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Turnover is Vanity, Profit is Sanity

Analysis of the MGM2020 Cost Reduction Plan

Miguel Júdice Bicker Ribeiro Realista
25872

A Project carried out on the Master in Finance Program, under the supervision of:

Francisco Antunes da Cunha Martins

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Abstract

In highly competitive industries, which is the case of MGM, different players dispute every bit of market share available. The low switching costs for consumers make hotel and casino operators fight for the attention of potential visitors. Everyone wants the spotlight, but reality is, it is equally important for companies to focus on how that revenue translates into cash. In this context, MGM is currently in the middle of MGM2020 – an efficiency enhancement program focused on cost reduction and digitization. In this paper, we analyze the financial impact of meeting or failing the targets on the valuation of the company.

Keywords: Cost Reduction, MGM2020, Efficiency, Sensitivity

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The MGM2020 Plan

The MGM2020 program is presented as the natural step to better position the company for the future. It consists on improving cost efficiency through further centralization of company-wide functions, a reduction of the personnel expense and intensification of procurement efforts, as well as a focus on the digitization of the operation, both to improve efficiency and improve the experience for customers.

Management aims at a yearly EBITDA improvement from cost reduction of $100M in 2019, 2020 and 2021, i.e. resulting in $300M incremental EBITDA by the end of 2021. This improvement breaks down into cost reduction, for the reasons previously discussed, and revenue optimization – a process about which the company does not provide much color – in a 3x1 ratio. Roughly half of the total EBITDA improvement is to be achieved through staff cuts alone.

The Predecessor – Profit Growth Plan

The MGM2020 plan follows the Profit Growth Plan, successfully implemented by the company by the end of 2017, with a focus on centralization of core functions - with a more integrated management of the resorts – and better staff management. The first target of $300M EBITDA enhancement for 2015-17 announced in the beginning of program was reiterated to $400M in the beginning of 2016, considering the positive results experienced by the company. This more ambitious target was fully met by the end of 2017. This adds to the credibility of the company regarding the further EBITDA improvements planned through MGM2020, as the company holds a positive track record in meeting the targets it sets.

Living Up to Expectations

The outlook seems rather optimistic for meeting the 2019 targets, as program related cost reductions are estimated to total the estimated $75M mark. Management highlights the positive

results so far when reporting to investors and is currently bullish on fully meeting the $300M EBITDA uplift by 2021. Most of the investment required for the cost optimizations has been incurred in the first half of the year, totaling close to c.$40M. The majority of the cost reduction came at the cost of close to 1,000 employees that lost their jobs this year, mostly in Las Vegas – naturally generating backlash towards the management's decisions. Following this backlash, James Murren - the CEO - has publicly announced the expected staff cut has finished and the rest of the staff force should rest free of concerns about their future in the company.

Methodology

We have forecasted a margin evolution structure based on the turnover of each forecasted scenario (Base, Bull or Bear) assuming there was no cost reduction plan in place (i.e. the margin improvement came solely from economies of scale). Upon this estimation, we incorporated the impact of fully meeting the targets for cost reduction - $75M in 2020 and $75M in 2021 – representing the scenario projected by management. This structure allowed us to build a dynamic forecasting model that estimates the margin in the domestic segment for any level of "target meeting", i.e. modeling profitability on the variable that is how much of the cost reduction is successfully executed.

Forecasted Base Case and Sensitivity Analysis Results

Despite the positive results thus far, following the backlash and public announcement of the CEO, we are reticent of a full target meeting for the rest of the program, considering constraint for further staff reduction, which was the main lever for cost reduction up to date, and was expected to still be a lever of efficiency enhancement in the future. Therefore, we do not expect the company to fully meet its targets, but given the uncertainty behind the assumption, we could not overlook the potential impact on the valuation.

Currently, under the base case, we expect an intrinsic value of the MGM stock of $34.77, representing an upside of 4.4%, with a 2027e ROIC of 10.9% and an 2027e EBITDA margin% for the US operations of 27.9%.

If the company was to fully meet its efficiency enhancement targets, as management predicts, the future cash-flow generation would imply a stock value of $37.04, meaning an upside of 11.2%, which would apparently justify a bullish position on the stock. ROIC would total 11.3% as US operations would record an EBITDA margin% of 28.6%. The valuation would significantly shift upwards, turning our investment recommendation to a buy. The upside for the stock under the three different top-line scenarios would be positive for every scenario, as Table 1.

Table 1: Scenario Analysis of Full Target Meeting

Source: ER Analysis

	Market Cap			Upside			Implied EV/EBITDA		
	Scenarios US			Scenarios US			Scenarios US		
Scenarios China	*Bull*	*Base*	*Bear*	*Bull*	*Base*	*Bear*	*Bull*	*Base*	*Bear*
Bull	20 660	19 421	18 055	20.3%	13.0%	5.1%	11.9x	11.7x	11.4x
Base	20 349	19 110	17 744	18.4%	11.2%	3.3%	11.8x	11.6x	11.3x
Bear	19 978	18 740	17 374	16.3%	9.1%	1.1%	11.7x	11.5x	11.1x

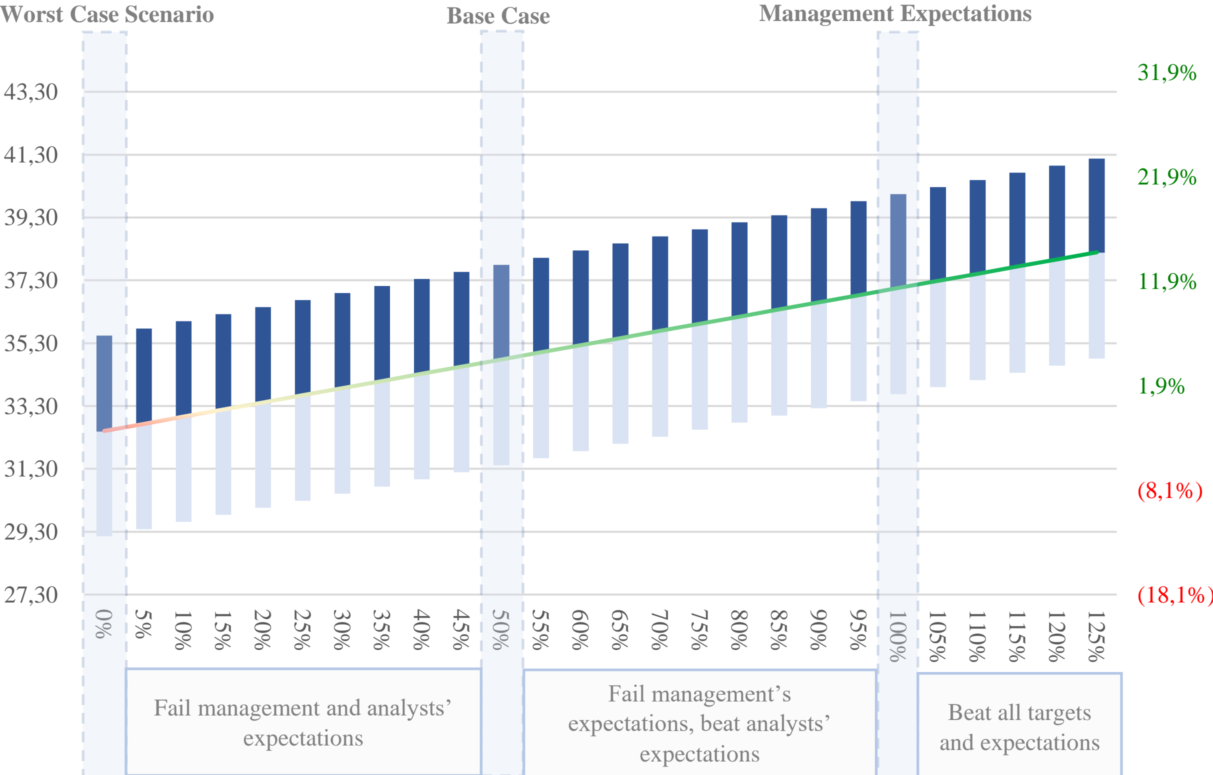
An extreme case where the company would generate no further EBITDA enhancement through the program's cost reduction efforts, after successfully meeting the 2019 targets, would result in a stock price of $32.49, implying a downside of 2.4% of the current stock value. This scenario is highly unlikely and was modelled solely for the purpose of the sensitivity analysis of intermediate scenarios. Additionally, for the sake of discussion, the scenario in which not only would MGM2020 generate no cost reductions for the future, but also 2019 had been a disaster, with the investment resulting in no cost reductions whatsoever, was estimated. To clarify, the impact would not simply be the $75M EBITDA enhancement in 2019, but the impact this margin improvement represents for future operations. The result would be a stock value of $30.03 (for which the implied downside of 9.8% is no applicable, since the current stock price

considers full target meeting in 2019), with 2027e ROIC totaling 10.2% and EBITDA margin% converging to 26.5%.

The results of the sensitivity analysis are better presented through the graphic application. Below is the result of the estimation, where the X-axis represents the % of the targeted cost reduction achieved (Figure 1).

- An achievement % of over 95% would be required to imply an upside of over 10% in the base case of top line estimations, ceteris paribus.
- A 20% achievement is the minimum required for the stock to be valued above current market quote, ceteris paribus.
- A 125% achievement (beating the management's target and expectations) would imply an upside of 14.7%, with EBITDA margin% at the reaching 28.6% in 2027e. Although unlikely, the Profit Growth Program recorded an over 130% achievement of the initial targets set by the company.

Figure 1: Price Range (Bear – Base – Bull) Sensitivity to MGM2020's Execution Success
Source: ER Analysis



Final Remarks

Operating margin has tremendous impact on the cash-flow generations and, subsequently, on the valuation of a company. A cost reduction program such as MGM2020 has undeniable potential to boost the value for shareholders, from the moment it is announced, depending on the market's expectations of a full target meeting. As conditions change, both externally (such as the macroeconomic and industry trends affecting turnover) and internally (such as the backlash suffered from the staff cut), the expectations set by the management team may become more or less likely to live up to, and the investors' perception of the likelihood of success come into play. The analysis conducted is motivated by our expectations of a partial execution of the plan going forward, and how the upsides for each scenario presented in the valuation would change if, instead, we assumed a full cost reduction, as management predicts. Through this analysis, the investor can make a more educated decision, knowing the impact of the assumption on the success of the program in the overall valuation.

Naturally, the model cannot estimate the non-financial impact of meeting or failing management's guidance. A company announcement that indicates a lower degree of confidence in the success of the program will, not only affect the "target meeting %" and therefore the intrinsic valuation performed by the investor, but also the overall market sentiment regarding the stock. This impact is naturally difficult to estimate, reason for which the analysis focuses merely on the financial impact of the program, taking this disclosure into consideration for a more holistic view.