Elstree

Crown Note developments: July 2016

Where are we now?

Crown Resorts credit rating was affirmed at "BBB" with a "Stable" outlook. This is a material improvement on the credit rating after S&P's 15 June announcement that the rating was on a negative outlook which could "result in either an affirmation of the current rating or a downgrade of not more than one notch" (which would have left the rating at "BBB-", the lowest investment grade rating).

What happened? Ratings agencies getting snarky

If you are a corporate entity with an investment grade credit rating, there is a playbook for dealing with changes in strategy. You take the strategy changes to the ratings agency along with the financial implications and the ratings agency will do some work and tell you what the rating outcome will be. You then decide if that is an acceptable outcome and if so, you prepare your communications piece and the ratings agency publishes its opinion at the same time. It takes time and coordination but in the end everybody is happy. The Crown announcement of mid-June that they were going to divest from Asia, joint venture some of the development projects and pay James Packer/CPH an extra $8m p.a. was very different. It looks like it was a thought bubble (there wasn't even a PowerPoint: just a 4 page Word document and there was no detail on the demerger or Hotel Property Trust), so clearly there was no consultation with ratings agencies.

Crown CFO and S&P conversation goes like this…

At the same time, it's essential that Crown maintains its' investment grade credit rating, so it seems to us that the Crown CFO rang up S&P and explained; "we're doing all this strategic stuff, sorry about no notification, but whatever happens we'll tweak it so that we maintain an investment grade credit rating. We'll get you the numbers in the next week or so when we get some idea of what we actually want to do". So S&P put out the announcement saying we will "either affirm the rating" (if the credit profile is unchanged) or "downgrade the rating but not by more than one notch" (because the CFO has promised us that he will tweak the strategy enough to ensure an investment grade credit rating).

Why do they need an investment grade rating

Investors pay a premium for stable cash flows and the Crown's Australian gambling operations are arguably one of the most attractive monopolies in Australia. So the model (originated by Macquarie and copied around the world) is to take good assets and gear them up with lots of cheap debt and generate high returns on equity (RoE). In Crown's case it looks like they are going to get through c$6b of capital expenditure in the next 5 years, so they need a lot of debt. Unless they want to raise more equity and potentially dilute James Packer's holding, they also need access to subordinated debt such as the CWNHA and CWNHB. In order to get cheap debt, you need an investment grade credit rating and markets to trust you. The market's concern with Crown's governance after the Packer privatisation bid late last year led to a capital market strike. Spread margins on senior debt moved from 1.8% in September last year to 3.1% in March. Margins are 2.1% now. Clearly a margin of 3.1% meant that CWN couldn't borrow much and it wasn't cheap. It's not quite back to pre-privatisation levels, but maybe by the time CWN has to approach markets again it will be more acceptable.

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Hybrids?

Last night's (July 13) closing price of $85 on the CWNHB is close to the highest close since January 4 (it reached an intra-day high in the low $90s on 16 June). A price of $85 translates to a spread margin of over 8%. This is not at all consistent with the corporate message or the pricing of the senior debt. There may be a number of reasons for this;

- There is still a stock of willing sellers of the security (over $100m of CWNHA/CWNHB traded in the $70's).
- Hybrid owners are more naturally pessimistic.
- Current owners don't share our lack of worries about Crown maintaining an investment grade rating.
- Ongoing concerns about governance and the lack of protection in hybrid documentation.

Our view is that there is a little of each in the current pricing. Maybe the third point will take some time to digest but we think that there will be real progress on all but the fourth point in the next few months. If that occurs, we think the price of the CWNHB settles in the low to mid $90s with the CWNHA a few $ higher. Key milestones will be the release of the detailed demerger plans and indications of the success of the proposed Hotel Property Trust. We expect they will issue a bond later this year, which will give an indication of the markets appetite for the new Crown.

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