QUARTERLY COMMENTARY

30 September 2022

Manager Update: October 2022

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The storm clouds in global markets and economies have coalesced into one giant vortex of doom. We wish we could be more optimistic, but decades of policy mismanagement and excess have led to this inevitable day of reckoning. Our fears on liquidity and interest rates were documented as far back as mid-2020 in various blog posts[1] and later, in Orlog Capital quarterly reports.

Adding further fuel to the flames, inflationary and economic pressures are causing social unrest catalysing increasingly populist and nationalistic policies and politics. We fear the clash between governments buying short term votes and central banks managing long term economic realities may intensify in coming months. It would not be surprising to see Western governments oscillate between the far left and the far right while recessions in Europe and North America are likely within the next year.

The Orlog Capital Fund has low exposure to the worst of these risks. While all risk-assets have sold down, our bottom-up stock picking have avoided expensive, over-monetised or long term cashflow questionable businesses which have been hit the hardest. Also, until recently, we had found limited value in Western companies whose earnings and valuations reflected the best versions of themselves. Nonetheless our Fund performance took a hit this quarter with net performance of -15.3% QTD and +10.9% YTD. This is not unusual given our style of investing.

Against this backdrop we've adopted some changes. The basic strategy remains the same: buy the best risk/reward companies and adjust the portfolio according to the competition between ideas, but since early August we also started shorting index ETFs: QQQ, SPY and XLY. This short position was approaching 20% of the net portfolio value at quarter end. The reasons we decided to initiate this position include:

1. Maintain our net long equity position at a similar level
2. Hedge against tightening liquidity conditions and rising interest rates
3. Active bet on the unwinding of asset bubbles caused by passive investing

We plan to maintain this short position as long as liquidity conditions deteriorate and our long equities position remains high. We primarily track US liquidity conditions via the National Financial Conditions Index (NFCI) and Adjusted NFCI (ANFCI) which have been flashing warning signals since July. Our studies indicate that extreme NFCI and ANFCI readings have coincided with severe market crashes in the past. Note: we do not expect to short individual companies any time soon.

Astute readers likely deduced we made significant stock purchases this quarter (flat net long position even with the ETF shorting). Despite all our macro misgivings we think waiting for the market bottom is a mistake and we doubt our ability to recognise the bottom even after it arrives. Our memory of February 2009 was a relentless flow of negative news and 'experts' proclaiming the end of days. By mid-March the gloomy economic headlines persisted but asset prices staged a dramatic rebound and didn't look back for over a decade. We suspect it was the act of rising asset prices which finally ignited the ample tinder from prior central bank stimulus – a self-fulfilling feedback loop between observation and the real economy as described by Soros' reflexivity theory. We have little confidence in our ability to add value from interpreting macro events let alone navigate the complexities of interactions between market forces and reality (strong trading ability likely required?). Therefore we think the best expression of both our macro fears and our excitement over cheap stocks is to short market beta and long portfolio alpha (or short Fed driven systematic risk and long our curated collection of global non-systematic risks). It is both a hedge and a vote of confidence in the companies we own.

The current equity pricing environment is full of extremes which increases the likelihood of strong returns for investors with a time horizon beyond two years. Unless macro or trading is a strength (Dr Michael Burry, Stanley Druckenmiller), following consensus to the sidelines today is a certain path to mediocrity. Yet many of our well-heeled, 'stock picking specialist' peers are slashing their portfolios and investment favourites. If timing didn't save their performance before, why would it be any better now? At Orlog we are the barefooted and we aren't afraid of those wearing shoes. With traumatised prices and low competition, we are busy ploughing our fields and sowing winter crops in anticipation of spring.

This quarter's stock analysis will look at our Macau casino investments.

[1] https://www.investin1.com/post/all-markets-are-fair-but-not-necessarily-sustainable
https://www.investin1.com/post/the-fed-printer-it-s-alive
https://www.investin1.com/post/preparing-winter-rations-for-the-promised-summer

About Macau Casinos

Macau casinos have been through the crucible over the past three years. They've accumulated significant losses since early 2020 when Covid first hit, and the situation has worsened this year as China and Macau enforced strict zero-Covid policies (total visitors number and Gross Gaming revenue in 1H22 was only 17% and 18% of the figures achieved in 1H19). Secondly, Macau began a crackdown on junkets in late 2021 which will reduce future VIP business. Lastly the gaming license renewals are yet to be concluded and may result in the departure of an existing license holder.

Naturally the share prices of all players (except Galaxy) are trading at historical lows.

Visitation Recovery

Macau's recovery depends almost entirely on the return of Chinese tourists. The recently announced reinstatement of China's packaged tours and eVisas for individual visits starting November 2022 (both cancelled since the start of the Covid outbreak in 2020) seems like a major win. However, uncertainty remains high in the near term given the overriding nature of China's zero-Covid policy enforcement.

Over the longer term we remain optimistic that visitations will recover and expand beyond 2019 levels. Chinese love to gamble and the Chinese government prefers they visit Macau instead of overseas casinos. Additionally, Macau is designated as the tourism/leisure region in the 2030 Pearl River Delta development plan which aims to integrate the major cities of Guangdong province with Hong Kong and Macau. We think this policy is important to the future growth of Macau.

License Renewal

The new gaming license details was released mid-2022 with no major surprises: six licenses, 10-year term, similar tax rate as previous. Tenders were submitted mid-September and results will be announced before year end. Additional information:

- There were seven bidders for the six licenses with the surprise outside (provisional) bid coming from Genting
- The Macau Chief Executive publicly stated no further gaming land would be released. Concessionaires can only develop on existing facilities
- The bidding criteria put a heavy emphasis on attracting international tourism and developing non-gaming tourism and projects

We think the most likely situation is the current six concessionaries win license renewals. In the unlikely event Genting wins, we believe they will need to buyout the facilities of the losing license holder at a fair price since under the Gaming Law only the gaming facilities are owned and recoverable by the government. Otherwise it would create a catch-22 situation: Genting can't win unless they can deliver on a plan to improve the existing service offering but to do that they need total control of the asset. We think the Macau gaming commission would need certainty such a deal would be forthcoming.

At the very minimum, we believe the fair price would be the replacement cost of the facilities. We've estimated this as the original build cost adjusted for 5% per annum cost inflation from the time of opening less 3 years e.g. a facility opened in 2013 would have cost inflation of 5% pa applied from 2010 until now.

We disagree with the widely floated theory that the US operators (Sands, Wynn) are the most at risk of losing their license. If there was a change, we think it is more likely to be one of the three Ho family connected entities (SJM, Melco, MGM China). SJM makes the most sense but recent entity wide restructuring makes this difficult to assess.

Investment Thesis

Our investment thesis is based on a two stage mean reversion framework: 1) license renewal, 2) recovery in visitations.

Two tables overleaf summarise the investment risk/reward structure:

1. Price table: Current share price vs 1 Month average share price ending 14/9/2021 (pre-license concerns) and Average 2019 share price

2. Valuation table: P/Adj Tangible Book, P/E, EV/EBIT with normal earnings estimated by the 2018-2019 average

We think in this investment situation 'a rising tide lifts all boats' since the two major mean reversion factors are common to all. Secondly, we believe the risk of absolute loss will likely be mitigated by Genting paying a fair price for the losing concessionaire's facilities (though crystallising that value will depend on the listco's willingness to return proceeds). The Adjusted Tangible Book value is equivalent to our estimate of replacement cost (see above). The primary considerations for our Macau casino investment picks are: operational efficiency, capital returns history and the current gearing level.

According to this investment rationale, we've chosen to diversify and invest in both Sands China and Wynn Macau. Our studies indicate they are the two best operators (Sands in mass, Wynn in premium) with the highest margins and ROIC in the industry. Their capital returns history has been exemplary (dividend payout >100% for their listed history), likely due to their 'non-local' status and the capital needs of their parent entities. In a license loss scenario, we actually think there is greater chance investors will receive the liquidation value than with one of the local operators.

Price Table

Company	Code	Price (LC): 30/9/2022	Price (Avg 2019)	Price (1M Avg to 14/9/2021)	% Return (2019 Avg)	% Return (14/9/2021 Avg)
SJM	0880.HK	2.95	7.9	6.3	168%	115%
Wynn Macau	1128.HK	5.04	17.8	8.8	252%	74%
Sands China	1928.HK	19.7	38.0	24.9	93%	26%
Galaxy Entertainment	0027.HK	46.4	51.2	49.1	10%	6%
MGM China	2282.HK	4.34	13.5	7.9	211%	82%
Melco Resorts	MLCO.O	6.63	22.0	12.8	231%	93%
Studio City	MSC	2.19				
Total (inc 46% of Studio City)					**161%**	**66%**
Total (inc 46% Studio City, ex Galaxy)					**191%**	**78%**

Valuation Table

Company	Price (LC): 30/9/2022	Mcap (US$m)	Net Debt (US$m)	EV (US$)	Adj Tangible Book (US$m)	P/Adj Tangible Book	P/E (2018-19 avg)	EV/EBIT (2018-19 avg)
SJM	2.95	2,135	3,146	5,281	5,330	40%	6.0	14.1
Wynn Macau	5.04	3,337	5,117	8,454	6,251	53%	4.6	9.5
Sands China	19.7	20,312	8,273	28,585	18,704	109%	10.2	12.9
Galaxy Entertainment	46.4	25,773	-1,297	24,476	15,065	171%	15.1	16.0
MGM China	4.34	2,101	3,013	5,114	5,220	40%	11.3	18.1
Melco Resorts	6.63	3,141	6,364	9,505	6,892	46%	8.4	14.0
Studio City	2.19	422						
Total (inc 46% of Studio City)		**56,993**	**24,616**	**81,610**	**57,462**	**76%**	**9.3**	**14.1**
Total (inc 46% Studio City, ex Galaxy)		**31,221**	**25,913**	**57,134**	**42,397**	**58%**	**8.1**	**13.7**

*Total: Return and Valuation ratios based on Equal Weighted average of companies

Valuation

We estimate the fair value based on license renewal alone (realisable before end of this year) is in a range related to their 14/9/2021 average share price and P/Adj Tangible Book=1. For Wynn Macau this is HK$8.8-9.5/share (75-88% return) and for Sands China this is ~HK$18-24.9/share (-9% to 26%) though the likelihood of Sands China losing its license seems very low.

Post license renewal, fair value will depend on the extent of the recovery in Macau tourist numbers. This is highly uncertain but we estimate the recovery towards 2019 earnings levels within a 2-3 year timeframe. Valuation will probably be bounded by the average 2019 share price and 15-20x normalised earnings.

Although Wynn Macau is cheaper and has more mean reversion upside, we think Sands China has faster earnings recovery and greater structural growth when visitations come back. Also Sands China's debt is lower which decreases the time needed before shareholder returns can resume. Sand's China's EV/EBIT is the second lowest after Wynn Macau among all peers.

Unlike consensus, we see little point investing in Galaxy which has low mean reversion upside and poorer capital returns history. For a similar risk profile Sands China seems to be a superior bet. Similarly, we prefer Wynn Macau to the Ho family entities for valuation mean reversion – better capital returns history and higher efficiency operations.

Final Comments

We started accumulating our position (in the predecessor portfolio) from mid-September 2021 when fears about the gaming license renewal first hit the Macau casino stock prices. My thoughts on the situation were documented in two posts[2].

We focused initially on Sands China and later on Wynn Macau. Our buying accelerated after May 2022 during a second period of share price weakness. Where the market focused on the short term lock-down induced losses to these operators, we saw it as an opportunity to lay down bets alongside the House to cheaply acquire the next ten years of oligopoly rights to the biggest casino market in the world. And while the market remains worried about political risks to the US operators, we are willing to bet that the government is fair, or least understands that Macau's future depends on maintaining long-term confidence.

Our Macau casinos are an example of the investments we find attractive in this market - strong risk/reward payoff profile and value drivers unrelated to the macroeconomic conditions and policies in the US and Europe. And if we're right about Genting's bid, the worst-case scenario – losing the gaming license, may actually turn out to be a blessing in disguise.

[2] https://www.investin1.com/post/betting-on-the-house
https://www.investin1.com/post/betting-on-the-house-the-maths-angle

Portfolio Overview

ORLOG CAPITAL

Top Five Major Holdings (in alphabetical order)	
CNOOC	Oil & Gas Exploration & Production
DADA Nexus	E-Commerce
JD.com	E-Commerce
Sands China	Casino operations
Spirit Aerosystems	Aerostructure Manufacturer

Performance	
Non Annualised Net Returns in US$[1]	
Year to date	7.3%
3 months	-18.0%

1. Net of 1.5% annual management fee and 20% performance fee (excess return above 5% hurdle rate and subject to HWM)

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