CREDO WEALTH

Still a good bet

Over recent weeks, amidst a barrage of negative news flow, we have received several questions from investors about our thought process regarding our investment in Crown Resorts. Therefore, we thought that we would take the opportunity to set out our thinking.

Firstly, a quick recap: Crown Resorts operates casino resorts in Melbourne and Perth. We purchased the company in 2017. At the time, they were in the process of building a new resort in Sydney, which was due to open in 2020 and we believed that the full potential earnings of this were not reflected in the share price. The reason for the negative sentiment was that the Chinese government had in the previous year clamped down on marketing by foreign casinos to local "VIPs" (high rollers), a common practice up to that time. Unfortunately, as part of this crackdown, 18 Crown employees were detained. As a result, Crown ceased all marketing in both China and South East Asia and in 2017 saw a c.50% fall in VIP gaming revenue. Competitors who had only ceased marketing in China but not in South East Asia experienced a smaller drop in revenue. Post the earnings reset, we believed Crown's VIP business had an opportunity to regain some of the lost business.

In April 2019, leaked media reports suggested that Crown were in talks to be acquired by Wynn Resorts. In hindsight, the leak could not have come at a more awkward time. Wynn had presumably hoped to lock down the final price and terms via an agreed scheme of arrangement, before announcing it to the market and US state regulators. However, under Australia's continuous disclosure regime, Crown was obligated to release a statement confirming they had received a proposed offer of AUD 14.75 per share. Once news of the talks came out, Wynn pulled out of discussions.

In May 2019, Melco Resorts agreed to buy a 19.9% "strategic stake" in Crown from James Packer, who controlled 45% of Crown, at AUD 13.00 per share. Melco's CEO said in a statement that he welcomed the opportunity to increase their stake in Crown, subject to regulatory approvals. In other words, Melco wanted to bid for the company if regulators approved them as suitable. Despite buying the first 10% in July 2019, unfortunately, the purchase of the second 10% was called off due to the Coronavirus pandemic. Furthermore, in early 2020, Melco was forced to sell their stake to Blackstone, due to their own liquidity issues.

In the second half of 2019, a media expose prompted a public inquiry in New South Wales ("NSW") into whether Crown was suitable to operate the new Sydney Casino. Crown allowed Asian "junkets" to operate separate VIP areas within their other casinos, catering to Chinese high rollers. The report alleged that some of these patrons had ties to Asian crime syndicates and laundered money through the Melbourne casino. This prompted further inquiries to be announced by the Victoria (Melbourne) and Western Australian (Perth) State governments.

In February 2021, the NSW inquiry found Crown to be unsuitable to hold the licence in their current state. However, it also offered Crown a path to becoming suitable if they implemented the recommended reforms – notably a forensic audit, restructuring of the Board of Directors and implementing a comprehensive compliance function, reporting directly to the Board, with independent oversight to monitor progress. ▶▶

Despite the ruckus, a bidding war subsequently erupted, with Crown receiving three separate proposals in just the last six months along with rumours of others. In May, Crown rejected an AUD 12.35 per share cash offer from Blackstone as it undervalued the company. Crown also received an all share offer from Australian rival, Star Entertainment, at over AUD 14.00 per share. Separately, Oaktree offered to invest AUD 3bn in Crown via debt and convertible notes, which would enable Crown to buy back the 35% stake still held by Packer, who has precipitated Crown's current problems.

In May this year, an Australian newspaper reported that Crown's Sydney casino was likely to open by the end of the year, citing comments from NSW ILGA Chair Philip Crawford at a press conference, where he said that he was pleasantly surprised by the reform efforts.

Unfortunately, during the ongoing Victoria (Melbourne) inquiry and forensic audit, old revelations have been rekindled and new revelations have come to light regarding underpaid taxes. The tax issue relates to Crown incorrectly deducting customer incentives from the gaming revenue and paying tax on the lower number. Whilst Crown has pre-emptively paid back the taxes, including penalties, it is possible that the total exposure could end up being higher.

Last week the counsel assisting the Victoria inquiry told the commission that Crown was not presently a suitable person to hold a licence. At the same time, he acknowledged that, "cancellation of the casino licence with immediate effect ...... would be highly disruptive - having the potential to cause significant harm to many third parties who have had no involvement whatsoever in the misconduct of Crown Melbourne over the years". Crown Melbourne is the largest single site employer in the State, accounting for approximately 12,500 jobs. The company also contributes over 10% of Victoria State's total tax take. The council noted further "if the decision is taken that it is no longer appropriate for Crown Melbourne to hold the casino license in Victoria, some level of disruption will be inevitable, but if the end result is the grant of a new license to a person who is suitable, then that disruption may itself be in the public interest in the long run".

From this, we can deduce two likely recommendations from the enquiry in Victoria and neither involves shutting down the casino. In the best-case scenario, as happened in Sydney, the inquiry could find Crown currently unsuitable to hold a licence but set out a pathway to becoming suitable. Likely through implementing reforms within a certain timeframe and allowing them to operate under supervision in the interim. In the worst-case scenario, if Crown were found irredeemable, any cancellation of Crown's licence would be deferred for a period (say 12-18 months), to protect jobs, State tax receipts, and allow for an orderly sale process to a suitable person, as a going concern.

Subsequent to the council's submission, Star Entertainment withdrew its offer, citing the uncertainty about Crown's ability to retain their Melbourne licence, whilst "remaining open to exploring potential value-enhancing opportunities with Crown". For their part, Crown remains willing to engage. We do not believe Star's interest in Crown's assets has waned, rather this is a change in tack reflecting the reality that Crown might need to be broken up if there are the disparate State enquiry recommendations. ▶▶

Whatever the case, the private market value of Crown is substantially higher than what the current share price implies. Crown's assets are world class - highly profitable, based in attractive jurisdictions, near large growing population centres, operating a monopoly, duopoly licences, with very long tenures (50 years). The assets themselves do not require any turnaround or strategic fix. All that is needed is a change of control and implementation of compliance best practices. We are confident that there are many bidders waiting for the outcome of the inquiries before making a move.

Important notice