SECTOR IN-DEPTH
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US Gaming

The Walls are Closing in on Regional Casinos

» **No growth catalyst in sight.** The regional gaming industry has been struggling for some time to increase revenues as consumers continue to count their discretionary dollars. At this point, there is little to suggest this dynamic will change any time soon.

» **Longer-term fundamentals look similarly bleak**. The gaming industry is facing a longer-term trend that could prove worrisome for any real revenue revival: the number of older people in the US is outpacing that of younger generations. An aging population implies both lower labor force participation and savings rates, and raises the concern of slowing economic growth.

» **Younger generations are less enthused about gambling**. Younger generations are growing up with more extensive entertainment choices, including broad advances in technology. Many of these choices – whether it is using electronic games or watching online entertainment – do not include visiting brick-and-mortar casinos. This tech savvy generation will continue to have new and more sophisticated recreation-type products that will compete for their interest, time and discretionary dollars.

» **Debt maturities are looming.** Over the past several years, many highly-leveraged regional gaming companies have managed to refinance large amounts of maturing debt at relatively low interest rates and have negotiated "covenant-lite" debt agreements. Even so, debt maturities are starting to emerge – a particular concern for regional gaming companies that have a B3 Corporate Family Rating and 50% or more of outstanding debt maturing within the next three years: Mohegan Tribal Gaming Authority (B3 negative), Jacobs Entertainment, Inc. (B3 negative), Rivers Pittsburgh Borrower, L.P . (B3 stable), and Cannery Casino Resorts, LLC (B3 stable).

No growth catalyst in sight

It's no secret that US regional gaming revenue has not kept pace with improvements in the overall economy, and that the primary cause for this trend is that gaming consumers have had to limit their spending to items more essential than gaming. Unfortunately for this highly speculative-grade sector – more than 75% of rated US casino gaming issuers have a B2 or lower Corporate Family Rating – it doesn't appear that there is a meaningful catalyst on the horizon that will permanently reverse this situation anytime soon.

Longer-term fundamentals are not looking particularly good, either. In addition to casino oversupply conditions and the resulting cannibalization of customer dollars that is occurring throughout many US gaming markets, US population demographics continue to move in a direction that doesn't favor casino gaming. Projected population demographics point to a more significant shift in age distribution of the US population to people aged 65 years and older (Exhibit 1, page 3). An aging population implies both lower labor force participation and savings rates, and raises the concern of slowing economic growth. This in turn raises concerns about the amount of discretionary income that will be available in the future to spend on highly discretionary leisure activities like casino gaming.

At the same time, the younger generation may not be spending as much time playing casino-style games at regional casinos as previous generations did. This younger demographic has a much larger, more diverse, more sophisticated and more mobile type of entertainment options to spend their discretionary income on, compared to previous generations. And this tech-savvy generation of new consumers will continue to be bombarded with new and more sophisticated recreation-type products that have nothing to do with gaming, and will compete for their interest, time and discretionary dollar.

While the impact of shifting population and consumer preference trends may be gradual, a number of highly leveraged gaming companies will soon have to ask the capital markets to bet on the long-term prospects of the regional gaming sector just when the odds are increasingly going against the industry. Large debt maturities are starting to appear on the horizon. About $13.3 billion (27%) of the $49.5 billion of high-yield gaming debt currently outstanding will mature between now and 2018; $18.2 billion (37%) by 2019. Although several years away, these debt maturities will need to be addressed well before they mature. In some cases, companies may need a deleveraging event, such as an injection of equity capital, or another solution to facilitate a refinancing that does not involve any impairment to creditors (see Sale-Leasebacks May Not Be the Solution for the Highly Leveraged Gaming Sector).

Regional gaming issuers with a B3 Corporate Family Rating and 50% or more of outstanding debt maturing in the next three years are the most exposed to refinancing risk. These include Mohegan Tribal Gaming Authority (B3 negative), Jacobs Entertainment, Inc . (B3 negative), Rivers Pittsburgh Borrower, L.P. (B3 stable), and Cannery Casino Resorts, LLC (B3 stable).

The big chill

While December and January year-over-year comparable monthly gaming revenue trends were encouraging – December was up +6.7% and January was up +9.9% – February monthly gaming results (excluding Nevada) were up only 0.7%, according to data released by 17 states we track on a regular basis. This suggests that milder winter weather, not improving fundamentals, was responsible for the positive comps that occurred in December and January (see The Weather May be Getting Warmer, But Gaming Revenues Remain Out in the Cold). December 2013 and January 2014 experienced particularly harsh winter weather relative to December 2014 and January 2015. In theory, this February's improvement should have been better than last year given that weather conditions were milder and there was a neutral calendar.

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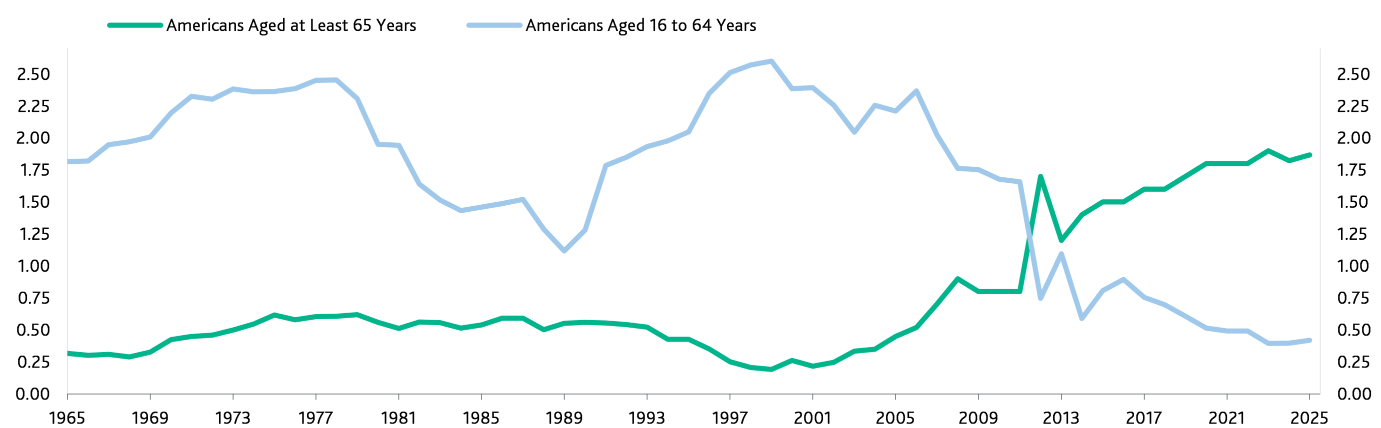
Feeling the effects of aging

A generational shift is occurring as the baby boomers and mature generations retire and the millennial generation takes their place. These generations have historically been the bread and butter of regional casinos due to their availability of discretionary time and money. This is not good news for regional casinos as this has negative implications for consumer discretionary spending, for which casino gaming competes with many other forms of entertainment.

Exhibit 1 highlights the gradual shift in population age demographics that began about 15 years ago, and projected population age demographics over the next 10 years. This shift is expected to have a significant influence on future economic growth (see Population Aging Will Dampen Economic Growth over the Next Two Decades).

Exhibit 1
Profound Shift in Age Distribution of US Population May Influence Financial Markets for Years to Come
Actual and predicted annual change in millions of people



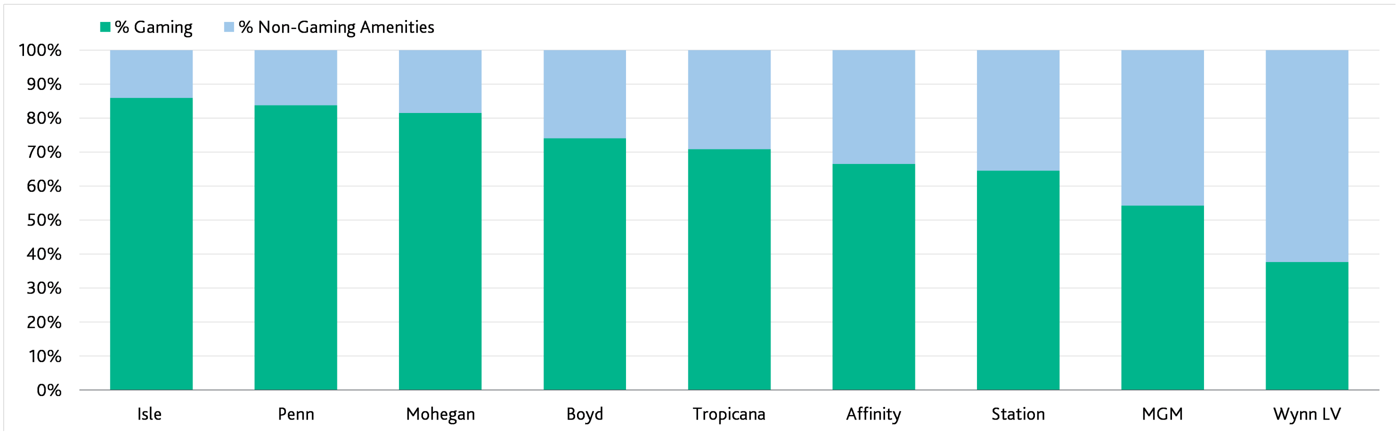
Source: US Bureau of the Census, Centers for Medicare & Medicaid Services, Moody's Analytics

An aging population is often tied to lower productivity of the labor force, a downward trend in overall consumer spending, a reduction in the household savings rate that negatively affects investment, and slower economic growth. The smaller working age population also needs to support the growing older dependents (social security, entitlement programs). This could also mean increased financial pressure on the younger generation, which has limited discretionary income and doesn't appear to have as high a level of interest in the traditional casino games that older generations did.

Same as it ever was

Regional casino companies still get between 65% and 85% of their revenues and earnings from slot machines and table games (Exhibit 2, page 4). Despite their best efforts to do so, even the largest and most geographically diverse regional casinos like Penn National Gaming, Inc. (Ba2 stable), Pinnacle Entertainment, Inc. (B1 stable), and Boyd Gaming Corp . (B2 stable) have not come close to duplicating the revenue mix characteristics of the Las Vegas Strip destination-type casinos. Wynn Las Vegas, LLC, a wholly-owned subsidiary of Wynn Resorts Limited (Ba2 stable), gets over 60% of its gross revenue from non-gaming amenities (retail, restaurants, entertainment, nightclubs), while MGM Resorts International (B2 stable) gets slightly over 50%. This was the model that many regional operators felt would be key to maintaining and growing their customer base over the long-term – a unique destination-type entertainment location with an attractive and diverse offering of non-gaming amenities that people would be willing to travel longer distances to get to.

Exhibit 2
Breakdown of Gross Gaming Revenue: Gaming vs. Non-Gaming



Source: Company filings

Meet the new boss

The continued heavy reliance on slots and table games puts "bricks and mortar" regional casinos at risk. The traditional casino customer that grew up with slot machines is being supplanted by a generation shaped by technology that can get its entertainment satisfaction in ways that older generations couldn't, and that may not involve spending time at slot machines or table games. If this newer generation is less enthused about casino games and chooses to spend its time and money on recreational activities that are not offered by regional casinos and completely unrelated to the industry, then casinos have a major fundamental problem unless they can quickly introduce a significant amount of new gaming and non-gaming products that appeal to a younger population and are, at the same time, unique to casinos.

The Las Vegas Strip gaming market – one we consider more of a destination market than a regional market – is less affected by slot and table concentration than the regional markets. Compared to the US regional and local gaming markets, the Las Vegas Strip casinos owned by Wynn Resorts Limited and owned by Las Vegas Sands Corp . (B2 stable), have a much broader, deeper and diversified pool of visitors to draw from than the regional markets as it attracts people on a nationwide and global basis, along with a very large revenue and earnings component related to the mid-week convention business and greater revenue from non-gaming sources such as rooms, entertainment and retail.

Jumping through hoops

Regional gaming companies continue to promote their non-gambling amenities (retail, restaurants, entertainment, nightclubs) in an effort to bring the newer generation inside the casino and also turn them into casino gaming participants. New Jersey recently took their efforts a step further, giving Borgata, Atlantic City's largest casino, permission to allow a basketball free throw contest. For a $20 buy-in fee, people competed against each other in a bracket-style basketball free throw competition (see Necessity is Spurring Invention in Atlantic City Gaming Market). Borgata is owned and operated by Marina District Finance Company, Inc. (B2 negative).

The idea of allowing real-money skill-based gaming to take place inside a casino has significant potential. It opens the door to other gaming products that are unique to a casino and appeal to a younger population demographic, a consumer group that is showing less interest in games of pure chance like slot machines than the previous generation. We do believe New Jersey's actions will prompt casino operators and regulators in other states to work together to find ways to create new products that appeal to a new generation of consumers. However, the legislative and regulatory hurdles that casinos have to go through to make these potentially game-changing products will not disappear anytime soon. For that reason, a high level of cooperation between casino operators and state regulators will be needed to get things done. Otherwise, casino product development will slow back down to a dribble.

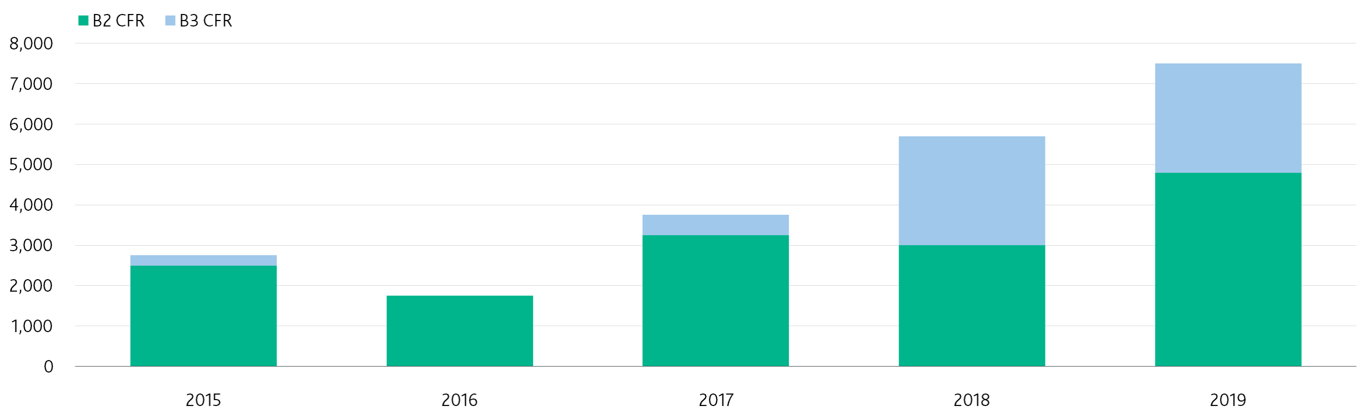
(Still) kicking the can down the road

A very difficult period during and following the recession has made it equally difficult for regional gaming companies to reduce their leverage during the past seven years. While this didn't prevent some of these same companies from refinancing large amounts of maturing debt at relatively low interest rates and negotiating "covenant-lite" debt agreements, debt maturities are starting to creep up over the horizon (Exhibit 3).

This is of particular concern for regional gaming companies that have a B3 Corporate Family Rating and 50% or more of outstanding debt maturing within the next three years: Mohegan Tribal Gaming Authority, Jacobs Entertainment, Rivers Pittsburgh Borrower, and Cannery Casino Resorts.

Exhibit 3

B2 and B3 Debt Maturity Profile for US Gaming Companies (in $ millions)



Source: Company filings

Given the increased fundamental challenge faced by regional casinos throughout the US, we have heightened concern regarding whether or not these and other regional gaming companies can once again refinance maturing debt at a rate and with terms that provide the long-term financial flexibility needed to compete on a broader level.

Historically, regional gaming companies have benefitted significantly from low-interest rates, partly because of an overall low-interest rate environment, but also because of the once favorable fundamental characteristics that made this industry so attractive to the debt capital markets – high barriers to entry, very low threat of product substitution, a favorable demand/supply imbalance, significant growth potential, and perceived immunity to economic downturns. Unfortunately, other than the low-interest environment that exists today, these characteristics no longer exist to the degree they did in the past.

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