Crown Subordinated Note Holders Feeling Dazed and Confused

We upgrade CWNHA to Accumulate; CWNHB remains on Hold. Suitable for investors with a high risk appetite.

Morningstar Research
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Unconfirmed Privatisation Scenarios Present Buying Opportunity

Holders of Crown Resorts' subordinated notes have watched in dismay as the value of their holdings has fallen since press reports surfaced that Crown or some of its assets may be either fully or partially privatised by a consortium, including Consolidated Press Holdings, or CPH, and a third party, possibly a private equity or a pension fund. The fear among investors is that Crown will opt to either not redeem the notes at first call or cease paying interest to holders in such an event.

Credit markets have always been important to Crown's funding strategy, and during a period of significant capital expenditure requirements, this is not expected to change. Crown will likely continue to require access to all funding sources in its capital structure, making it less probable, in our view, the downside scenarios being priced in by the market will play out.

Key Takeaways

- A Crown privatisation scenario, particularly one that is debt-funded, would require the clearing of significant political and regulatory hurdles. For example, under the Casino Agreement, Crown's total liabilities must not at any time exceed 60% of total Crown assets without the prior written approval of the Victorian Casino Control Authority, severely limiting the likelihood of a leveraged privatisation.
- The long-term benefits of keeping all funding options open and minimising reputational damage should motivate Crown to redeem both notes at first call. However, investors should be aware that, although all interest payments accrue and compound until maturity, there is the possibility (albeit unlikely in our view) that Crown at its sole discretion could defer interest payments until then.
- We upgrade Crown Subordinated Notes I, or CWNHA, to Accumulate from Hold. Crown Subordinated Notes II, or CWNHB, remains on Hold. We increase our security investment risk on both securities to High from Medium.
- We remind investors that CWNHA and CWNHB should not be viewed as like-for-like substitutes for government-guaranteed term deposits or traditional fixed-income products. These securities are only suitable for investors with a high risk appetite.

Securities Mentioned

Name/Ticker	Issuer Economic Moat	Security Investment Risk	First Call Date	Maturity Date	Current Price ($)	Gross Running Yield (%)	Gross Yield to Reset (%)	Trading Margin (%)
Crown Subordinated Notes I CWNHA	Narrow	High	14-Sep-18	14-Sep-72	83.00	9.23	16.95	13.10
Crown Subordinated Notes II CWNHB	Narrow	High	23-Jul-21	23-Apr-75	70.35	9.40	15.33	12.08

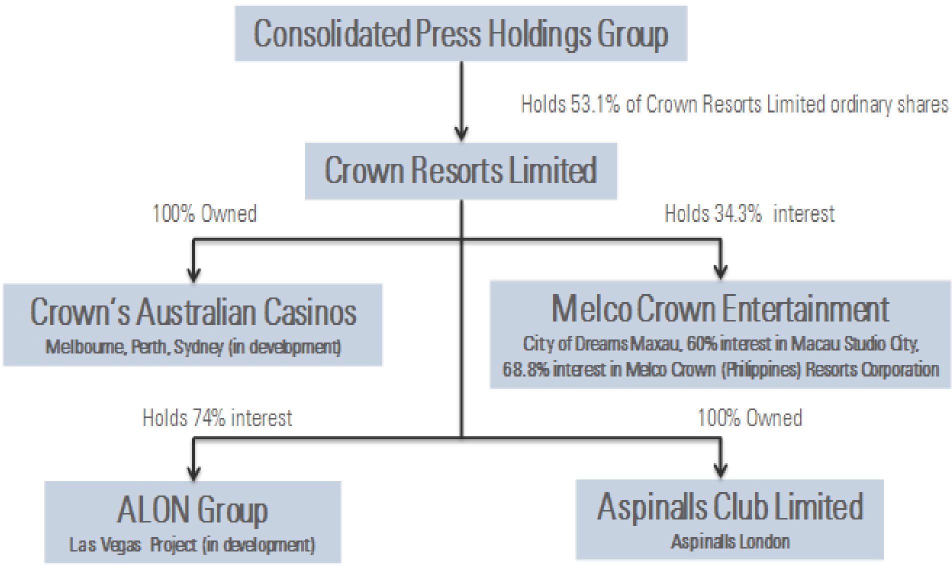
A Brief Timeline of Events

On Dec. 16, the Australian Stock Exchange, or ASX, sent a price query to Crown regarding the change in price of the entity's common equity to AUD 12.14 from the previous day's close of AUD 10.65. The ASX also noted media speculation that CPH was in talks with parties regarding a possible joint bid for Crown or some of its assets. Crown responded by stating that it was unaware of any such proposal. Included in the response was a letter from CPH stating that, from time to time, they have confidential discussions with third parties regarding their investments, including their 53% shareholding in Crown.

Speculation regarding potential privatisation was further fueled on Dec. 21, when James Packer resigned as a director of Crown, leading to suggestions that the motive behind the move was to remove potential conflicts of interest in the event of such a transaction. Remaining a co-chairman of Melco Crown Entertainment (MPEL) and Alon, Packer said that he had made the decision with the intention to "devote my energies to a number of development projects in Sydney, Melbourne, and Las Vegas, as well as Crown's online platforms".

The names suggested in the press as possible partners with CPH in a privatisation bid for Crown include the state run Canadian Pension Plan Investment Board, which had approximately AUD 278 billion in assets under management as at Sept. 30, and Blackstone Real Estate, one of the world's largest private equity real estate investors. Crown has to date refused to be drawn into a direct public statement on the media speculation regarding the likelihood of privatisation. We wait to see whether management will update the market on the status of any potential privatisation discussions at the company's interim results announcement on Feb. 25.

Exhibit 1 Crown's Businesses



Source: Crown, Morningstar Direct

Let's Not Neglect the Politics

Considering the importance of the Crown assets to their respective state governments, any potential privatisation of Crown would need to jump through political and regulatory hoops. The following figures regarding Crown Melbourne highlight this importance:

(i) Employs approximately 9,400 people, with an annual payroll exceeding AUD 400 million;
(ii) Attracts approximately 20 million visitors per year;
(iii) Is investing AUD 1.8 billion in Melbourne's tourism infrastructure during fiscal 2007-16;
(iv) Contributes more than AUD 350 million in taxes annually to the Victorian government, and more than AUD 1.3 billion in taxes during the four years to fiscal 2013; and
(vi) Contributes about AUD 3.1 billion to the Victorian economy annually.

The importance of Crown Melbourne to the Victorian government suggests that any privatisation would be expected to attract significant government scrutiny and would likely play out over a protracted period of time. The risk of this is further heightened when we consider that such a transaction would require approvals from the Victorian, New South Wales, and Western Australian governments. This is not to say that it's not possible; however, we think that the regulatory hurdles presented by a full privatisation with further leveraging of Crown make this an unlikely scenario.

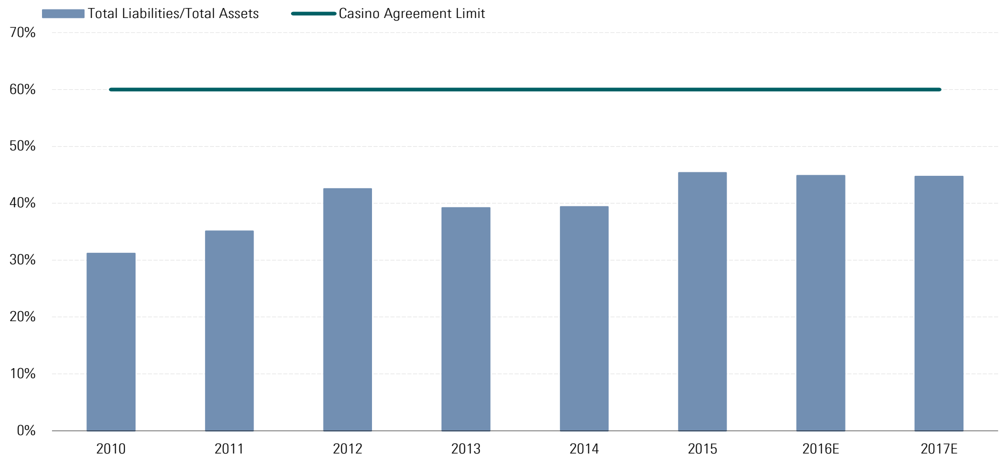
The Casino Agreement Caps Gearing

On Sept. 21, 1993, the Victorian Commission for Gambling and Liquor and Crown Melbourne Limited entered into an agreement (Casino Agreement) under the Casino Control Act 1991.[1] Within the text of the 77-page agreement is section 22, "Conditions Relating to Company Structure". Section 22(ma) states that "Total liabilities must not at any time exceed 60% of Total Group Assets without the prior written approval of the Authority" (Authority refers to the Victorian Casino Control Authority, while Group refers to Crown). In other words, under the terms of the Casino Agreement, it is unlikely that the target company (Crown) will be leveraged with large amounts of debt given the company's limited capacity to enter into such an agreement without approval from the Authority.

Holding total assets constant, Morningstar estimates that a further AUD 1.2 billion in liabilities may result in a breach in the requirements of section 22(ma), as per the fiscal 2015 accounts. The Authority has a strong incentive to prevent a breach of section 22(ma), in that materially higher leverage will heighten Crown's financial risk and potentially impact their revenues.

1 The Casino Agreement can be found at: http://assets.justice.vic.gov.au/vcglr/resources/6899db6c-0201-47cd-beca-4f733e1030af/casino_agreement.pdf

Exhibit 2 Crown: Total Liabilities/Total Assets



Source: Crown, Morningstar Direct

Privatisation Scenarios Present Several Potential Outcomes for Note Holders

Press reports have suggested either a complete privatisation of Crown or the privatisation of some of its assets, namely Melco Crown.

A Complete Privatisation of Crown

A complete privatisation would require CPH (and/or partners) to purchase the outstanding 46.9% of Crown that it doesn't already own. Under this scenario:

(i) Crown may redeem the notes at any time if a Change of Control Event, Tax Event, Capital Event, or Accounting Event occurs (we discuss these events in further detail on pages 10-11). Unfortunately for note holders, none of these events will transpire under the suggested privatisation scenario. As such, we do not expect an early redemption of these notes.

(ii) The notes may remain listed as Crown becomes a private entity. Although this will require continued disclosure, as well as listing fees being payable to the ASX, there are examples of unlisted companies, such as Healthscope, issuing listed notes.

(iii) Although Crown would become a private entity, new management could elect to retain an investment grade credit rating in order for the business to have a lower cost of funds and the availability of a wider choice of funding. This would give Crown incentive to redeem at first call, as the notes qualify as 50% equity credit by ratings agencies until that date.

(iv) Crown could become burdened with debt to the point its credit metrics reflect high-yield levels. Higher funding costs for a high capital expenditure business, in addition to the limitations faced on gearing through the Casino Agreement, make this a low-probability outcome, in our view. Furthermore, management has long argued the merits of maintaining investment grade metrics, although a shift to a private structure could change this.

(v) Privatisation could occur without further leveraging of Crown. For example, a pension fund might elect to fund the purchase out of its own reserves, avoiding the scenario of burdening Crown with further debt. We believe this scenario would be more likely to result in redemption of the notes at first call, compared with a debt funded privatisation.

A Privatisation of Melco Crown

Under a Melco Crown privatisation scenario, CPH could acquire Crown's 34.3% interest in Melco Crown. Under this scenario:

(i) Crown will remain a listed entity and will continue to use the public markets for its funding needs, including subordinated notes. As highlighted in Exhibit 3, Crown's major sources of debt funding include bank debt, European and Australian medium-term notes, the U.S. private placement markets, and subordinated notes. This scenario increases the likelihood of redemption at first call, particularly considering that a key motive for issuing the notes was accessing the 50% equity credit the rating agencies provide up until the first call date.

(ii) Crown will retain an investment grade credit rating as a public entity, with the possibility of a ratings/outlook upgrade when we strip out the Melco Crown earnings uncertainty and add the sale proceeds to the balance sheet. A higher credit rating brings cheaper funding as Crown's earnings streams become more predictable. This increases the likelihood of redemption of the notes at their first call dates so they don't remain on the balance sheet as expensive debt.

(iii) The value of Crown becomes clearer and easier to measure by removing the uncertainty of Melco Crown earnings, which remain clouded by political and regulatory risks in Macau. This will likely leave equity holders and credit holders satisfied, continuing to support access to public funding markets.

Exhibit 3 Crown Debt Maturity Schedule at June 2015

Source: Crown, Morningstar Direct

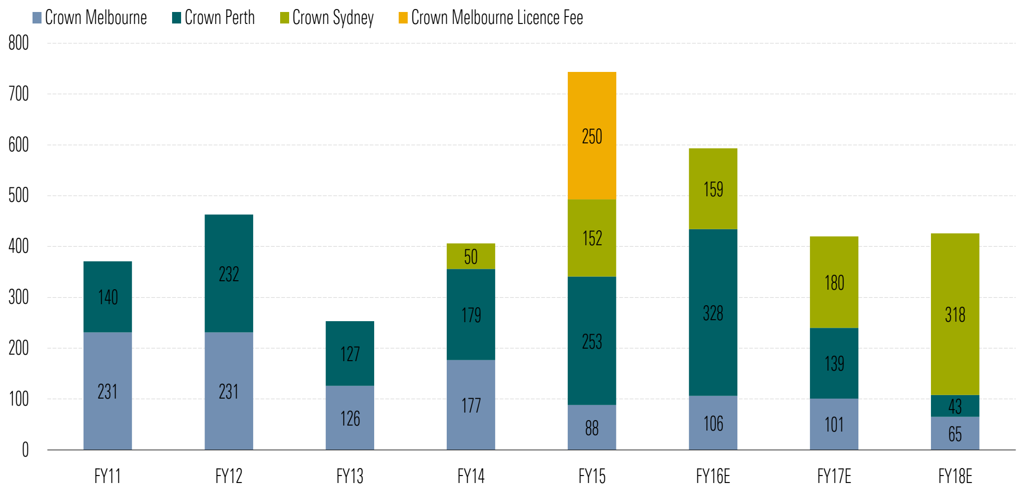
The more desirable scenario for subordinated note holders would be the privatisation of Melco Crown by CPH. This would leave more incentives for Crown not only to redeem the notes at first call, but also to maintain this type of security in Crown's capital structure. Furthermore, we believe this scenario will clarify Crown's value, will cost less than a complete privatisation, and will continue to provide Crown with access to public funding markets to support its growth.

Incentives to Redeem Subordinated Notes

Preserves a Valuable Funding Source

Listed debt securities have been an important funding source for the Packer family since Publishing and Broadcasting (PBL) issued a perpetual note in 1999, which it then redeemed in June 2007. Should Crown management not redeem these notes at their first call date, it will suffer reputational damage that could limit its ability to use such funding arrangements in future, whether this is at Crown or any other entity. For a business with high capital investment requirements, as shown in Exhibit 4, we would question the long-term logic of shutting out a potentially attractive component of the capital structure.

Exhibit 4 Crown Investment in Australian Resorts (AUD, Millions)



Source: Crown, Morningstar Direct

Loss of Equity Credit

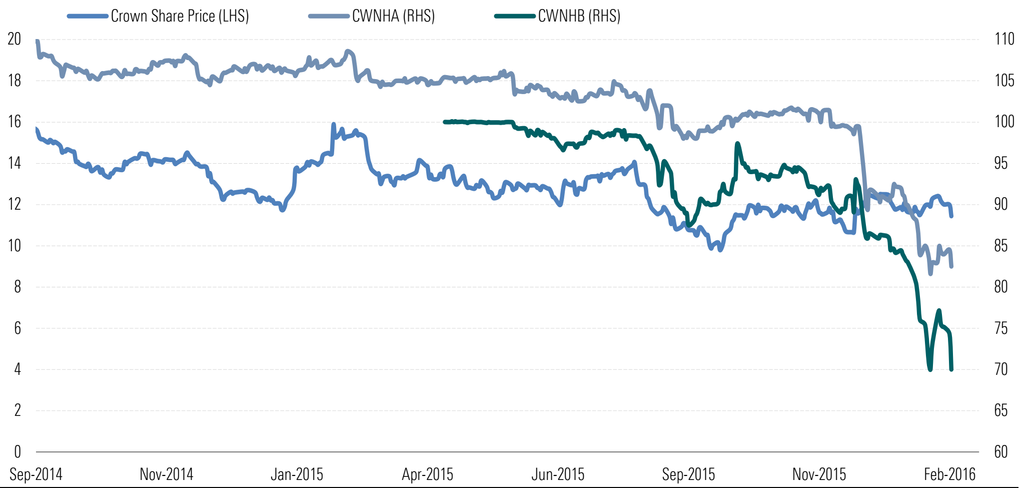
A key driver behind issuing these securities is that Crown enjoys the benefit of 50% equity credit for the total amount outstanding of the notes. As per the rating agency terms, this equity credit will cease after the first call date should the notes not be redeemed, potentially rendering them expensive debt and adversely affecting their investment credit rating. This would add further debt of AUD 266 million at September 2018 when CWNHA is due for its first call and a further AUD 315 million at July 2021 when CWNHB is due for first call. In total, this will add AUD 581 million to Crown's total debt by July 2021. As management continues to reiterate, maintaining an investment grade rating is very important to Crown. Therefore, there is strong incentive to redeem at first call and replace with a new issue.

Reputational Risk

This is a key risk of non-redemption, particularly considering domestic retail investors' general expectation of having their hybrid securities called at the first call date, which seems to be the scenario that investors are currently pricing in, as highlighted in Exhibit 5. In the event this doesn't occur, future subordinated note issuance by Crown, or even entities associated with unredeemed notes, can be expected to face a more difficult and costlier issuance climate, should they return to that market.

In this instance, the argument is that if Crown is completely privatised, there will be no future need for subordinated note issuance; therefore, the company can afford to let the notes run until maturity and absorb the reputational damage in that market. However, there are several counter arguments to this. First, subordinated notes can be issued by a private entity. We have seen this undertaken before, for example by Healthscope and MYOB. If Crown management doesn't redeem the notes, this would likely prevent a return to this market indefinitely, especially if the notes remain outstanding. Second, the reputational damage might even spill over and affect pricing across other funding sources in the capital structure. Finally, while this is within the terms of the prospectus, Crown would risk attracting the attention of the corporate regulator, the Australian Securities and Investments Commission, which might look closely at a privatisation transaction that result in non-redemption and interest payment deferrals.

Exhibit 5 Crown Shares and Subordinated Note Pricing (AUD)



Source: Crown, Morningstar Direct

Removal of Disclosure and Listing Fee Requirements.

As long as CWNHA and CWNHB remain listed, Crown will continue to face disclosure and listing fee requirements. Although we don't view this as a deal-breaker in the context of management's decision to redeem, it is another factor to consider.

James Packer's Direct Exposure to Subordinated Notes

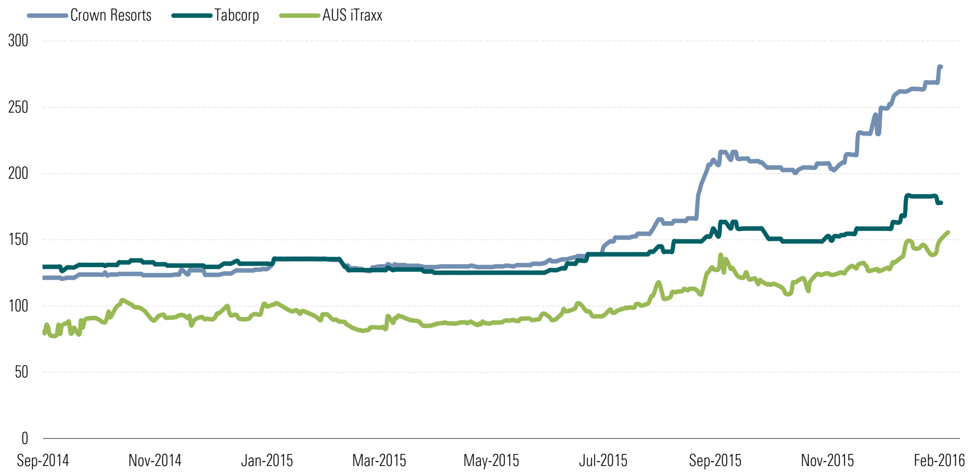
With about AUD 150 million worth of Crown subordinated note exposure, Packer stands to absorb a significant mark-to-market loss on the value of his investment if the notes are not redeemed as well as forego material running interest payments if mandatory or optional deferral of interest occurs.

Incentives Not to Redeem Subordinated Notes

May Represent Cheap Capital

Given the flexibility these securities provide, this may represent cheap capital for Crown, even if the company loses its 50% equity treatment. This would likely happen if Crown is burdened with debt and, after any privatisation transaction, its credit quality decreases to non-investment grade. CWNHA represents a cost of the Bank Bill Swap Rate (BBSW) + 5% (1% step-up in September 2038), whereas CWNHB represents a cost of BBSW + 4% (1% step-up in July 2041). Additionally, as long as the ATO continues to treat CWNHA and CWNHB as debt, Crown will continue to claim the interest payments as tax-deductible.

Exhibit 6 Five-Year Credit Default Swap Comparison (basis points)



Source: Morningstar Direct

Evident in Exhibit 6, Crown five-year credit default swap spreads, or the cost of insuring against default on Crown bonds, have been increasing since speculation regarding privatisation began, although Melco Crown risks and the broader risk-off sentiment have also been drivers of this spread widening. If Crown does go down the privatisation path with higher leverage, this increases the probability that the notes will represent cheap capital as alternative funding sources increase in price, providing further incentive not to redeem.

Liquidity Constraints

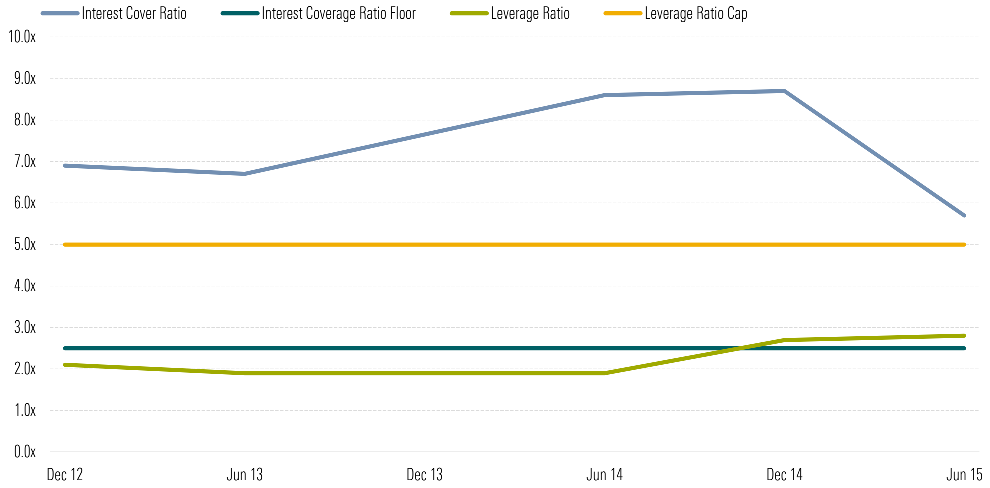
The total cost of calling the notes at their first call date is AUD 1.16 billion. This is not an inconsequential amount, particularly for a business with large ongoing capital expenditure requirements. Furthermore, should Crown be completely privatised, the acquirers might have alternative preferred destinations for their liquidity, rather than redemption of the subordinated notes.

Buyer Beware: The Note Terms and Conditions Allow the Notes to Remain on Issue
There's an expectation within the Australian investor community that hybrid securities should be called at first call date. However, a decision not to call the notes at the first call date is in line with the terms and conditions of the securities. Often referred to as extension risk, this is outlined in the prospectuses.

Mandatory and Optional Deferral of Interest Payments
Should Crown breach its subordinated note covenants, it will be required to suspend interest payments to holders under the requirements of mandatory deferral. Under the terms of both CWNHA and CWNHB, a mandatory deferral event occurs if Crown's:

(i) Leverage ratio is above 5.0 times for two consecutive testing dates; or
(ii) Interest cover ratio is below 2.5 times on any testing date; and
(iii) Crown has a solicited rating from a rating agency.

Exhibit 7 Crown Subordinated Note Mandatory Deferral Covenants



Source: Crown, Morningstar Direct

As seen in Exhibit 7, at June 30, the leverage ratio was 2.8 times and the interest cover ratio was 5.7 times, both within the requirements of the covenants. However, there has been a noticeable weakening in the interest cover ratio in recent years as interest expense increase while Melco earnings fall.

The requirement that Crown have a solicited rating from a rating agency implies that, should Crown withdraw its credit rating (which is a possibility under a full privatisation scenario), mandatory deferral won't apply, although optional deferral will.

Under the terms of optional deferral, Crown may determine "in its sole discretion" not to pay interest on the notes. Some consolation to investors is that deferred distributions, through either optional or mandatory deferral, are cumulative and compounding. So, assuming that Crown remains a going concern, investors will collect all accrued compounded distributions, but potentially not until legal maturity: 2072 for CWNHA and 2075 for CWNHB.

The terms and conditions for both CWNHA and CWNHB contain what is referred to as a dividend stopper. This prevents Crown or its subsidiaries from declaring or paying dividends, interest, or distributions on (or redeeming, reducing, cancelling, purchasing, or buying back) any equal- or lower-ranking obligations in the capital structure, such as ordinary equity. Dividend stoppers act as a deterrent to deferring interest payments and are a key driver behind our expectation that interest payments on the subordinated notes will not be deferred.

CWNHA also has a "dividend pusher" in the case of mandatory deferral. In other words, if Crown pays an ordinary dividend or purchases ordinary shares during a period of mandatory deferral, Crown must pay any mandatorily deferred interest payments no later than five years from the date of initial deferral.

Is a Credit Rating Important If Crown Is Privatised?

The maintenance of a credit rating, preferably investment grade, will support access to global capital markets, both public and private. Furthermore, it will serve as an important indicator of Crown's credit profile, should management retain outstanding debt or intend to issue new debt in the future.

If Crown becomes fully privatised and withdraws its credit ratings, it will either allow its outstanding debt to become unrated or buy it back. In the event that Crown debt becomes unrated and remains outstanding, some holders of the debt may have to sell, if their investment mandates don't allow holding unrated bonds. This scenario limits future funding options, owing to investor preference for rated debt.

Maintaining a credit rating isn't critical to a fully privatised Crown; however, we believe that from an operational viewpoint, credit ratings are important for underscoring the relative strength of a business, making funding easier in the long term. Therefore, a structure that can leverage off an investment grade rating is likely to be a key consideration for Crown management.

Crown's Redemption Rights

Crown may redeem the notes on their first call date or on any interest payment date thereafter. Crown may also redeem the notes at any time if a Change of Control Event, Tax Event, Capital Event, or Accounting Event occurs.

Change of Control Event

A Change of Control Event occurs if any person or party other than CPH (or certain related persons or associates) acquires more than 50% of Crown's shares. Under this scenario, there will be a 5% step-up in the margin of the notes if they are not redeemed by Crown. If, as the media is speculating, CPH takes Crown Resorts private, this would not constitute a Change of Control Event, meaning that there would be no change in the interest margin and no trigger to force redemption of the notes before first call date.

Tax Event

A Tax Event occurs if any interest payment would not be deductible for tax purposes as a result of a change in law or interpretation of law.

Capital Event

A Capital Event occurs if the notes are no longer eligible for the same or higher category of equity credit from a rating agency as was initially attributed to them at the time of issue, as a result of a change in the rating agency's assessment criteria.

Accounting Event

An Accounting Event occurs if there is a change in generally accepted accounting principles and applicable approved accounting standards in Australia after the issue date, and if the relevant rating agency confirms publicly or in writing to Crown that, as a result of this change, the application of mandatorily deferred interest payments for the subordinated notes will no longer satisfy its criteria for them to receive the same equity credit as they received at the time of issue.

Holders of the notes do not have a right to request redemption, unless Crown defaults on a payment. Deferral of interest payments do not qualify as a default.

Security Investment Risk: Increase to High for CWNHA and CWNHB

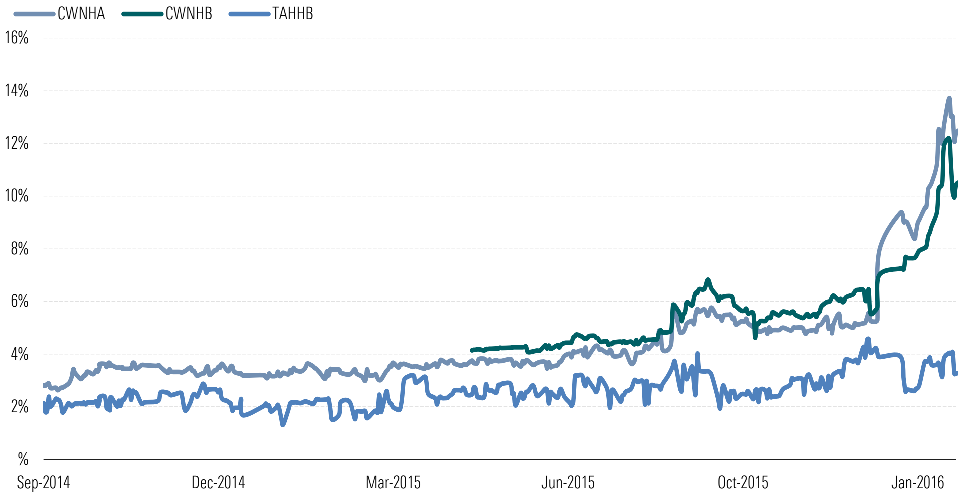
We are increasing our security investment risk on CWNHA and CWNHB from Medium to High, giving these securities the same investment risk rating as the Origin Energy Notes and Seven TELYS4. CWNHA and CWNHB have a number of issuer favorable terms, namely the ability to optionally defer interest payments until the final maturity dates (2072 and 2075, respectively) and CPH's ability to take over Crown without triggering a Change of Control event.

Pricing: Upgrade CWNHA to Accumulate, Hold Retained on CWNHB

Since speculation began regarding potential privatisation, CWNHA and CWNHB have suffered sharp price falls as investors continue to price in downside scenarios. At the close of trading on 10 February, CWNHA was trading at $83.00 on a trading margin of 13.10%, a running yield of 9.23%, and a yield to call of 16.95%. CWNHB was trading at $70.35 on a trading margin of 12.08%, a running yield of 9.40%, and a yield to call of 15.33%.

While this is not an exact like-for-like comparison, we have included the Tabcorp subordinated notes, or TAHHB, in Exhibit 8 to highlight the dramatic spike in the CWNHA and CWNHB trading margins. Admittedly, TAHHB does have a shorter term until first call (approximately one year) than CWNHA (approximately 2.5 years) and CWNHB (approximately 5.5 years), while Crown earnings remain vulnerable to Melco Crown earnings uncertainty.

Exhibit 8 Trading Margin Performance



Source: Morningstar Direct

On an absolute valuation basis, we believe both securities are now at levels that provide attractive risk-reward propositions for high-risk investors, remembering that subordinated notes should not be viewed as a like-for-like substitute for government-guaranteed term deposits or traditional fixed-income products.

We believe that current pricing is factoring in a high probability of the downside scenario that (i) the notes are not redeemed at first call, and (ii) interest payments are deferred. However, this is not our base case, for reasons we have discussed throughout this report.

On a relative basis, we prefer CWNHA to CWNHB, owing to the higher coupon and the greater transparency provided by a shorter term to reset. CWNHA has a higher trading margin than CWNHB, as the market begins to price the notes as perpetual securities. In the event that the notes aren't redeemed at first call, but the interest payments continue to be made, running yield becomes the more relevant metric for comparing relative value. On this basis, we don't see the logic of going three years further out on the term to reset the curve for a lower yield to call and a minor pickup on the running yield. Furthermore, CWNHA has a higher coupon margin than CWNHB (5%, versus 4%), and this higher cost of servicing CWNHA provides Crown a stronger incentive to redeem CWNHA. For these reasons, we upgrade CWNHA from Hold to Accumulate and maintain a Hold on CWNHB.

Key Risks to Our Recommendation

Credit Risk: Credit risk refers to the risk that Crown defaults on a payment, such as an interest or principal payment.

Liquidity Risk: Liquidity risk in this context refers to the ability to buy or sell a security for a fair price on a timely basis. Low levels of liquidity make it difficult to buy or sell a hybrid, raising the risk of having to buy at an inflated price or sell at a capital loss. For investors that plan to hold the subordinated note to maturity, liquidity risk is not a key concern.

Extension Risk: Extension risk is the risk that CWNHA or CWNHB are not redeemed at the first call date, which may see the securities trade like perpetual securities. We believe current pricing on the notes is already reflecting an element of extension risk.

Subordination Risk: Debt and hybrid securities typically consist of unsecured, subordinated investments, so in a wind-up scenario, investors could potentially lose all of their investment. Furthermore, in the event of the issuer issuing further equal- or higher-ranking securities on the capital structure, the security may effectively become further subordinated.

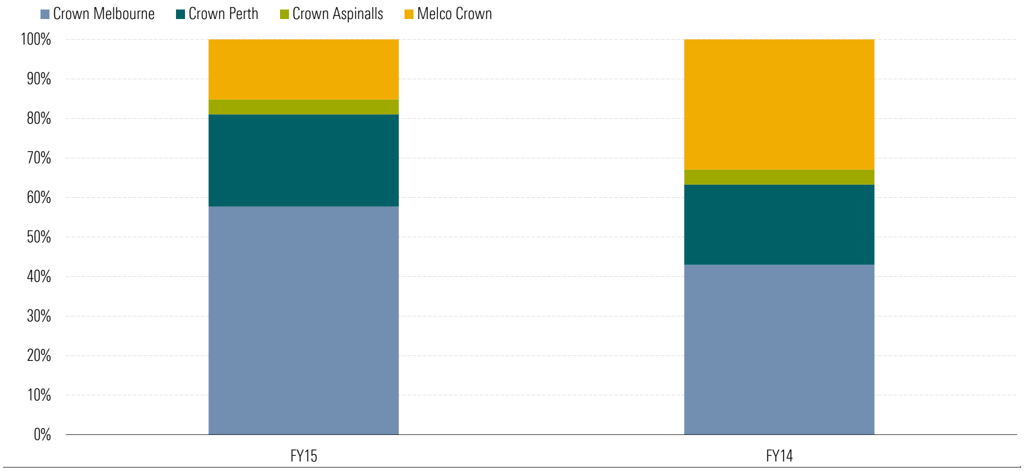
Market Price Risk: The market price of a debt and hybrid security could decrease below face value, depending on various market-related factors, such as credit spreads, interest rates, or the issuer's underlying performance.

Regulatory Risk: Regulatory risk is always present in the gaming sector, including potential tax increases, gambler harm minimisation measures, and unforeseen changes in governments' attitudes towards new licence issues, both in Australia and in overseas markets where Crown operates.

Issuer Investment Thesis

Crown Resorts operates strong-performing casinos in Melbourne and Perth, both of which boast impressive EBITDA margins of close to 30%. Management has a track record of consistent reinvestments into the properties, resulting in peerless property quality, stable visitor growth, and proven earnings resilience. While the VIP, or high-roller, business introduces some volatility into the consolidated business mix, the high VIP turnover provides some stability to the win rate and protects the company against "single-whale" risks. Highlighted in Exhibit 9, these dependable earnings and the free cash flow from the domestic casinos furnish the company with a strong defensive quality.

Exhibit 9 Crown Net Profit After Tax Contribution



Source: Crown, Morningstar Direct

These integrated Australian casino-entertainment-hotel complexes are also backed by long-term casino licences, with the one in Melbourne expiring in 2050, and that in Perth expiring in 2060. The onerous entry barriers stemming from these casino licences lead to a narrow economic moat for Crown Resorts, one that is further supported by the status of 34.3%-owned Melco Crown Entertainment as one of only six concession holders to operate casinos in the gambling mecca of Macau.

Further augmenting this thesis is the longer-term upside potential from various projects in the expansion pipeline. Chief among them is the entry into the lucrative Sydney casino market with the opening of Crown Sydney in 2019-20; this will be focused on the premium end of the gambling market, but it could encroach upon the mass market, depending on the size of the bet limits implemented.

We assign a Standard stewardship rating to Crown Resorts. The company's operating prowess is clearly demonstrated in the impressive long-term earnings track record of both Crown Melbourne and Crown Perth. In terms of capital allocation, the company rates well, with a consistent and astute investment track record for the Australian casinos. This is partly offset by a conservative payout policy and what could be viewed as a mixed acquisition track record overseas, which led to substantial write-downs in fiscal 2009.

Economic Moat

We believe Crown Resorts benefits from a narrow economic moat. Each of Crown Resorts' properties enjoys a privileged position, with a long-term casino operating licence from the relevant state government (expiring in 2050 for Crown Melbourne and 2060 for Crown Perth). This licensing regime creates an onerous barrier to entry, which acts as an intangible quality that underpins its economic moat. Furthermore, management has a consistent track record of reinvestment, resulting in a scale that is sufficiently large to deter new entrants in the unlikely event that governments decide to issue more licences in Crown Resorts' markets. Its economic moat is further supported by the market position of 34.3%-owned associate Melco Crown Entertainment. It is one of only six concession holders to operate casinos in Macau, which is by far the world's largest gaming market, and the only Chinese territory where gambling is legally permitted.

On the other hand, we believe this economic moat is narrow, rather than wide. While table-game gamblers and general casino-experience patrons have no alternatives in either Melbourne or Perth, the switching costs are very low for electronic gaming machine players, who we estimate account for 15%-20% of the group's revenue base. Furthermore, Crown Resorts generates 30% of its revenue from VIPs, or high rollers, who move quite freely between casinos, depending on the level of rebates and "comps". While the 34.3%-owned Melco Crown Entertainment is one of only six concession holders to operate casinos in Macau, changes in the licensing regime beyond the next 10 years are hard to predict.

Crown Resorts' moat trend is currently stable. In our view, it is highly unlikely that the next five or 10 years will see any significant changes in the casino licensing regime in the company's current operating markets in Melbourne and Perth. With the securing of the second casino licence in Sydney from November 2019, Crown Resorts is also set to expand its addressable market considerably in Australia. In Macau, while competitive pressure is ever-present, Melco Crown Entertainment is likely to maintain its market share, as the company opened its own Studio City in the area in October.

On the other hand, Melco Crown Entertainment's concession to operate casinos in Macau is due to expire in 2022. As that expiry approaches, much speculation and concern will surface as to what the Macau government might do. However, given the quality of the casinos that have been (and will be) built, and the significant capital that has been sunk, we think there is a low risk of the concession not being renewed or extended. Still, a renewal or extension of the concession will likely come at a cost, most likely in the form of higher taxes and further undertakings that greater investment will be made in nongaming facilities to help Macau diversify away from gambling.