Research Highlights

A weekly summary of our Best Ideas and developments within our coverage universe

All Wireless Spectrum Isn't Created Equal: Some Holdings Protect Moats, but Overvaluation Will Ultimately Limit Returns

17 November 2014 – 21 November 2014

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All market data as of Nov. 20, 2014.

All Wireless Spectrum Isn't Created Equal: Some Holdings Protect Moats, but Overvaluation Will Ultimately Limit Returns

Spectrum is the lifeblood of the wireless industry. Without it, wireless services of all kinds couldn't exist. Industry participants are now embroiled in a debate about the ultimate value of spectrum as wireless data demand continues to skyrocket. Regulators are at work to make more of this resource available in the U.S., with two auctions set to conclude over the next couple of years. Lost in the rhetoric, we believe, is careful consideration of how the wireless network is evolving and the high quality of service it is providing today, well into the heart of smartphone adoption. In addition, we believe claims regarding spectrum valuation fail to consider the basic economics of the wireless business. Spectrum ultimately has no value to private enterprise if an adequate profit can't be made in putting it to use.

In this piece, we examine the current spectrum landscape, exploring which carriers are best positioned today and the prospects for additional spectrum coming to the market. We also look at the technologies that are reshaping how wireless networks function, making better use of existing spectrum and providing more capacity where it is needed most. We believe technology, and the nature of wireless networking, will help restrict spectrum demand. Finally, we look at carrier profitability and the ability of the U.S. wireless industry to justify, economically, additional investment in spectrum. We find that AT&T and Verizon are exceptionally well positioned today versus Sprint and T-Mobile. In addition, only these giants generate adequate profits to justify investing additional capital in their wireless businesses. Over the near term, we believe T-Mobile's spectrum position is adequate to serve customers well.

Key Takeaways:

- Raw statistics don't tell the whole spectrum story. While AT&T and Verizon may not have the "most" spectrum in some markets, these two giants have the best positioning of any carrier by far. Both hold deep positions in the low-frequency bands for use in providing broad coverage and solid holdings elsewhere, providing the ability to add capacity where needed. Spectrum forms a key pillar in our narrow economic moat ratings on these firms, and we expect both will remain stalwarts of the telecom industry for years to come, making both solid portfolio holdings. At current prices, AT&T looks slightly more attractive on a pure valuation basis, but the difference is modest.

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- The need to invest in spectrum, either for legitimate capacity needs or to limit competition, at prices that are ultimately dictated by the U.S. government and the FCC limits the attractiveness of these businesses. We expect future spectrum purchases will pressure returns on capital at both Verizon and AT&T. Neither firm generates spectacular returns today. Given the maturity of the business, uncertainty around technological changes, and the potential for fluctuation in the competitive landscape, this downward pressure precludes us from assigning either firm a wide moat.

- T-Mobile's spectrum position is solid today thanks to its deep midband holdings and modest market share. We expect the firm will continue to perform well over the next couple of years as it puts this spectrum to use. T-Mobile still needs to boost its low-frequency spectrum holdings, though, if it ever hopes to match the network coverage and quality that AT&T and Verizon can deliver. The 700 MHz A block is a great first step, but T-Mobile has a long way to go to complete its holdings in this block. The firm will also need to fight against AT&T and Verizon in the broadcast auction to add additional low-frequency capacity. As the auction is currently constructed, we question T-Mobile's ability to fend off these far larger rivals. We doubt T-Mobile can count on Deutsche Telekom for financial support. Given its weak balance sheet and poor cash flow, we would look for a wide margin of safety before investing.

- Sprint's massive high-frequency (BRS/EBS) spectrum holdings have tremendous potential value, but these licenses are tricky to deploy and face inherent propagation limitations. As a result, we question Sprint's ability to extract the full value of these holdings on its own. The firm's recent decision to further curtail capital spending as it seeks to stabilize market share speaks to the challenges it faces. Additional capital from Softbank could radically alter this picture, but the cost to minority shareholders is clearly unknown. Sprint would also benefit greatly from the addition of more low-frequency spectrum, making the broadcast auction a critical event for the firm. As with T-Mobile, we question Sprint's ability to fend off AT&T and Verizon to gain the spectrum it needs, even with Softbank's financial support. We would only invest in Sprint with a very large margin of safety, taking a cautious approach to the value of its spectrum holdings.

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- We believe T-Mobile is a more attractive investment than Sprint, especially at current prices. Weak profitability coupled with relatively weak spectrum positions has painted both Sprint and T-Mobile into a corner strategically over the long term. Our no-moat ratings on these firms reflect this view. We believe M&A activity is the only viable long-term way out. A merger between the two firms is unlikely absent a major change at the FCC, perhaps after the 2016 election. T-Mobile is more likely to participate in M&A in the interim, given DT's marginal attachment to the company. As a result, we believe T-Mobile is more likely than Sprint to create a catalyst to eliminate any discount to fair value that emerges in its stock price. We also expect T-Mobile to face far fewer execution issues over the next couple years thanks to the recent revitalization of its brand and the relative network simplicity its spectrum position affords.

- We believe investor enthusiasm around spectrum valuation has pushed DISH Network's share price far beyond a reasonable level. While DISH has created a lot of value through its spectrum dealings to date, a conservative approach is appropriate in valuing the firm's spectrum holdings. The firm's options for its AWS-4 licenses are limited, as it must choose between using AWS-4 as it is currently set up—risking interference problems—or converting the entire band to downlink capacity—severely limiting its upstream capabilities. The firm's holdings of low-frequency spectrum are also extremely limited. DISH would benefit greatly from the addition of a carrier partner. However, we expect existing carriers will focus on deploying unused spectrum, refarming spectrum to new technologies, adding site density, and participating in government auctions before turning to DISH. Build out requirements on DISH's licenses limit the firm's ability to sit on spectrum for long.

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Strike While the Iron Is … Cold? Picking Steelmaking Winners in Iron Ore's New Normal

Cheap iron ore will have profound implications for the steel industry. Iron ore's new normal will mean lower steel prices and a flatter cost curve. At the company level, cheaper iron ore means different things for different players, which this report examines in depth. We strongly prefer firms that compete on conversion costs rather than input costs, and Nucor remains a Best Idea. Favorable end-market exposures are a secondary consideration in surveying long-term investment opportunities in the steel industry, as this advantage tends to be fleeting.

Key Takeaways

- Low iron ore prices will redefine how steelmakers compete. Input costs will remain a key driver of competitiveness but will diminish in relative importance. Conversion costs are increasingly critical. Firms with low conversion costs like Nucor and Ternium are poised to benefit in the new competitive landscape.

- Vertical integration loses its strategic appeal. Upstream exposure has always meant higher earnings volatility (fixed costs/variable prices), but the downside wasn't apparent amid high iron ore prices.

- Vertically integrated steelmakers will suffer margin contraction. Falling iron ore prices portend lower steel prices but provide no cost relief for vertically integrated players like CSN and U.S. Steel. Over the long term, we expect steel demand growth and better leverage over fixed costs to be the saving grace for these otherwise challenged companies.

- Our in-depth look at iron ore procurement costs uncovers some misconceptions. For example, we find that concerns about ArcelorMittal's upstream investments are overstated, allowing for a very attractive entry point on a promising turnaround story.

- Nucor, Ternium, and ArcelorMittal are our top three picks in the steel space.

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Healthy Profits Ahead for Express Scripts

Express Scripts is currently trading at a material discount to our $89 fair value estimate. We believe this is partly because some market participants lack confidence in the firm's ability to churn out solid profit expansion. From our perspective, Express Scripts has the opportunity to leverage positive macro and micro dynamics into long-term value creation. The confluence of a wide economic moat, growing pharmaceutical use in the U.S., and the need of payers to control health care costs will provide a strong bedrock for the firm to solidify its services, eliminate redundant costs, and leverage its scale advantages.

Key Takeaways

- We believe several positive trends will support the firm's operations. From our perspective, the pharmacy benefit manager's profit expansion over the coming years will be driven largely by the increasing need for its cost management services, greater centralized cost efficiency, and its position as one of the most powerful players within the entire health care sector.

- Over our explicit forecast period (2014-18) we believe gross profit per adjusted claim will increase by $1.58 to $6.99 driven by Express Scripts' significant supplier pricing advantages and increasing demand for its cost management services.

- Medco synergies and leverage should improve SG&A, leading to operating profit per adjusted claim increasing by $2.93 to $5.30. The lack of market conviction in operating margin improvement leads to our 2018 EPS estimate of $10.53, well ahead of consensus of $7.15.

- With payers looking at every option to curb health care expenses, shifting U.S. demographics, expanded health benefit coverage for most U.S. residents, and the growing use of pharmaceuticals as a first treatment option, we strongly believe Express Scripts' cost management services will become increasingly more critical and allow it to grow its spread retention at a good pace.

- Due to the new executive management structure and $1.0 billion targeted in cost savings, we believe the firm is back on track with its Medco synergy plan and has recovered from its initial integration missteps. From our perspective Express Scripts should be able to reach a normal operating level by the end of 2015, with SG&A scale taking hold and a resumption of normalized client retention rates.

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Utilities' Dividends Still Best of the Breed: Valuations Are Rich, but Sector Finances and Growth Are Super Strong

Although utilities' valuations appear historically rich, the sector's financial health, dividend growth outlook, and relative yield are as good as they have been in decades. Long-term investors searching for secure income that can grow faster than inflation should consider some of these highlighted utilities as long as they're willing to take some risk that the sector will underperform the market in the near term if interest rates start climbing. The utilities sector's yield paradox is sending mixed messages. On the one hand, the sector appears overvalued, trading at a 9% premium to our fair value estimates, an 18 P/E, and a 3.7% dividend yield that is below the sector's long-term average. However, income investors should like that utilities' average dividend yield still represents a historically attractive 136-basis-point premium to the 10-year U.S. Treasury yield. After meeting with more than 30 management teams at the Edison Electric Institute Financial Conference on Nov. 11-13 in Dallas, we think income investors should watch the following utilities.

Key Takeaways

- Hot dividend growth on tap: We think narrow-moat utilities CenterPoint Energy, Edison International, and Wisconsin Energy are poised to produce the best dividend growth in the sector during the next three years. On a valuation basis, CenterPoint is the most attractive, trading near our $25 per share fair value estimate, with a 4% yield and 12% annual dividend growth outlook.

- Stable, secure, long-term growth ahead: These won't shock you with hypergrowth, but American Electric Power, NextEra Energy, and Westar Energy have strong financial profiles and an investment runway that foretells above-inflation dividend growth for at least the next five years.

- A few utilities are still working through their challenges. Dividend growth could be several years off for Exelon and PG&E. We think TransAlta is the only utility at risk for a dividend cut even after cutting its dividend 38% in early 2014.

- For most utilities, environmental regulations and low load growth are key challenges. But there continue to be plenty of investment opportunities in transmission and renewable energy to keep most utilities' dividends growing.

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Best Ideas

	Price	Fair Value	Price/ Fair Value	Market Cap	Economic Moat Rating	Uncertainty Rating	Morningstar Rating	Analyst
Basic Materials								
Alumina Ltd (AWC)	1.72	3	0.66	4.83	None	High	★★★★	Taylor, Mark
BHP Billiton Ltd (BHP)	31.70	40	0.79	168.76	Narrow	Medium	★★★★	Taylor, Mark
BHP Billiton PLC (BLT)	1,662.00	2,175	0.76	88.48	Narrow	Medium	★★★★	Taylor, Mark
Monsanto Co (MON)	119.52	130	0.92	57.86	Wide	Medium	★★★	Stafford, Jeffrey
Nucor Corp (NUE)	54.23	62	0.87	17.30	Narrow	Medium	★★★★	Lane, Andrew
Rayonier Advanced Materials Inc. (RYAM)	25.70	47	0.55	1.10	Narrow	High	★★★★★	Rohr, Daniel
Communication Services								
KDDI Corp (KDDIY)	16.19	18	0.90	54.07	Narrow	Medium	★★★★	Nichols, Allan C.
Consumer Cyclical								
Amazon.com Inc (AMZN)	330.54	375	0.88	153.04	Wide	High	★★★	Hottovy, R.J.
Crown Resorts Ltd (CWN)	14.02	19	0.74	10.21	Narrow	High	★★★★	Han, Brian
eBay Inc (EBAY)	54.54	63	0.87	67.76	Wide	High	★★★	Hottovy, R.J.
Fiat Chrysler Automobiles NV (FCAU)	12.22	19	0.64	14.92	None	High	★★★★	Hilgert, Richard
General Motors Co (GM)	32.13	53	0.61	51.62	None	High	★★★★★	Whiston, David
Norwegian Cruise Line Holdings Ltd (NCLH)	41.71	42	0.99	8.48	Narrow	High	★★★	Katz, Jaime
Priceline Group Inc (PCLN)	1,153.88	1,500	0.77	60.41	Narrow	High	★★★★	Fleck, Adam
PVH Corp (PVH)	123.00	145	0.85	10.13	Narrow	High	★★★★	Weishaar, Bridget
REXAM PLC (REX)	443.30	550	0.81	3.12	Narrow	Medium	★★★★	Wenning, Todd
Swatch Group AG (UHR)	466.90	640	0.73	25.98	Wide	High	★★★★	Swinand, Paul

Best Ideas

	Price	Fair Value	Price/ Fair Value	Market Cap	Economic Moat Rating	Uncertainty Rating	Morningstar Rating	Analyst
Consumer Defensive								
Procter & Gamble Co (PG)	88.47	94	0.94	239.06	Wide	Low	★★★★	Lash, Erin
Energy								
BG Group PLC (BG.)	1,069.00	1,400	0.76	36.49	Narrow	Medium	★★★★	Good, Allen
BP PLC (BP)	41.77	56	0.75	127.48	Narrow	Medium	★★★★	Simko, Stephen
Cabot Oil & Gas Corp (COG)	34.71	46	0.75	14.34	Narrow	High	★★★★	Hanson, Mark
Petroleo Brasileiro SA Petrobras (PBR)	9.71	21	0.46	63.33	None	Very High	★★★★★	Good, Allen
Santos Ltd (STO)	11.94	18	0.66	11.54	Narrow	High	★★★★	Taylor, Mark
Schlumberger NV (SLB)	96.14	145	0.66	123.71	Wide	Medium	★★★★★	Bellinski, Robert
Tullow Oil PLC (TLW)	505.00	700	0.72	4.60	Narrow	High	★★★★	Simko, Stephen
Financial Services								
Apollo Global Management LLC (APO)	23.75	40	0.59	9.16	Narrow	High	★★★★★	Ellis, David
Australia and New Zealand Banking Group Ltd (ANZ)	31.82	39	0.82	87.72	Wide	Medium	★★★★	Ellis, David
Lloyds Banking Group PLC (LLOY)	78.49	94	0.84	56.02	Narrow	High	★★★★	Davis, Erin
Synchrony Financial (SYF)	29.24	33	0.89	24.38	Narrow	High	★★★	Werner, Dan
Health Care								
Baxter International Inc (BAX)	71.99	84	0.86	39.02	Wide	Low	★★★★	Andersen, Karen
Catamaran Corp (CTRX)	49.61	57	0.87	10.29	Narrow	Medium	★★★★	Lekraj, Vishnu
Elekta AB (EKTA B)	76.75	95	0.81	29.26	Wide	Medium	★★★★	Morozov, Alex
Express Scripts (ESRX)	79.89	89	0.90	58.63	Wide	Medium	★★★★	Lekraj, Vishnu
Sanofi (SAN)	75.02	91	0.82	99.09	Wide	Medium	★★★★	Conover, Damien

Best Ideas

	Price	Fair Value	Price/ Fair Value	Market Cap	Economic Moat Rating	Uncertainty Rating	Morningstar Rating	Analyst
Industrials								
AGCO Corp (AGCO)	44.17	55	0.80	4.06	None	High	★★★★	Webb, Kwame
MSCI Inc (MSCI)	48.01	53	0.91	5.38	Narrow	High	★★★	Wahlstrom, Peter
Technology								
Altera Corp (ALTR)	35.84	41	0.87	10.92	Narrow	Medium	★★★★	Ng, Andy
Utilities								
Calpine Corp (CPN)	23.22	28	0.83	9.05	None	High	★★★★	Bischof, Andrew
Exelon Corp (EXC)	35.94	41	0.88	30.89	Wide	Medium	★★★★	Miller, Travis

Exelon Corp. EXC

Morningstar Rating	Industry	Market Cap (GBX Bil.)	Market Price	Fair Value	Price/Fair Value	Fair Value Uncertainty	Economic Moat™ Rating
★★★★	Utilities – Regulated	30.89	35.94	41	0.88	Medium	Narrow

"We are reaffirming our $41 per share fair value estimate, wide economic moat, and stable moat trend ratings for Exelon."

Analyst Note as of 12 Nov 2014:

We are reaffirming our $41 per share fair value estimate, wide economic moat, and stable moat trend ratings for Exelon after discussing the outlook for its generation and retail businesses with senior management at the Edison Electric Institute Conference in Dallas, Texas. Exelon also unveiled new information in its investor presentation that supports our outlook, including its 2017 gross margin outlook for Exelon Generation that is in line with our mark-to-market estimates.

Exelon disclosed it has hedged 27% to 30% of its expected 2017 generation at prices that suggest a slight year-over-year uptick in hedged gross margin in 2017, compared to 2016 and 2015. Exelon Generation's hedged gross margin estimate for 2017 is $7.95 billion, and management presented a 95% confidence interval range of $6.0 billion-$10.55 billion. Our midcycle gross margin estimate for Exelon Generation is $9.9 billion.

Management's new disclosures also helped us estimate Exelon could realize about $0.15 per share of incremental earnings if regulators approve the proposed capacity performance changes in the mid-Atlantic power market. However this is a relatively small impact compared to about $700 million of pretax margin it could realize with a $5/MWh move in 2017 average power prices based on its latest disclosures. We do not include any explicit upside tied to the capacity performance proposal in our forecasts.

Based on our conversation with management, we think there could be upside to management's target $0.15 to $0.20 per share earnings accretion from the Pepco acquisition if they can get the utilities earning at their allowed returns. This would partially offset the $2 per share discount in our fair value estimate due to the merger. Pepco's utilities on average are underearning by one to two percentage points on a $7.5 billion rate base, so the upside could be another $0.05 to $0.10 per share.

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Valuation as of 06 Sep 2014:

We are raising our fair value estimate to $41 per share from $40 per share after incorporating time-value appreciation, current market power prices, and recently announced acquisitions and divestitures. Time-value appreciation was the primary driver. Exelon's incremental hedges and forward market power prices were little changed from our last update. Exelon's 2015-17 hedges imply mostly flat generation gross margins in line with our three-year forecast.

We continue to incorporate $2 per share of value dilution related to Exelon's proposed acquisition of Pepco. Based on our $19-per-share pre-merger fair value estimate for Pepco, Exelon's $27.25-per-share cash offer represents a 43% premium to fair value. Potential synergies and financing benefits partially offset the value dilution.

After incorporating Exelon's generation hedges through September 2014, our updated outlook implies mostly flat consolidated earnings through 2016, excluding contributions from Pepco, which we expect to be accretive on a full-year basis starting in 2016. On a midcycle basis, we continue to assume Exelon earns $4.30 per share with Exelon Generation contributing $5 billion EBITDA. This is almost double our 2016 trough mark-to-market EBITDA estimate for Exelon Generation.

Our midcycle power prices are about 20% above current forwards as of early November. They are based on a $5.40 per thousand cubic feet midcycle gas price and market heat rates about 20% higher than current 2016 forwards. At the retail business, we assume 8% long-term normalized gross margins and 1% annual volume growth beyond 2015 after incorporating the uplift from the Integrys Energy Services acquisition.

At the regulated utilities, we assume all three utilities earn average 10% returns on equity starting in 2016 and increase the rate base 7% annually over 2014-17 based on $3.0 billion of average annual investment. This does not include Pepco.

We use a 10% cost of equity and 7.5% cost of capital in our discounted cash flow valuation.

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Apollo Global Management LLC APO

Morningstar Rating	Industry	Market Cap ($ Bil.)	Market Price	Fair Value	Price/Fair Value	Fair Value Uncertainty	Economic Moat™ Rating
★★★★★	Asset Management	9.16	23.75	40	0.60	High	Narrow

"On a distributable earnings basis, which is our preferred metric because it removes the effects of unrealized incentive income and is closer to cash earnings, we value Apollo at 14 times our 2015 forecast. We're fans of the attractive nature of the alternative asset manager business model versus traditional asset managers. The alternative asset manager model includes higher profitability and secular tailwinds (increasing allocations from institutions), and we could see multiple expansion over time as investors obtain greater levels of comfort with the lumpier, but recurring, nature of performance fees over long time horizons."

Analyst Note as of 30 Oct 2014:

Apollo reported an underwhelming quarter, as economic net income declined to just $48 million versus $551 million last year, thanks to unrealized performance fee losses within its private equity funds, Fund VI and Fund VII. Despite the headline underperformance, we do not plan to change our $40 fair value estimate and narrow moat rating, as we think this quarter illustrates the limited value of economic net income. Economic net income serves as a primary valuation tool for many investors for alternative asset managers, versus our more robust model, which relies on distributable net income among other approaches. Because economic net income relies heavily on quarterly mark-to-market valuations for Apollo's private equity funds, it can be more volatile, while distributable income relies on realized performance fees, which is closer to cash earnings, and is thus less volatile. As a result, economic net income declined substantially this quarter, but distributable earnings only declined to $343 million from $456 million over the same time frame.

Aside from the difficulties with unrealized incentive income this quarter, we think Apollo is generally in good shape. Total AUM declined to $163.9 billion from $167.5 billion sequentially, with $4.6 billion in distributions the main driver behind the decline, but year to date investing activity is about $7.3 billion versus $5.5 billion at the same time last year, laying the groundwork for future realizations. Despite the volatility with incentive fees, management fee revenue increased more than 50% to $311 million from last year. In addition, private equity fund valuations increased about 2% for the quarter, lower than peers, but still respectable. Finally, Apollo still has $33.6 billion in uncalled commitments that it can put to work as more investing opportunities appear in this uncertain environment

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Valuation as of 06 Oct 2014:

We're maintaining our fair value estimate at $40 per unit. Our fair value estimate implies a 2015 price/economic net income multiple (the industry's preferred metric) of 13 times and a dividend yield of 6.0%. On a distributable earnings basis, which is our preferred metric because it removes the effects of unrealized incentive income and is closer to cash earnings, we value Apollo at 14 times our 2015 forecast. We're fans of the attractive nature of the alternative asset manager business model versus traditional asset managers. The alternative asset manager model includes higher profitability and secular tailwinds (increasing allocations from institutions), and we could see multiple expansion over time as investors obtain greater levels of comfort with the lumpier, but recurring, nature of performance fees over long time horizons. That said, we expect that the industry's use of the partnership rather than the traditional corporate structure means that the alternative asset managers will still trade at a discount to their traditional peers, probably because of potential tax ramifications, thanks to the industry's use of K-1s, which create tax complexity, and the carried interest tax issue. We also assume that carried interest tax reform eventually passes in some fashion and our long-term tax rate is 35%, but we do not see any near-term threats to the industry at this stage.

We expect results to weaken from 2013 levels, as Apollo will find it impossible, in our view, to replicate the success both of 2013's LyondellBasell profits and the close of its Fund VIII. Accordingly, we expect fee-earning AUM levels around $133 billion in 2014, economic net income of about $1.1 billion (distributable income is similar), and earnings per unit of $2.66. Beyond 2014, we expect modest earnings and AUM growth driven mainly by healthy markets, Apollo's strong reputation, and continued solid fund performance. That said, if Apollo and Athene continued to make aggressive acquisitions of credit-related AUM, our forecasts could prove conservative. In 2017, we project total AUM at $201 billion, economic net income of $2.0 billion, distributable earnings of $1.8 billion, and economic net income per unit of about $4.92.

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Crown Resorts Ltd. CWN

Morningstar Rating	Industry	Market Cap (GBX Bil.)	Market Price	Fair Value	Price/Fair Value	Fair Value Uncertainty	Economic Moat™ Rating
★★★★	Travel & Leisure	10.21	14.02	19	0.74	High	Narrow

"Crown Resorts is a company with very long-dated casino licenses in the core markets of Melbourne and Perth, which provide a narrow moat for the approximate AUD 850 million domestic earnings base. The Melco Crown associate, also with a narrow moat underpinned by its status as one of only six concessionaires permitted to operate casinos in Macau, provides valuable exposure to the region's multi-year structural gambling growth story.

Analyst Note as of 17 Nov 2014:

We believe the market is well aware of the headwinds buffeting Crown Resorts' operations. Persistently soft consumer sentiment is dampening growth in domestic revenues to low single-digit levels across the two properties in Melbourne and Perth. The law of big numbers means that VIP turnover is finding it increasingly difficult to grow from an AUD 50 billion base. All this is compounded by weakness in the Macau gaming market—one that has slumped 12% year-on-year in the four months to the end of October, impacting the performance of the 33.6%-owned Melco Crown.

Amid this extreme pessimism, long-term investors would be well advised to look further out on the horizon and focus on Crown Resorts' long-term appeal. It is a company with very long-dated casino licenses in the core markets of Melbourne and Perth, which provide a narrow moat for the approximate AUD 850 million domestic earnings base. The Melco Crown associate, also with a narrow moat underpinned by its status as one of only six concessionaires permitted to operate casinos in Macau, provides valuable exposure to the region's multi-year structural gambling growth story. And to round out its portfolio of premium-quality casinos for the mobile high rollers and increasingly affluent Chinese middle class, plans are in the pipeline to construct a casino in Sydney (the gateway to Australia) and one in Las Vegas (a critical market for any serious globally minded integrated casino group).

Granted, all these projects will require significant capital, and even more if Crown Resorts is successful in expanding into Brisbane and Japan. However, free cash flow generation is solid, leverage metrics are comfortable and we believe the company has firmly learnt the painful lessons from the global financial crisis in terms of financial risk management. Consequently, we maintain our view that Crown Resorts shares are undervalued, especially relative to our unchanged AUD 19 fair value estimate.

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Expanding further on the new growth projects, Crown Sydney is expected to open its doors in November 2019, catering to VIP and premium mass gamblers, especially those from Asia. The property would be perfectly positioned to ride the coat-tail of rising Asian middle-class consumers, one that already numbers 300 million (almost equal to the entire population of the United States) and is forecast to balloon to 1.4 billion by 2030. Being in the heart of Sydney at Barangaroo, surrounded by marquee attractions (Harbour Bridge, Opera House, Sydney Harbour), Crown Sydney's leverage to the expected growth in inbound middle-class Asian tourists would be significant.

Due to this structural thematic, we also do not believe it will be a zero-sum game with the Crown Sydney property situated so close to the current Star casino property in Pyrmont. To broadly illustrate this point, in fiscal 2014, Crown Melbourne generated normalized earnings before interest, tax, depreciation and amortization, or EBITDA, of AUD 562 million. Star casino made EBITDA of just AUD 284 million in the same year. Despite operating in a bigger market, Star earns only half of what Crown Melbourne does. In our view, Sydney's profit pool can be just as big as that of Melbourne, particularly with the long-term tailwind of inbound Asian tourism. Over the long-term, we believe Crown Sydney can generate about AUD 280 million in EBITDA, without materially cannibalizing Star's earnings base, and produce a healthy low double-digit return on the expected AUD 2.0 billion capital cost of the project (before any proceeds from Crown Sydney apartment sales to defray the capital cost).

As for Crown Las Vegas, management's current plan is to have majority ownership in the property which is expected to have a capital cost of between $1.6 billion and $1.9 billion. We believe Crown Resorts' actual equity investment in the project is likely to be between $400 million and $500 million, with project financing likely to be utilised extensively. Again, we see high likelihood of double-digit returns on the capital employed. More strategically, the impending presence on the Las Vegas strip fills a critical hole in Crown Resorts' geographical spread, particularly as the United States is still one of the top tourist destinations for the rising Asian middle class, despite Australia's growing popularity. Furthermore, while Las Vegas long ago lost its mantle to Macau as the world's largest gambling mecca, it is still a $6 billion market. Indeed, Crown Resorts' entry into the region may well prove to be highly opportunistic in light of the recovery in Las Vegas strip gaming revenues which returned to growth from 2012 after three years of decline following the global financial crisis.

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Valuation as of 14 Aug 2014:

Our fair value estimate for Crown Resorts is AUD 19.00 per share, which implies a forward fiscal year price/earnings ratio of 22.4x, an enterprise/EBITDA ratio of 11.4x, and a free cash flow yield of 1.7%. We value the company's Australian casinos using a discounted cash flow methodology. In addition to this, we incorporate into the valuation the company's 33.6% interest in Melco Crown Entertainment—one on which we have a $35 per share fair value estimate.

In terms of growth and profitability, we project revenue growth of around 4% per annum for the next three years, compared to the 9% average over the past three years, as the top line slows from renovation-induced lift in recent years and adjusts to the more benign consumer spending trend in Australia. We expect EBITDA margin to average 27.9% over the next three years, in line with the 27.8% average over the past three years. For Melco Crown Entertainment, we assume average earnings growth of 13% for the next three years.

Longer-term, our top-line growth assumption is 6% per annum and EBITDA margin is projected to be 29.2%, as the company reaps the benefits of current capital projects. Furthermore, Melco Crown Entertainment is expected to achieve earnings growth of around 12%. This leads to an estimated long term return on invested capital, or ROIC, of around 20% which is comfortably above the company's weighted average cost of capital, or WACC, of 9.2%.

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