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Research Update:

SKYCITY Entertainment Group Outlook Revised To Stable On Solid Earnings Recovery; 'BBB-' Ratings Affirmed

April 15, 2021

Rating Action Overview

- SKYCITY Entertainment Group Ltd.'s earnings recovery is progressing quicker than we anticipated. We forecast its adjusted debt-to-EBITDA ratio will remain below 3.0x by the end of fiscal 2021.
- In our view, SkyCity's capital expenditure peak has likely passed and the company should be able to maintain credit metrics commensurate with the 'BBB-' rating as it continues to navigate through the COVID-19 recovery phase.
- On April 16, 2021, S&P Global Ratings revised its outlook on SkyCity to stable from negative. At the same time, we affirmed our 'BBB-' long-term issuer credit rating on the New Zealand-based casino operator and our 'BBB-' long-term issue ratings on its debt.
- The stable outlook reflects our view that SkyCity will maintain its solid earnings recovery through the COVID-19 recovery phase over the next two years, and that the company will appropriately manage its remaining development activity in Auckland within our rating tolerances.

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Rating Action Rationale

We revised our outlook on SkyCity because the company's earnings recovery is progressing quicker than we had initially anticipated and downgrade risks have abated. We anticipate earnings in the fiscal year ending June 30, 2021, will recover to at least 75% of fiscal 2019 levels, and approach near normalized levels in fiscal 2022. According to our forecasts, EBITDA in fiscal 2021 will exceed fiscal 2020 levels, resulting in an S&P Global Ratings-adjusted debt-to-EBITDA ratio of under 3.0x, and further falling to the mid-2x range over fiscals 2022 and 2023. The improvement will likely be supported by the strong recovery in gaming and nongaming revenue, primarily at the company's Auckland and Adelaide assets. Furthermore, management continues to target a 2.5x net debt-to-EBITDA ratio as part of the company's capital allocation framework and commitment to the 'BBB-' investment-grade rating.

SkyCity's results for the first half of fiscal 2021 revealed the strength of the company's long-term monopoly positions, particularly in Auckland. All product classes, including electronic gaming machines (EGM), tables, and local gaming, were at or above pre-COVID-19 levels. In addition, the Adelaide casino reported significant growth in nongaming revenues following its expanded entertainment facilities. In our view, Adelaide should become a stronger contributor to group revenues.

The group's capital expenditure (capex) peak has likely passed. The completion of the Adelaide casino and hotel development in late 2020 has reduced the group's capex requirements over the next two years, with only about NZ$160 million of net cash capex remaining on the New Zealand International Convention Centre (NZICC) and Horizon Hotel. We expect this to be spread over the next few years, with the Horizon Hotel likely to be completed by late 2021 and the NZICC by around mid-2023. SkyCity spent NZ$119 million on capex in the first half of fiscal 2021, compared with NZ$202 million in the prior corresponding period. That said, we believe some execution risks remain for the NZICC during its rebuild phase and potential project delays.

We believe SkyCity can appropriately navigate any future interruptions to trading. The company's operating assets experienced the reinstatement of COVID-19 restrictions following the Alert Level 3 introduction in Auckland on Feb. 28, 2021. That said, the restrictions applied for only a short period of 10 days, while the Adelaide casino and other New Zealand assets continued to trade, providing cash flow diversity.

In our opinion, SkyCity will prudently manage its licensing obligations and risks associated with the international VIP market. The company has ceased all business relationships with international junket operators and will interact directly with international business customers after undertaking appropriate customer due diligence. We will also monitor the group's nascent online casino operations as regulatory settings evolve.

We expect SkyCity's management to remain committed to supporting the 'BBB-' rating. In June 2020, the company raised NZ$230 million of equity to bolster its liquidity and credit metrics. The equity raising reflects our view that SkyCity's management would undertake prudent financial actions to support the company's credit quality. We consider the equity raising to be consistent with the group's financial policies and commitment to maintaining the 'BBB-' rating. In addition, SkyCity did not declare an interim dividend for fiscal 2021 and has strong liquidity of about NZ$390 million to manage its capex requirements.

Outlook

The stable outlook reflects our view that SkyCity will maintain its solid earnings recovery through the COVID-19 recovery phase over the next two years, and that the company will appropriately manage its remaining development activity in Auckland within our rating tolerances.

Our base case does not include any prolonged period of government-imposed operational closures due to COVID-19.

Downside scenario

We could lower the rating on SkyCity if the company's earnings recovery is weaker than we expect, resulting in its adjusted debt-to-EBITDA ratio sustaining above 3.0x, if not offset by capital management actions.

The company's adjusted debt-to-EBITDA ratio could also stay above 3.0x if:

- Leverage materially increases because of higher-than-anticipated capex; or
- Additional operational restrictions are reimplemented over the forecast period for a protracted period.

Furthermore, material adverse changes to the licensing or regulatory environments in which SkyCity operates, particularly in Auckland, could also have a negative impact on the rating.

Upside scenario

We consider upward rating pressure to be unlikely over the next two years. However, upward momentum could emerge from material diversification of SkyCity's earnings base, while the company maintains a prudent financial risk profile.

Company Description

SkyCity operates in the gaming, entertainment, hotel and convention, hospitality, recreation, and tourism sectors in New Zealand and Australia. The company owns and operates casinos in Auckland, Hamilton, and Queenstown in New Zealand; and Adelaide, Australia. The company has an online casino, based in Malta. In fiscal 2020, SkyCity reported revenues of about N$715 million and its S&P Global Ratings-adjusted EBITDA was about NZ$184 million.

Our Base-Case Scenario

- New Zealand's real GDP growth of 4.2% in 2021, 3.0% in 2022, and 2.9% in 2023. Australia's real GDP growth of 4.0% in 2021, 3.3% in 2022, and 2.6% in 2023.
- Improving market conditions and strengthening consumer discretionary spending across New Zealand and Australia over 2021-2023.
- SkyCity's revenue to grow by double digits in fiscal 2021 compared with fiscal 2020, driven by solid gaming and nongaming revenues at its Auckland and Adelaide assets, in particular for table games, EGM, and local gaming.
- High single-digit revenue growth in fiscals 2022 and 2023, following a normalization of gaming and nongaming volumes at the Auckland and Adelaide assets.
- Earnings in fiscal 2021 to rebound to at least 75% of fiscal 2019 levels, reach 85%-95% of fiscal 2019 levels in fiscal 2022, and fully recover in fiscal 2023 as mass-market gaming and nongaming volumes strengthen.
- International business revenues to remain minimal following a cessation of junket operations.
- EBITDA margins to be in the low-30% range over the next two years, supported by improved tables, local gaming, and EGM volumes.
- Capex of NZ$150 million-NZ$250 million over the next 12 months for the redevelopment of NZICC and maintenance capex.
- Dividends to resume in fiscal 2022 at 60%-90% of net profit after tax.

- No material debt-financed acquisitions.
- Restricted cage cash of NZ$30 million that we do not net off against debt.
- No major outbreak of COVID-19 which could impair SkyCity's operating businesses for a prolonged period.

Based on these assumptions, we arrive at the following adjusted credit measures for fiscals 2021-2023:

- Adjusted debt-to-EBITDA ratio of below 3.0x in fiscal 2021, declining toward 2.5x-2.7x in fiscal 2022 and under 2.5x in fiscal 2023.
- Adjusted ratio of funds from operations to debt in the mid-20% range over fiscals 2021-2023.
- Negative free operating cash flow in fiscal 2021, followed by positive free operating cash flow in fiscals 2022 and 2023.

Liquidity

We assess SkyCity's liquidity as strong. We expect the company's sources over uses to be greater than 1.5x over the 12 months to April 30, 2022, and remain positive in the subsequent year. In our view, SkyCity can maintain strong liquidity, even if its EBITDA declines by 30%, given the group's cash balance and undrawn bank facilities.

SkyCity holds bank facilities with major Australian and New Zealand banks, which extended further lines during the height of the COVID-19 pandemic in mid-2020 to bolster the company's liquidity levels. This demonstrated its well-established, solid relationships with banks. SkyCity has consistently raised capital in the U.S. private placement market, supported by its generally high standing in credit markets. The company's risk management practices remain prudent, as evident from its equity raising in 2020, which also underpins our liquidity assessment.

The company's sources and uses of funds over the 12 months to April 30, 2022, are as follows:

Principal liquidity sources include:

- Cash and short-term investments of about NZ$58 million.
- Undrawn bank facilities of about NZ$345 million.
- Cash funds from operations of NZ$185 million-NZ$200 million.

Principal liquidity uses include:

- Drawn bank facility of NZ$175 million maturing.
- Capex of NZ$150 million-NZ$250 million.
- Dividend distributions of about NZ$66 million.

Covenants

We believe SkyCity will remain compliant with and have sufficient headroom under its covenants. We expect the group to continue to satisfy the requirements under the negative pledge deeds of its funding facilities.

Issue Ratings - Subordination Risk Analysis

Capital structure

We consider SkyCity's debt maturity profile--which currently averages about 2.5 years--to be adequate. As of April 15, 2021, the group's total drawn debt included about NZ$217 million of U.S. private placements and about NZ$283 million of drawn bank debt.

Analytical conclusions

We rate SkyCity's debt 'BBB-', in line with the issuer credit rating, given that no significant elements of subordination risk are present in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Stable/--

Business risk: Satisfactory

- Country risk: Low
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Intermediate

- Cash flow/leverage: Intermediate

Anchor: bbb-

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb-

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March

28, 2018

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Leisure And Sports Industry, March 5, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed; Outlook Action

	To	From
SKYCITY Entertainment Group Ltd.		
Issuer Credit Rating	BBB-/Stable/--	BBB-/Negative/--
Senior Unsecured	BBB-	
SKYCITY Auckland Holdings Ltd.		
Senior Unsecured	BBB-	
SKYCITY Australia Pty Ltd.		
Senior Unsecured	BBB-	