MARKET COMMENTARY

NZ FUNDS

NO WINNINGS FOR AUCKLAND CASINO IN SKY CITY RESULT

19 AUGUST 2009

Sky City's ("SKC") value mainly resides in the performance of the Auckland gaming floor and once again it was pretty unimpressive, with Auckland gaming machine revenues flat for the second half. For the intrinsic operating leverage in this business to manifest itself that revenue has to grow – the machines are a fixed installed cost and incremental revenue should drop to the bottom line. The difficulty with Sky City over the years is that it has consistently failed to demonstrate gaming machine revenue growth. Given that it now faces the additional hurdle of pop up information screens on all its gaming machines, it is hard to have confidence a turn around in pokie performance is imminent.

While Adelaide has performed very well, presumably driven by Australian government stimulus, if the stock trades up strongly on the back of that it really is a case of the tail wagging the dog as it contributes only around $25m of a more than $220m EBIT line.

Management deserve credit for the turnaround in Adelaide and for efforts to improve the operational performance of the casinos but they are battling tough economic conditions. They have also significantly improved the capital structure of the business.

NZ Funds Management believes that at current prices Sky City is an "expensive defensive". In order to be a good investment a company has to meet the dual criteria of being a good business at an attractive price and at current prices it is hard to see a great deal of upside. Sky City has suggested that they will struggle to reach double digit profit growth, which implies a profit of around $127m will be a significant achievement – at current prices a P/E of about 15x. Given the ongoing grind that is trying to improve Auckland gaming, questions around the sustainability of Adelaide growth in a post-government stimulus environment and an impending smoking ban in Darwin, it is hard to get too excited about owning the stock.

SKC PRICE

Source: Bloomberg.

SKC RELATIVE TO NZ SHARES

Source: Bloomberg.