RMB Devaluation Risks and Rewards

Beijing has the motives and means to maintain a managed float.

Morningstar Equity Research
17 August 2015

Daniel Rohr, CFA
Director, Basic Materials
+1 312-384-4836
daniel.rohr@morningstar.com

Lorraine Tan, CFA
Director, Asia
+65 6340 1296
lorraine.tan@morningstar.com

Contents

Executive Summary

The PBoC's surprise decision to unmoor the renminbi (RMB) from its de facto dollar peg rattled already uneasy global markets. There's certainly cause for concern. Currency devaluations have sparked a fair number of international financial crises in the past few decades. Steep further devaluation of the RMB could trigger competitive currency devaluations, destabilizing capital flows, and possibly an emerging market debt crisis. But close examination of the PBoC's motives suggests a measured pace is more likely. A sharply devalued RMB, while marginally supportive to China's struggling industrial sector, would undermine the principal motives behind Beijing's decision to allow a freer floating currency: an internationalized RMB and a halt to recent capital outflows. Critically, unlike devaluation episodes that have sparked past crises, China has the foreign currency reserves to maintain a "managed" float.

Key Takeaways

- **Breaking the dollar peg was a necessary step toward the government's long-term goal of RMB internationalization.** The government desires a more "internationalized" RMB, with a larger share of global trade settled in RMB and RMB assets occupying a more important role in global portfolios. Inclusion in the IMF's Special Drawing Rights basket would be a major milestone and would require the RMB's value to be determined by market forces. An increasingly free-floating RMB is a means to an end.
- **By allowing a freer float, Beijing hopes to stem capital outflows that have been undermining efforts to stimulate the economy.** Capital has been flowing out of China since the summer of 2014, as many of the conditions that had drawn capital into China over the past several years began to move in the opposite direction. China's de facto dollar peg exacerbated the problem of capital outflows as it short-circuits the pricing mechanism that normally rebalances capital flows.
- **De-pegging could exacerbate capital outflows in the short term.** If the market expects the RMB to weaken significantly in the months to come, there could be considerable capital flows out of China as investors look to get ahead of the move. This is the motivation behind the PBoC's assertion that "there is no basis for persistent depreciation of RMB," assurances that it will "keep the exchange rate basically stable," and threats that it will "severely punish illegal FX transactions…and maintain a compliant and orderly capital flow."
- **Export competitiveness was not Beijing's principal motivation.** While a significantly weaker RMB would bolster export competitiveness, the export sector's modest share of GDP (2.7%) would mute the impact on economic growth and employment. Tellingly, Beijing did not resort to a major devaluation during the global financial crisis, despite the fact that net exports were three times more important to the Chinese economy at the time.

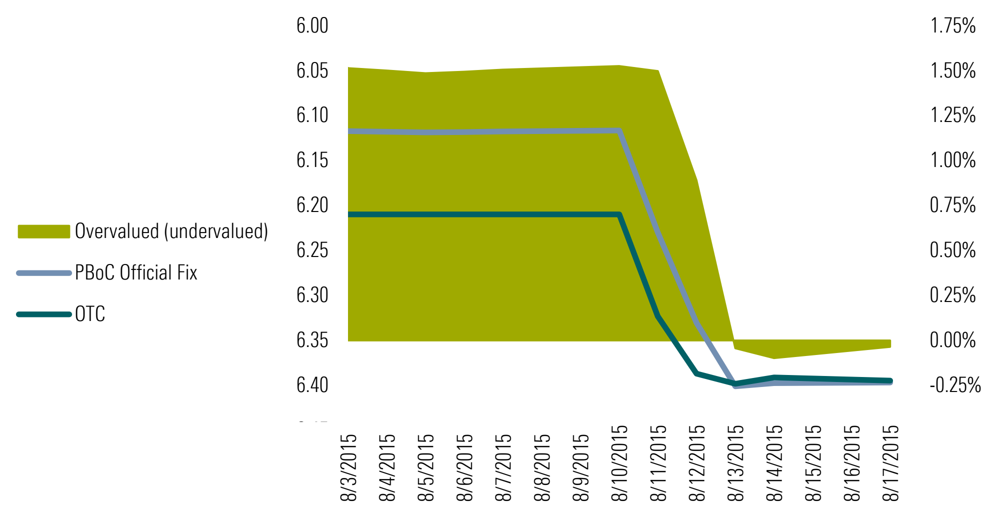
Macro Analysis

The People's Bank of China's, or PBoC, Aug. 11 devaluation of the renminbi, or RMB, caught markets by surprise. Until last week, the RMB-USD pair had been a rock of stability amid a sea of currency volatility. From Aug. 11 to Aug. 13, the PBoC's fix fell 4.5%, covering more ground in three days than it had in that prior four years.

By Friday, things seemed to settle down a bit, as the PBoC assured markets that "there is no basis for persistent depreciation of (the) RMB" and China's state-owned banks sold dollars to stem the tide of RMB depreciation. The PBoC fixed the RMB at 6.3975 on Aug. 14, slightly stronger than Thursday's 6.4010.

In the OTC market, which permits trading 2% above or below the official fix, the RMB ended the week at 6.391. The disconnect between the official fix and OTC trading, which had seen the RMB trading 1.5% cheaper in the OTC market in recent months, closed.

Exhibit 1 RMB Had Been Trading at a Discount in the OTC Market Since December 2014
RMB per USD: PBoC Fix and OTC



Source: China Foreign Exchange Trading Center, CEIC, Morningstar

Despite the PBoC's assurances that it would "keep the exchange rate basically stable" and the still modest size of the RMB's depreciation thus far, the market response has been strongly negative. Investors fret that the move signals China's economy could be even weaker be than the official data suggests.

Speculation abounds regarding possible knock-on effects of the RMB's surprise unmooring from the dollar. If the PBoC were to permit, or even encourage, rapid depreciation of the RMB, the risks of igniting competitive devaluation and capital outflows from China and other emerging markets would be significant.

Given the role devaluations have played in triggering past global crises (the Tequila crisis of December 1994, the Asian financial crisis of summer 1997), these are valid concerns.

Beijing's Motives Offer Clues of What Comes Next

We can better gauge the prospects of a large and destabilizing devaluation by understanding the motives behind Beijing August 11 decision to abandon the RMB's de facto peg against the dollar. Three main explanations have been offered:

1) The PBoC aims to bolster China's export competitiveness, lifting flagging GDP and improving employment.
2) The PBoC seeks to improve the prospects of RMB internationalization.
3) The PBoC wants to stem capital outflows that have been undermining efforts to stimulate the domestic economy.

As explained below, we believe Beijing's principal motives were to put the RMB on a path to internationalization and to halt recent capital outflows. Export competitiveness was likely a secondary consideration.

With this in mind, we think any future devaluation of the RMB is likely to be slow and steady. Although a large and sudden devaluation of the RMB would greatly improve China's export competitiveness, it would undermine the government's long-term objective of internationalizing the RMB and short-term aim of halting capital outflows.

The PBoC Did Not Devalue to Stimulate Exports

Many speculate that the PBoC devalued the RMB to bolster the competitiveness of China's large export sector. The release of weak July export figures on Aug. 7 and poor industrial production data on August 12 appeared to lend credence to this explanation.

Without question, the RMB's strength has been a significant headwind for Chinese exporters. Since 2010, the RMB has been the strongest performing major currency according to the Bank for International Settlements' measure of real effective exchange rate or REER, which incorporates nominal exchange rates as well as inflation differentials versus trading partners.[1]

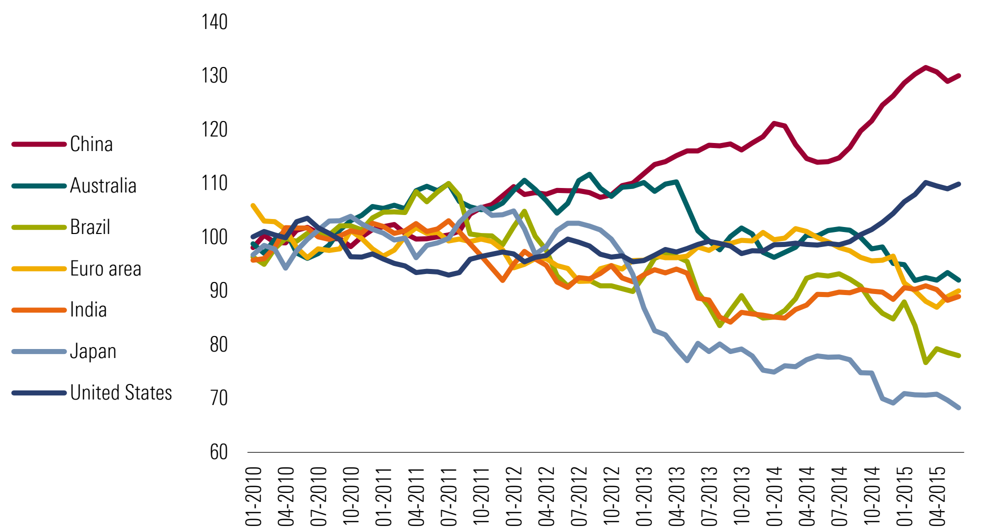
In REER terms, the RMB is now 30% more expensive than it was in 2010. Most emerging market currencies have weakened over the same interval. The Brazilian real and Indian rupee are 22% and 11%

[1] A quick primer on REER for readers who may be unfamiliar with it. Suppose Country X fixes the value of its currency at a ratio of 1/1 with that of Country Y. Over the course of the year, inflation in Country X is 10% and inflation in Country Y is 0%. By year-end, the nominal exchange rate is still 1/1 due to Country X's peg. But the real effective exchange rate of Country X has increased by 10% because citizens of Country Y can now buy 10% fewer goods from Country X for a given amount of their own currency. China's REER rises not only when its trading partners devalue, but also when domestic Chinese inflation exceeds foreign inflation.

cheaper than they had been in 2010. Among major developed market currencies, the euro and yen have fallen 10% and 32% in REER terms. The U.S. dollar has strengthened in real terms versus its trading partners, but only by 10%.

The RMB's strength has been especially apparent since summer 2014, when other major currencies began their descent versus the dollar. From June 2014 to June 2015, the RMB strengthened 14% in real effective terms versus China's trading partners.

Exhibit 2 RMB has strengthened dramatically in real effective terms
Real effective exchange rate, 2010=100



Source: Bank for International Settlements, Morningstar

At first glance, the July export data seem suggest an export sector struggling under the weight of a stronger RMB. Exports fell 8.3% in July versus the prior-year period. Year to date, Chinese exports are down 0.8%.

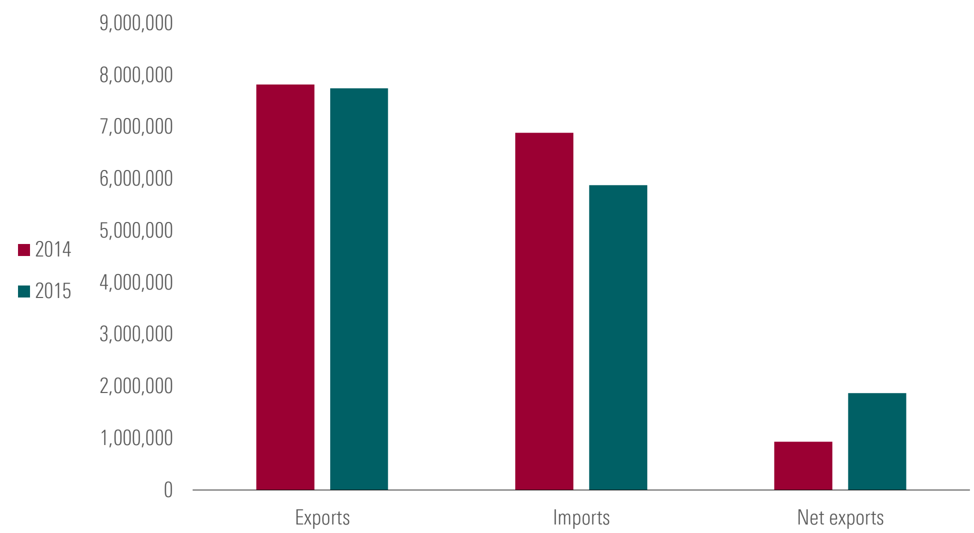
However, the apparent weakness in Chinese exports is largely a consequence of falling commodity prices, which have pushed the value of Chinese imports down 14.6% year to date. To a great extent, weak export figures reflect the phenomenon of China's exporters passing on lower input costs to their customers. For example, when iron ore import prices are cheaper, it's natural for steel export prices to fall, too.

The unusually weak figures for the month of July are probably a function of a difficult comparison more than anything else. July 2014 was an unusually strong month for exports, which rose 14.5% from July 2013.

Net exports, which capture the value-added by Chinese producers, are less influenced by fluctuating commodity prices and therefore more accurately reflect the overhaul health of the export sector.

Through July, China's net exports have doubled. From this vantage point, there does not appear to be a pressing need for dramatic cuts to the RMB.

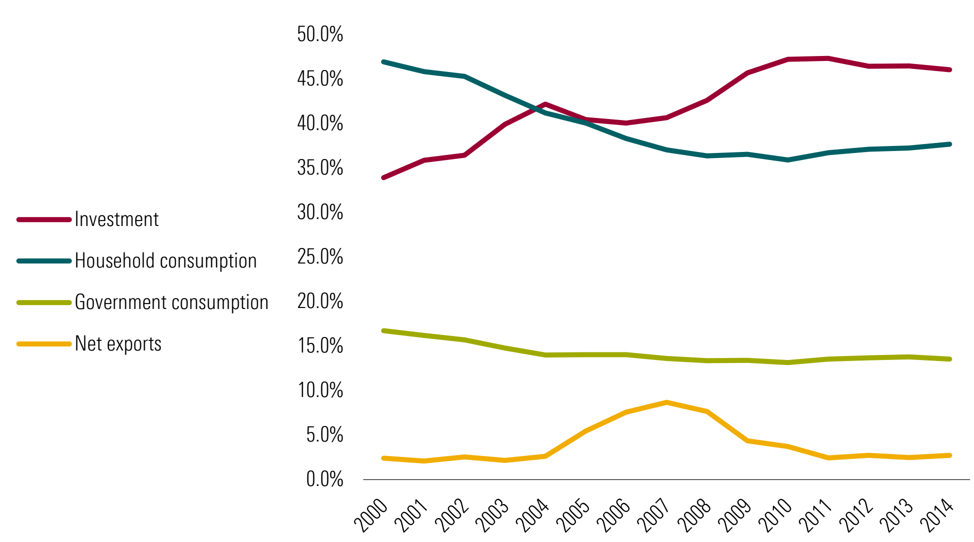
Exhibit 3 Falling Commodity Prices Explain Much of China's Export Weakness
Exports, Imports, and Net Exports through July: 2014 versus 2015 (RMB millions)



Source: General Administration of Customs, CEIC, Morningstar

Even if Beijing sharply devalued the RMB, doing so would unlikely generate a meaningful lift to the economy as a whole. That's because the export sector has diminished in relative importance over the past several years. At present, net exports account for less than 3% of GDP, down from nearly 9% in 2007.

Exhibit 4 Net Exports Now Account for Less than 3% of Chinese GDP
Chinese GDP by Expenditure



Source: National Bureau of Statistics, CEIC, Morningstar

As a consequence, it'd be far easier for Beijing to drive economic growth and maintain employment by stimulating domestic demand (consumption or investment). Generating a 1-percentage-point increase in GDP would require a 1.03% increase in domestic demand, but a 36.7% increase in foreign demand for Chinese goods.

Even for China's more export-oriented industrial sector, domestic demand seems a surer route to growth. Supposing Beijing wanted to prop-up flagging industrial production growth, which dipped to 6.0% in July from 6.8% in June, it would take a 3.1% increase in domestic demand for industrial goods to push growth back to the 2014 pace of 8.3%. Net exports would need to increase by at least 17.4% to achieve the same outcome.[2]

Tellingly, Beijing did not resort to a major devaluation of the RMB during the global financial crisis, despite the fact that net exports were 3 times more important to the Chinese economy at the time. Instead, the PBoC maintained its fix at roughly 6.84 to the dollar. Meanwhile, because China's major trading partners saw their currencies fall versus the dollar and because Chinese inflation was higher than that of its trading partners, the RMB strengthened significantly in REER terms throughout the crisis.

Finally, a sharp devaluation of the RMB aimed at bolstering the export sector would come with a significant cost as well. While exporters might benefit from a weaker RMB, the many Chinese corporates that took advantage of comparatively low U.S. dollar borrowing rates in the past several years would suffer as those liabilities swelled in RMB terms.

Given this situation, we think it's far more likely that China continues to introduce targeted policies to boost domestic demand in a bid to address manufacturing weakness, rather than resort to significant devaluation. We have already seen a rise in committed infrastructure spending by the government and anticipate additional monetary easing by the PBoC in banks’ reserve requirement ratios.

PBoC Depegged in Pursuit of RMB Internationalization

We're more inclined to favor the PBoC's explanation that its primary motive behind the devaluation was to "enhance the market-orientation" of the official fix. As noted above, the RMB had been trading more cheaply in the OTC market since December 2014. Aligning the fix with OTC levels required a material cut to the RMB's value, but is an important step towards a freely floating currency.

This is not to say Beijing views a more market-based exchange rate as an objective in and of itself. Rather, an increasingly free-floating RMB is a means to an end. Specifically, the government desires a more "internationalized" RMB, with a larger share of global trade settled in RMB and RMB assets occupying a more important role in global portfolios.

[2] For simplicity's sake, this assumes 100% of China's exports are goods rather than services. To the extent services account for a portion of Chinese exports, it would take an even larger increase in exports to drive an increase in overall industrial production.

Inclusion in the IMF's Special Drawing Rights, or SDR, basket would be a major milestone in RMB internationalization. The basket's current constituents are the U.S. dollar, Japanese yen, British pound, and euro. The IMF reviews the SDR basket once every five years and a review is upcoming.

The IMF described the PBoC's move as a "welcome step," while cautiously noting that the "exact impact will depend on how the new mechanism is implemented in practice." And although the IMF emphasized that "the announced change has no direct implications for the criteria used in determining the composition of the basket," it hinted that "a more market-determined exchange rate would facilitate SDR operations in case the Renminbi were included in the currency basket going forward."

Managed Float Suggests Beijing's Commitment to Reform and Is Good News For China's Long-term Growth

Notwithstanding the near-term risks of competitive devaluation and capital flight, we view the PBoC's devaluation as a positive step to the extent it evidences Beijing's commitment to market reform. As we've written previously, giving a freer hand to market forces will be absolutely critical if China is to successfully transition to a consumer-led growth model.[3]

But the true test of Beijing's commitment to reform would come when markets signal to the PBoC that the RMB should move in an unwanted direction. As we saw with Chinese equities, Beijing was happy to countenance an unfettered market when prices were rising, but unwilling to relinquish control when the market rendered a judgment counter to the party's wishes. One way liberalization is not liberalization at all.

With an eye toward a successful economic rebalancing, we'd like to see signs that Beijing is willing to endure the pain of liberalization, as the necessary reforms will be very painful. Allocating credit according to market principles would eliminate the wealth transfer that hinders household consumption and starves private enterprise of capital. But it would also lead to widespread defaults (or bailouts) of technically insolvent state-owned enterprises, or SOEs, and local governments. Breaking the SOE stranglehold on key sectors of the economy would allow more nimble and efficient private firms to drive economic growth forward. But doing so would lead to significant job losses at SOEs.

Unless Beijing is willing to endure the pain of liberalization, China risks a Japan-like scenario, where persistent misallocation of capital and labor hamstring economic growth.

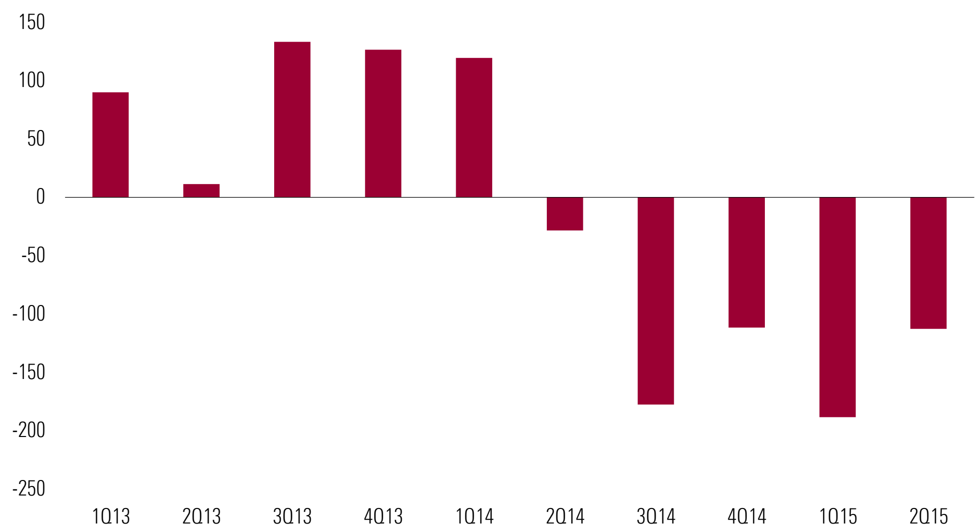
De-Pegging the RMB Should Improve the Efficacy of Domestic Stimulus

[3] See, for example, China's Rebalancing Act from July 2013, China's Rate Cut Is a Shot of Whiskey to Cure a Hangover from November 2014, and The Cure Is Worse Than the Cold from July.

By allowing market forces to exert more influence on the official fix, the PBoC aims to curtail the capital outflows that had been undercutting Beijing's stimulus efforts.

Capital has been flowing out of China since summer 2014, as many of the conditions that had drawn capital into the country over the past several years began to move in the opposite direction. Deteriorating economic conditions in China increased the probability of further PBoC rate cuts. Meanwhile, an improving U.S. economy made a Federal Reserve rate hike more likely.

Exhibit 5 Capital Has Been Leaving China Since Summer 2014 at a Rapid Pace
Estimated Net Capital Flows by Quarter (USD billions)

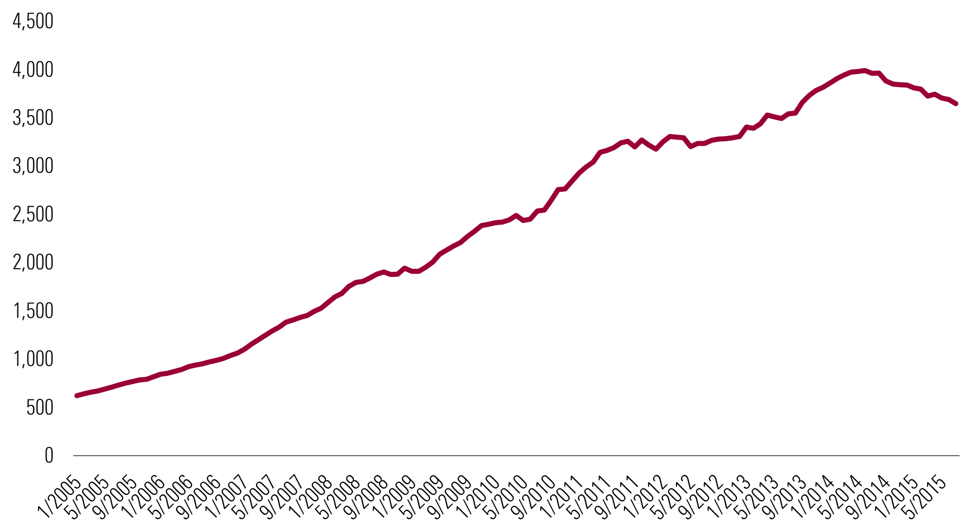


Source: People's Bank of China, State Administration of Foreign Exchange, CEIC, Morningstar
Note: Capital flows estimated by subtracting current account balance from change in foreign reserves.

Just as capital inflows injected a significant amount of RMB to the system as the PBoC provided investors and companies RMB in exchange for their dollars (expanding China's foreign reserves in the process), capital outflows suck RMB out of the economy. As a result, China's foreign reserves fell to \$3.65 trillion in July, down from a peak of \$4.0 trillion in June 2014.

Exhibit 6 Capital Outflows Have Reversed China's Foreign Reserve Accumulation

Foreign reserves (USD billions)



Source: People's Bank of China, CEIC, Morningstar

This has undermined the PBoC's efforts to pump money into the system, which it has done by cutting the reserve requirement ratio, or RRR. When the PBoC cuts the RRR, it reduces the amount banks are required to hold at the PBoC, freeing up RMB for lending.

China's de facto dollar peg exacerbates the problem of capital outflows. Under a fully floating currency system, falling demand for RMB assets and rising demand for USD assets would have caused the RMB to depreciate against the dollar. That process would continue until a new equilibrium exchange rate is reached that fully reflects the future return expectations on USD-denominated and RMB-denominated assets.

A fixed exchange rate short-circuits this repricing mechanism. As a result, large capital outflows persist, draining foreign reserves from the PBoC's coffers, and putting further pressure on the PBoC to devalue. This is essentially what happened in the Tequila crisis of 1994 and Asian financial crisis of 1997.

Critically, however, China has accumulated far greater foreign reserves than its ill-fated predecessors. This affords the PBoC the breathing room to maintain a "managed float" for a significant period of time, thereby engineering a slow and steady RMB devaluation rather than a rapid and potentially destabilizing crash.

De-Pegging Could Exacerbate Capital Outflows in the Short Term

By devaluing the RMB, the PBoC risks exacerbating near-term capital flight before market equilibrium with the dollar can be achieved. That's because the PBoC's move is likely to shift expectations about the RMB's future value. If the market expects the RMB to weaken significantly in the months to come, there could be considerable capital flows out of China as investors look to get ahead of the move.

Much will depend on market expectations regarding the pace and magnitude of future devaluation. This is the motivation behind the PBoC's assertion that "there is no basis for persistent depreciation of RMB" and assurance that it will "keep the exchange rate basically stable."

The PBoC's concern that devaluing the RMB move might trigger an increase in capital outflows is also evident in its more aggressive regulatory posture for dealing with so-called "hot money" outflows from what remains, nominally at least, a closed capital account. The PBoC says it will "strengthen the examination of banks' foreign exchange transactions according to relevant laws and regulations, adopt effective measures to fight money laundering, terrorist financing and tax evasion activities, and improve the monitoring of suspicious cross-border capital flows." And it promises to "severely punish illegal foreign exchange transactions, including underground banks, and maintain a compliant and orderly capital flow."

Sector and Company Analysis—China

Marginally Positive for China-Based Exporters and Energy Firms

A weaker RMB is positive for China-based companies that export or sell goods denominated in foreign currencies and whose costs are largely RMB-based. This slight devaluation provides some breathing space on margins and cash flows. These include the following sectors and industries:

Energy: China oil and gas and coal companies have RMB labor costs and RMB debt servicing with selling prices linked to USD-based commodity prices so a slight benefit is anticipated albeit muted by weak energy prices. CNOOC and Yanzhou Coal also have significant offshore assets in Canada and Australia, respectively, so there may be a slight positive translation impact to profit. — *Jennifer Song*

Port Operators: Domestic port operators, particularly container terminals such as China Merchants Holdings, Cosco Pacific, and Shanghai International Port Group, may benefit if the move serves to boost trading activity from China. As China Merchants Holdings has the highest proportionate activity in the Pearl River Delta, which is more export-driven, it should benefit the most. — *Jennifer Song*

Technology: Theoretically, a weaker RMB is positive for Lenovo as an exporter and the stock responded favorably to the PBoC's move. However, Lenovo also has factories outside of China and it actually generates 50% of its earnings from selling in China. So on the whole, benefits are likely to be slight if any. — *Dan Baker*

Retail (Apparel Manufacturers): Japan’s fast retailing is guiding for limited impact from the RMB devaluation. It indicates that 70% of its production is manufactured in mainland China, and contracted in the USD. The company has a forward foreign exchange contract covering imports from China over the next three years so procurement costs should be stable. Li & Fung, on the other hand, could receive some marginal benefit with lower costs for its OEM activities, but its main sourcing operations are commission-based and should match the decline in the RMB. — *Chelsey Tam*

Negative on China Companies With USD Debt

Those China companies that may see some negative impact would be those with substantial foreign currency-denominated debt while capital expenditure costs may rise slightly given USD-based commodity prices and reliance on capital equipment imports, although some sharing of pain is possible. We’ve already seen commodity prices drop on the news. Notably, these include the following:

China airlines: Using Air China as an example, international travel accounts for roughly one third of total revenue so some erosion in outbound travel may occur, but we don’t expect this to be substantial to warrant a change in our revenue growth assumption. USD-denominated debt accounts for 72% of total interest bearing debt for Air China so the RMB devaluation will lead to higher interest payments, but this negative impact, as well as that of higher translated jet fuel costs, should be buffered by the recent decline in overall fuel costs. — *John Hu*

China real estate: China Overseas Land & Investment ("COLI") and China Resources Land derive ~100% of earnings from China but offshore debt-denominated in HKD and USD account for 80%, and 50%, respectively, of the total debt outstanding with no currency hedging in place. COLI recently placed some Euro bonds to diversify its currency risk to HKD/USD, and should continue to do so going forward. — *Phillip Zhong*

The move may be negative on select Asian hospitality companies.

Retail and Hospitality Real Estate Developers and Operators: Kerry and Wharf have significant exposure in China, with ~50% earnings coming from China residential trading and investment properties. In addition, Wharf's Hong Kong assets are negatively affected by a weaker RMB due to lower tourist arrival and spending from mainland. Link REIT and Swire Properties should be least affected by the RMB depreciation. Singapore hospitality REIT, CDL Hospitality, may also be negatively impacted if there's a prolonged drop in the RMB that further dampens Mainland tourist arrivals into Singapore. To a lesser extent, retail REIT CapitaMall Trust may also see its share price languish on the extended retail segment headwinds. — *Michael Wu*

Sector and Company Analysis—Global

Mined commodities: A significant depreciation of the RMB would have materially negative consequences for commodity prices. Not only would a weaker RMB reduce purchasing power of Chinese buyers, but also it would improve the cost position of Chinese producers. Falling costs for Chinese miners would be a major price headwind for commodities like iron ore, where China is the marginal producer.

To the extent a weaker RMB triggers depreciation of other key commodity currencies like the Indonesian rupiah or Aussie dollar, the downward pressure on commodity prices is exacerbated. The whole cost curve shifts downwards.

Finally, RMB devaluation could trigger near term price pressure for commodities used as collateral by mainland borrowers to obtain USD-denominated loans. This had been a popular means of obtaining cheap financing as long as USD rates were low and the RMB expected to remain strong. But with the Fed likely to raise rates in the coming months and the potential for significant RMB depreciation, the attractiveness is severely diminished. Prices for "financialized" commodities like copper would fall as those loans unwind. — *Daniel Rohr*

Steel: The devaluation of the Chinese yuan makes Chinese steel exports more attractive on a relative cost basis, raising the specter that Chinese steel exports will continue to increase. Although a devaluation of the magnitude we've witnessed might have only a modest impact on Chinese steel export volumes, additional cuts would surely have a meaningful impact on global commodity trade flows. Currently, we estimate that China has more than 300 million metric tons of excess steelmaking capacity, roughly 4 times the amount of steel produced in the U.S. in 2014. Since becoming a net exporter of steel in 2005, China's increasing net export position is undoubtedly the most influential headwind facing the global steelmaking industry. Although the devaluation of the yuan has stoked these fears, we reiterate our assertion that steelmakers on the low end of the cost curve will emerge healthy and, therefore, represent attractive value for investors with a longer time horizon. — *Andrew Lane*

European automakers: European luxury car makers will see weaker translated profits. A weaker RMB means the absolute amount of joint venture equity income will be lower. If the RMB were to hold at 6.40 to the dollar for the duration of the year, the negative impact would be roughly 4% excluding any cost-cutting actions by each of the automakers. The currency issue exacerbates an already unfavorable pricing environment, especially for luxury vehicles. This has a greater impact on Audi, BMW, and Mercedes, but also on DS for Peugeot and JLR for Tata. Mercedes has the benefit of adding more dealerships to catch up with competitors and their sales volume has been up 39% through June, dramatically better than other luxury vehicle companies. The China businesses are not consolidated, so there will be no impact on revenue. — *Richard Hilgert*

U.S. automakers: For U.S. automakers, other than Lincoln and the Explorer, almost all production is local so that eases the pain to a degree (though not on translation). Pricing for a consumer may be hurt on a weaker yuan but Western brands are so much higher quality and in demand there that people will still want those models, in my opinion. Automaker GM has large exposure with over $2 billion of equity income and over a third of its global unit volume in China. Equity income is roughly 16% of the valuation and nearly all of equity income is from China. That said, translation of income onto dollars suffers but pricing may not be that bad as a lot of production is local. Remember, too, that the long-term path for Chinese vehicle penetration is upward.—*David Whiston*

Luxury goods: For luxury goods names, underlying demand is the key. For most luxury goods companies on a pure math standpoint, the impact of the devaluation is very small. On a 2% devaluation the change in revenue is less than 0.5%. Add to that the fact that most disclosures don't include the breakout of non-CNY revenue in the region and it is even smaller.

Given that most companies have seen some improvement in sales in China in 2015, (but not in Hong Kong or Macau—which are USD related), the sentiment of consumers is more important to revenue. Yes, China is generally more profitable for gross margins, but again, we believe the revenue volatility (or improvement) will wash out the less than 2% move in currency for the region.

So, at the end of the day, a small change in demand or sentiment by dealers and consumers is much more important than the devaluation. The biggest risk, in our view, would be for U.S.-based companies tourist businesses, such as Tiffany, which are already losing sales to Europe (and maybe Japan) as the euro/dollar has moved so much that prices are significantly cheaper in Europe. Tiffany has 10% of sales just in New York and that is 50% tourists (we estimate). —*Paul Swinand*

Yum Brands: We believe last week's devaluation of the Chinese yuan has opened up a buying opportunity for Yum Brands. Shares traded briefly below $80 on Aug. 12, but have since recovered to $84. This still represents a 16% discount to our $100 fair value estimate, which remains unchanged given that the 2%–3% yuan devaluation against the U.S. dollar will have limited currency translation consequences and our belief that, barring a complete economic collapse, consumer spending in China will continue at a relatively healthy clip. Our long-term assumptions—including 7% average annual top-line growth and operating margins rising from the midteens to the low 20s over the next decade—remain in place, with several near-term positive catalysts (same-store sales recovery in China, improving fundamentals among Yum concepts outside of China, and a potential spin-off of Yum China) all still in play.

The greatest risk to our investment thesis coming out of the yuan devaluation would be a material slowdown in consumer spending. We concede that management's full-year comp guidance calling for low-single-digit growth—our model currently calls for 1.7% growth—could be at risk if consumer sentiment is pressured by recent macro concerns, but we haven't seen evidence to make that assumption at this point. We still take an optimistic view of Yum's longer-term opportunities in China given its highly fragmented restaurant industry, a growing China middle class, ongoing urbanization trends, and the market becoming increasing conducive to franchising.

We also believe China concerns may lead to greater investor calls to spin off all or part of Yum's China division, which would allow investors to tailor their level of exposure to China and other markets. As we've stated in the past, a spin-off would not affect our wide moat rating, as Yum China—which we assign a pre-spin stand-alone value of $48 per share—is a mostly self-contained supply chain, distribution, site selection, and advertising ecosystem. — *RJ Hottovy*

Casinos: The RMB devaluation has pressured Wynn, Las Vegas Sands, and MGM shares because of their exposure to the Chinese consumer (two thirds of total visits to Macau come from mainland China). Wynn, Las Vegas Sands, and MGM are forecast to receive 62%, 55%, and 27% of 2015 EBITDA from Macau, respectively. Although currency may present a near-term sentiment overhang on shares, barring an economic collapse, we see the RMB devaluation as manageable for Macau operators.

The Macau operators do not have translational risk from RMB depreciation. Sales and expenses derived in Macau are denominated in the Macau pataca, or MOP, the region's legal currency. The MOP is pegged to the Hong Kong dollar, or HKD, which is in turn pegged to the USD. If the RMB continues depreciating, it will face decreased purchasing power relative to the HKD; this could have a negative transactional impact on those operating in Macau. That said, further RMB depreciation could result in Hong Kong devaluing the HKD to stay competitive against other countries. This would neutralize the purchasing power headwind, but would create a manageable translation headwind. For instance, a 1% change in the USD/MOP exchange rate equals a gain/loss of $13.7 million for Las Vegas Sands, which is manageable based on our 2016 net income estimate of $2.3 billion for the firm.

Over the past one- and three-year periods, the RMB has seen midteens and high-30% appreciation, respectively, versus the Japanese yen, or JPY. This could be why China has now decided to devalue. Regardless of the reason, we maintain our narrow-moat and stable-moat-trend ratings on Wynn and Sands, along with our no-moat-stable trend on MGM. We also maintain our fair value estimates ($152 Wynn, $62 Sands, $25 MGM). We believe the mid-$90s Wynn shares are pricing in flat Macau sales and margins over the medium and long term, which we view as unlikely given the long-term Macau growth we see. — *Dan Wasiolek*

About Morningstar® Institutional Equity Research™

Morningstar Institutional Equity Research provides independent, fundamental equity research differentiated by a consistent focus on sustainable competitive advantages, or Economic Moats.

For More Information

+1 312 696-6869
equitysupport@morningstar.com

MORNINGSTAR®

22 West Washington Street
Chicago, IL 60602 USA