New estimates

We are lowering our forward estimates for NagaCorp as noted above. Our 2015 EBITDA estimate goes to USD212mm (from USD221mm) and compares to consensus of USD212mm. Our 2016 EBITDA estimate goes to USD251mm (from USD260mm). Please see Figure 1 for detailed revenue, EBITDA and EPS estimates.

Figure 1: New estimates and consensus expectations

Capital IQ Company Statistics (FY-Dec)			
52-week high	$8.80	Annualized Dividend/Share	$0.33
52-week low	$5.42	Dividend Yield	5.5%
Market cap ($mm)	$13,733	Insider Ownership	0.0%
Shares outstanding (mm)	2,270.0	Institution Ownership	25.2%
Average daily volume (mm)	10.8	Revenue growth (2-year)	19.4%
Short interest (mm)	na	EBITDA growth (2-year)	na
Short Interest as % of float	na	EPS growth (2-year)	9.0%

Annual Results	2012	2013	2014	2015E	2016E
Union Revenues ($mm)	**$279**	**$345**	**$404**	**$564**	**$644**
Previous revenue estimate	-	-	-	$533	$643
Change	-	-	-	$31	$1
Capital IQ revenue estimate	-	-	-	$492	$576
Union EBITDA ($mm)	**$138**	**$172**	**$176**	**$212**	**$251**
Previous EBITDA estimate	-	-	-	$221	$260
Change	-	-	-	($9)	($9)
Capital IQ EBITDA estimate	-	-	-	$212	$245
Union EPS	**$0.054**	**$0.063**	**$0.060**	**$0.072**	**$0.081**
Previous EPS estimate	-	-	-	$0.070	$0.086
Change	-	-	-	$0.002	($0.005)
Capital IQ EPS estimate	-	-	-	$0.067	$0.071
Valuation - EPS Multiple				**10.4x**	**9.3x**
Valuation - EV/EBITDA Multiple				**7.6x**	**6.8x**

Source: Union Gaming Research Macau, Capital IQ

Price Target HKD7.50

We value NagaCorp using an EV/EBITDA approach on forward earnings in addition to incremental present value associated with the company's Naga 2 project, which should open in 2017. Our 12 month price target is now HKD7.50 (from HKD8.00), and is based on an 8.5x multiple of our 2015 EBITDA estimate (HKD4.00) in addition to the per share present value for Naga2 (HKD3.50). Our calculations assume a share count of approximately 3,848mm, which accounts for the dilution associated with the company's acquisition of the USD369mm CityWalk and Naga2 complex from CEO Tan Sri Dr. Chen in the form of share issuance / convertible bond. We note that the 8.5x multiple represents a slightly lower multiple than we have previously ascribed (9x), which we would attribute to broader multiple pullback in the gaming space. However, it still remains a discount to its peer group in Macau, to which we ascribe a multiple approximately 3 or 4 turns higher. We feel an 8.5x multiple is justified for Naga as the company has consistently executed on its growth initiatives, enabling the company to growth faster than its peer group. It is also in the home stretch of shedding its image as a single-asset story, with Naga2 now under construction in a meaningful way and Vladivostok on the horizon. Our price target, along with an expected dividend yield of 7% in 2015 represents 33% upside to today's closing price.

Risks

Risks to shares of NagaCorp include: country risk (loss of exclusive license, adjustment to the company's advantageous low monthly fixed obligation tax), development risk including delays to Naga2 and the Vladivostok project, incremental regional competition (especially from Vietnam should locals be allowed to gamble), volatility associated with being a single-asset operator (for now) in the context of increasing exposure to the VIP segment.

Appendix 1: Important Disclosures

Additional information is available upon request.

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Ratings methodology

We use a traditional ratings construct (Buy, Hold, Sell) that is underscored by percentage upside/downside form current trading levels along with dividend yields for total return. We exclude special dividends and only contemplate regular dividends in our total return forecasts. These are absolute ratings, not relative or forced ratings. We define a Buy rating as a company whose shares exhibit total return (appreciation and dividends) potential of at least +15% within the next twelve months, and conversely a Sell rating as a company whose shares exhibit downside potential of at least 15% within the next twelve months. A Hold rating is reserved for companies whose shares exhibit total return potential between those parameters.

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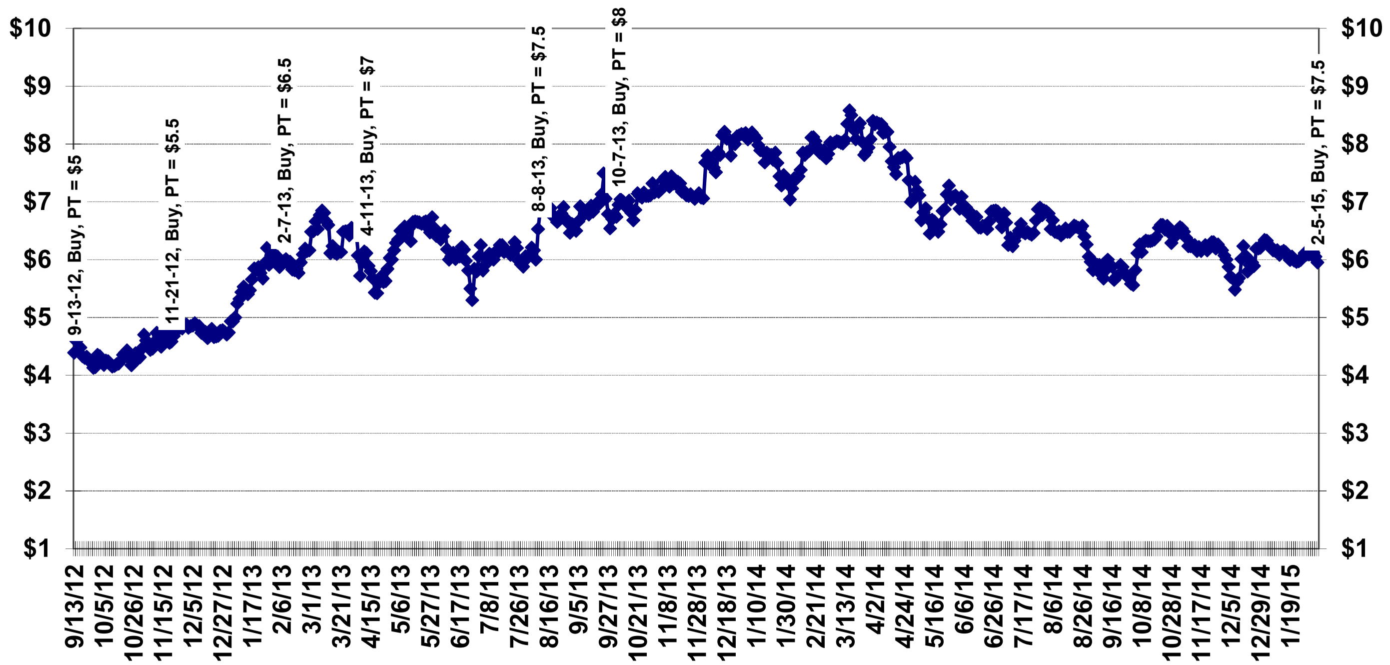

Source: Union Gaming Research, LLC and Union Gaming Research Macau Limited; Capital IQ

Distribution of Subject Companies' stock ratings

Buy	Hold	Sell
92%	8%	0%

Source: Union Gaming Research, LLC and Union Gaming Research Macau Limited

Distribution of Subject Companies with affiliate banking relationships

Buy	Hold	Sell
100%	0%	0%

Source: Union Gaming Research, LLC and Union Gaming Research Macau Limited

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